Final Course

(Revised Scheme of Education and Training)

Study Material

Elective Paper 6C

International Taxation

(Relevant for May, 2020 and November, 2020 examinations)

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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BEFORE WE BEGIN …

Revised Scheme of Education and Training: Bridging the competence gap

The role of a chartered accountant is evolving continually to assume newer responsibilities in a dynamic environment. There has been a notable shift towards strategic decision making and entrepreneurial roles that add value beyond traditional accounting and auditing. The causative factors for the change include globalisation leading to increase in cross border transactions and consequent business complexities, significant developments in information and technology and financial scams underlining the need for a stringent regulatory set up. These factors necessitate an increase in the competence level of chartered accountants to bridge the gap between competence acquired and competence expected from stakeholders. Towards this end, the scheme of education and training is being continuously reviewed so that it is in sync with the requisites of the dynamic global business environment; the competence requirements are being stepped up to enable aspiring chartered accountants to acquire the requisite professional competence to take on new roles.

In the Revised Scheme of Education and Training, the concept of electives has been introduced at the Final level in line with the school of thought that specialisation is the key to developing professionally competent chartered accountants. As per this school of thought, an emerging chartered accountant has to be geared up to assume new roles as consultants and advisors, necessitated on account of growing business complexities, dynamic changes in legislations and regulatory requirements and client expectations.

Elective Paper on International Taxation: Paving way for specialization in this key concern area of businesses engaged in cross border transactions and tax administrations

Consequent to borderless economies, it has become imperative that subjects which transcend borders be added in the curriculum, for instance, Global Financial Reporting Standards and International Taxation. In fact, globalisation, capital mobility and increased trade and services have resulted in the whole world virtually becoming one market and consequently, international taxation has become a key concern area both for business enterprises engaged in cross border transactions as well as for tax administrations of the concerned States. In a highly advanced IT enabled business scenario where an entity operates from many establishments spread throughout the globe, chartered accountants have to be well versed with the nuances of international taxation to be able to give an informed and correct advice and ensure compliance with tax laws. With this objective, International Taxation has been introduced as an elective paper in the Final Course. In fact, the core paper on Direct Tax Laws and International Taxation [Paper 7] in the Final Course, in which there is a dedicated part on International Taxation for 30 marks, lays the foundation for further specialisation in the area of International Taxation by opting for the Elective Paper [Paper 6C] on International Taxation.

Syllabus of International Taxation: Division into two parts

The syllabus of this elective paper on International Taxation is divided into two parts: Part I comprises of "Taxation of International Transactions and Non-resident Taxation in India" covering Transfer Pricing provisions under the Income-tax Act, 1961, Non-resident Taxation, Double Taxation Relief, Advance Rulings as well as an Overview of the Law and Procedures under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015. Part II comprises of "Other aspects of International Taxation" covering Taxation of E-Commerce Transactions, Overview, Features, Application and Interpretation of Tax Treaties, Anti Avoidance Measures and Overview of Model Tax Conventions.

Elective Paper on International Taxation: Building on the knowledge base of the Core Paper on Direct Taxes and International Taxation

Part I of the syllabus of this paper comprises of five chapters and Part II comprises of four chapters. In this Study Material, the contents of Part I on Taxation of International Transactions and Non-resident Taxation in India are based on the provisions of income-tax law, as amended by the Finance (No. 2) Act, 2019. The relevant assessment year is A.Y.2020-21.

Students may note that in the chapters comprised in Part I of the Syllabus of this Elective Paper, the special provisions relating to non-resident taxation, transfer pricing, double taxation relief and advance rulings under the Income-tax Act, 1961 are dealt with in detail in this Study Material. Also, certain general provisions of the Income-tax Act, 1961 which would apply in the same or modified form to non-residents have been discussed at some length. Since these general provisions and other general provisions of the income-tax law are dealt with in detail in the core paper on Direct Tax Laws and International Taxation [Final Paper 7], students are expected to integrate and apply the provisions of income-tax law (dealt with in Final Paper 7: Direct Tax Laws and International Taxation and in the Elective Paper 6C: International Taxation) in making computations and addressing relevant issues in case study based questions raised in the Elective Paper on International Taxation.

Enhance your knowledge through the webpages on international taxation and non-resident taxation and relevant Acts and Rules available at the Income-tax Department website

Along with the Study Material, students are also advised to read the relevant provisions of the Income-tax Act, 1961 [as amended by the Finance (No.2) Act, 2019], the updated edition of the Income-tax Rules, 1962, Black Money (Undisclosed Foreign Income and Assets) and Imposition of

Tax Act, 2015 [As amended by the Finance (No.2) Act, 2019], the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Rules, 2015, Chapter VIII of the Finance Act, 2016 on Equalisation Levy and Equalisation Levy Rules, 2016 available at the website of the Income-tax Department, Government of India, www.incometaxindia.gov.in. It is desirable that the above Acts and Rules form part of a candidate's reference material for open book in addition to the September, 2019 edition of the Study Material of Final Paper 6C International Taxation, the October, 2019 edition of the Study Material of Final Paper 7 Direct Tax Laws and International Taxation, the webhosted Statutory Update and Judicial Update and any other material/book/text which he may opt to take as reference material for open book examination.

The double taxation avoidance agreements (DTAAs) entered into by India with different countries are available on this website, and it is important that students read and appreciate the different articles forming part of the DTAAs. Furthermore, the webpage on international taxation https://www.incometaxindia.gov.in/pages/international-taxation.aspx contains useful compilation on various topics relating to international taxation, like, advance ruling, transfer pricing, withholding tax, DTAAs etc and the webpage on non-resident taxation https:// www.incometaxindia.gov.in/ pages/ non-resident-specific-content.aspx details the specific provisions relating to non-residents. Students are advised to go through the contents of these webpages and enhance their knowledge on international taxation. This would help them to solve the case study based questions in a more effective manner. Students may note that case studies on international taxation are being hosted at the BoS Knowledge Portal on the Institute's website www.icai.org from time to time.

Happy Reading and Best Wishes!

ELECTIVE PAPER – 6 C: INTERNATIONAL TAXATION

(One paper – Three hours – 100 Marks)

Objective:

To develop an understanding of the concepts, principles and provisions relevant to international taxation and acquire the ability to apply such knowledge to make computations and address issues in practical case scenarios.

Content:

Part I - Taxation of International Transactions and Non-resident Taxation in India

1. Transfer Pricing provisions under the Income-tax Act, 1961, including

(i) Arm's Length Price

(ii) International Transactions

(iii) Most Appropriate Method

(iv) Functions, Assets and Risk Analysis

(v) Documentation & Compliances

(vi) Specific Reporting Regime in respect of Country by Country reporting and master file

(vii) Advance Pricing Agreements

2 Other Provisions relating to taxation of international transactions and non-resident taxation under the Income-tax Act, 1961

(i) Non-resident Taxation (including Source Rule of Taxation)

(ii) Double Taxation Relief

(iii) Advance Rulings

3. Law and Procedures under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 – An Overview.

Part II – Other aspects of International Taxation

1. **Overview of Model Tax Conventions**
   - (i) OECD Model Tax Convention
   - (ii) UN Model Tax Convention
   - (iii) US Model Tax Convention*
2. **Tax treaties, Application and Interpretation**
   - (i) Features of Tax treaties
   - (ii) Overview of Tax Information Exchange Agreements
   - (iii) Commentaries and their importance
   - (iv) Role of Vienna Convention in application and interpretation of tax treaties
3. **Anti Avoidance Measures**
   - (i) Controlled Foreign Corporations
   - (ii) Base Erosion and Profit Shifting
   - (iii) Other Anti Avoidance Measures
4. **Taxation of E-Commerce Transactions**
   - (i) Introduction
   - (ii) Emerging issues
   - (iii) Equalisation levy

Note – If any new legislation(s) are enacted in place of an existing legislation(s), the syllabus will accordingly include the corresponding provisions of such new legislation(s) in the place of the existing legislation(s) with effect from the date to be notified by the Institute. Similarly, if any existing legislation(s) on direct tax laws ceases to be in force, the syllabus will accordingly exclude such legislation(s) with effect from the date to be notified by the Institute.

The specific inclusions/ exclusions in any topic covered in the syllabus will be effected by way of Study Guideline every year, if required. Specific inclusions/ exclusions in a topic may also arise due to additions/ deletions made every year by the Annual Finance Act.

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* Excluded from Syllabus by way of Study Guidelines

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CHAPTER 1

TRANSFER PRICING

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the need for incorporation of transfer pricing provisions in the Income-tax Act, 1961;
- **examine** the meaning and significance of arm's length principle and the practical difficulties in application of arm's length principle;
- **appreciate** the meaning and significance of the terms "associated enterprise", "international transaction";
- **analyze** the functions performed, assets used and risks assumed to determine the arm's length price of an international transaction;
- **determine** the arm's length price of an international transaction using the most appropriate method;
- **pinpoint** the responsibilities of a person entering into an international transaction to keep and maintain prescribed information and documents;
- **examine** the country-by-country reporting requirements and related matters incorporated in the income-tax law in compliance with BEPS Action Plan 13;

- **identify** the circumstances when the Assessing Officer can invoke the power to determine the arm's length price;
- **identify** the cases where secondary adjustments have to be made;
- **appreciate** the mechanisms for dispute resolution in transfer pricing cases, including filing of objections before Dispute Resolution Panel, filing of appeal, adoption of safe harbour and entering into advance pricing agreements;
- **appreciate** the specific anti-avoidance measures incorporated in the Income-tax Act, 1961 in respect of transactions with persons located in notified jurisdictional areas;
- **appreciate** the provisions incorporated in the Income-tax Act, 1961 restricting interest deduction claimed by an entity in respect of borrowings from an associated enterprise in line with BEPS Action Plan 4;
- **integrate, analyse and apply** the relevant provisions to make computations and address issues relating to transfer pricing.

1.1 INTRODUCTION

Transactions between related entities may have inherent advantage as compared to transactions between unrelated entities. Such advantage may be by means of price concessions, extended credit period, reduced interest rates, lower logistics expenses, etc. With the advent of globalization, multinational companies (MNCs) have established presence in all parts of the world and are conducting business seamlessly. They can enjoy the privileges of doing business with related parties whereas companies which deal with unrelated parties in an open market are not able to exploit such benefits. Therefore, in order to ensure safe and fair dealing among all companies and markets, the need to introduce regulations for transfer pricing was felt.

In addition to price related benefits, MNCs may also bear in mind the goal of minimizing tax burden and maximizing profits but the two tax jurisdictions/countries also need to ensure that they are not losing their fair share of tax revenue in such cases. This has given rise to an internationally accepted practice that such 'transfer pricing' should be governed by the Arm's Length Principle (ALP) and the transfer price should be the price applicable in case of a transaction of arm's length. In other words, the transaction between associates should be priced in the same way as a transaction between independent enterprises. Today, transfer pricing is one of the most important issues faced by MNCs as they attempt to fairly distribute their profits amongst the companies within the group. While on the other hand, the tax authorities implement transfer pricing regulations and strengthen the enforcement in order to prevent a loss of revenue for each regime where these companies are incorporated. The net result of this dichotomy is that transfer pricing has become a major tax issue for the companies.

The principles governing the taxation of MNCs are embodied in the OECD Model Tax Convention of Income and Capital (OECD Model Convention), which serves as the basis for the bilateral income-tax treaties between Organization of Economic Cooperation and Development (OECD) member countries and between OECD member and non-OECD member countries. According to these guidelines, "Transfer prices" are ***the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises***. Two enterprises are "associated enterprises" if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if both enterprises are under common control. Since international transfer pricing involves more than one tax jurisdiction, any adjustment to the transfer price in one jurisdiction requires a corresponding adjustment in the other jurisdiction. If a corresponding adjustment is not made, double taxation will result.

1.2 WHAT IS TRANSFER PRICING?

Transfer pricing as a concept traditionally began with the amount charged by one segment of an enterprise for a product or service that it supplied to another segment of the same enterprise. With the evolution of MNC concept, segments of the enterprise started spreading as independent entities operating in various parts of the globe. Accordingly, the term has evolved to mean ***price which is charged between two or more entities of a MNC [associated enterprises (AEs)] operating in different countries.***

For example, common business transactions between the AEs are in the nature of purchase and sale of assets, raw materials, finished goods and provision of services. Due to the lack of a natural conflict between the parties involved in commercial transactions in a group scenario, most MNCs, given their wide geographical presence, have a possibility to use their position to arrange business transaction to favourably exploit tax positions. By structuring transactions in a way which is most beneficial to the MNC from a tax perspective, the MNC is basically able to steer and manage where it books its profits and therefore also can influence actively the tax burden.

This, the tax administrators believe is unjust. Thus, to protect each country's fair share in an MNC's total profit, the tax authorities have established principles under which it can be assumed that related parties deal with each other as if they were independent and this principle is called the arm's length principle.

Example:

X Limited, a trader of goods, purchases and sells goods as below:

Particulars	Related parties	Unrelated parties
Purchases	8,00,000	5,00,000
Sales	10,00,000	10,00,000
Profits	2,00,000	5,00,000

By increasing the costs of purchases from related parties, X Ltd has reduced its taxable profits in said jurisdiction.

1.3 MEANING OF THE TERM "ARM'S LENGTH PRINCIPLE"

The Arm's Length Price (ALP) of a transaction between two associated enterprises is the price that would be paid if the transaction had taken place between two comparable independent and unrelated parties, where the consideration is only commercial.

The Arm's Length Principle, in the context of taxation, is explained in the OECD Model Tax Convention as under:

"Where conditions are made or imposed between two associated 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 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."

The OECD transfer pricing guidelines provides guidance on the application of the arm's length principle in order to arrive at the proper transfer pricing range between associated enterprises. Market forces determine business relations between independent parties. The arm's length principle seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises. It treats each enterprise as a separate independent entity rather than as inseparable parts of a single unified business.

1.4 SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

There are several reasons as to why the OECD member countries and other countries have adopted the arm's length principle.

Parity between MNCs and independent enterprises – A major reason is that the ALP provides broad parity of tax treatment for MNCs and independent enterprises. Since the ALP puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. The ALP, thus promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

Determines real taxable profits - The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise.

Reduction of artificial price distortion - If the ALP is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market.

Minimization of double taxation – The ALP is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction.

Accurate measurement of economic contribution – The ALP provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of the ALP is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

1.5 PRACTICAL DIFFICULTIES IN APPLICATION OF ALP

There are, however, certain practical difficulties in applying the ALP, which are described hereunder:

True comparison difficult in certain cases – The commercial and financial conditions governing a transaction between independent enterprises are, by and large, never similar to those existing between associated enterprises. As a result, there cannot be a true comparison. The economies of scale and integration of various business activities of the associated enterprise may not be truly appreciated by arm's length principle. Further, associated enterprises may enter into transactions which independent enterprises may not enter into, like say, licensing of valuable intangible or sharing the benefits of research. The owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, he may be prepared to offer terms that are less restrictive to associated enterprises because the use of the intangible can be closely monitored. Further, there is no risk to the overall group's profit from a transaction of this kind between members of an MNC group. In such situations, where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the ALP is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.

Availability of data and reliability of available data – There may be difficulty in getting adequate and reliable information and data in order to apply arm's length principle. The comparison of controlled and uncontrolled transactions between associated and independent enterprises usually requires a large quantum of data. Easily accessible information may be incomplete and difficult to interpret while the relevant and required information may be difficult to obtain due to geographical constraints or secrecy and confidentiality aspects. In other cases, information about an independent enterprise which could be relevant may not exist at all. Due to these difficulties, the tax administration and tax payers may have to exercise reason and judgment when applying the ALP.

Absence of market price - There must be a reasonably reliable and comparable uncontrolled market price. The ALP does not meet this condition because of the nature of the market place. A market price is an outcome of unique negotiations. It may be possible to know the price range, but it is very difficult to know the actual market price unless a market transaction actually takes place.

Absence of comparable market price for "intangible" transactions - The ALP reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions where the price range is narrow and market price is certain. However, the ALP generally fails to achieve a comparable market price for transactions involving intangibles because they are unique. The unique nature of these transactions creates a very wide price range.

Administrative burden - In certain cases, the arm's length principle may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions.

Time lag - Although an associated enterprise normally establishes the conditions for a transaction at the time it is undertaken, at some point the enterprise may be required to demonstrate that these are consistent with the arm's length principle. The tax administration may also have to engage in the verification process perhaps some years after the transactions have taken place. It may result in substantial cost being incurred by the tax payer and the tax administration. It is also difficult to appreciate the business realities which prevailed at the time when the transactions were entered into. This may lead to bias against the tax payer.

In spite of the practical difficulties listed above, OECD member countries are of the view that the ALP does provide a sound basis to appreciate the transfer pricing between associated enterprises. It has so far provided acceptable solutions to both taxpayers and the tax administrations. The experience gained so far should be effectively used to remove the practical difficulties and improve the administration.

1.6 EVOLUTION OF TRANSFER PRICING IN INDIA

Post the globalization/ liberalization in 1991, the enhanced presence of MNCs in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions, made the issue of transfer pricing a matter of serious concern for the Indian exchequer. Just like their global counterparts, the Indian tax authorities presumed the ability/intention of the MNCs to resort to transfer pricing as tool to shift profits and thereby erode the Indian tax base. This presumption ultimately laid to the evolution of the transfer pricing regulations in India.

Pre 2001 scenario: Prior to the introduction of comprehensive transfer pricing regulations by the Finance Act, 2001, certain basic provisions existed under the income-tax and the customs and excise legislation. While provisions like erstwhile Section 92 and Rule 10 did exist in law (which empowered the Assessing Officers to examine inter-company transactions of MNC group), however, given their restricted scope/ methodology, it was felt over a period of time that the same were not sufficient enough to prevent the erosion of the Indian tax base on account of inter-company transactions undertaken by MNC members. There was no detailed statute on transfer pricing. Further, the term "related parties" found mention under the company law and the anti-trust legislation.

In *Mazagaon Dock Ltd v. CIT*, the concept of transfer pricing was considered by the Supreme Court with reference to section 42 of the Indian Income-tax Act, 1922, when the law relating to transfer pricing was in its rudimentary stage. The question before the Supreme Court was whether the transaction between the non-resident British companies and the Indian company were at arm's length. If not, whether it is covered within the scope set out under section 42(2) of the Indian Income-tax Act, 1922. It was observed that section 42 states that it is not the question of the non-residents carrying on business in the abstract but of their carrying on business with the resident. The arrangement has to be looked into and decided on the taxability.

The Apex court rejected the contentions of the Indian company and held that profits, if any foregone, must be taxed. The court expressed the view that the fact, that the dealings were such as to yield no profit, was immaterial.

Section 42(2) in the Indian Income-tax Act, 1922 dealt with the situation concerning 'Transfer pricing'. On the enactment of the Income-tax Act, 1961 (the Act), the provisions of section 42(2) were incorporated in this Act in the form of section 92 with minor changes to bring out the purport of the section more clearly. Section 92 was backed by Rule 10 and 11 of the Income-tax Rules, 1962.

For invoking section 92, certain requisite conditions had to exist. These were:

(i) The business was transacted between a resident and a non-resident.

(ii) There was a close connection between the two.

(iii) On the account, the course of business was so arranged that the business produces either no profit or less than normal profit to the resident.

If the conditions at (i) to (iii) were found to exist, the Assessing Officer was empowered under the Act to:

- determine the amount of profits, which may reasonably be deemed to have been derived from such business; and
- include such amount in the total income of the resident.

Rules 10 and 11 provided the methodology for working out the normal profit to be included in the income of the resident assessee in the circumstances mentioned earlier. The normal profit could be calculated:

(i) at such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable, or

(ii) on any amount which bears the same proportion to the total profits and gains of the business of such person, as the receipts so accruing or arising bear to the total receipts of the business, or

(iii) in such other manner as the Assessing Officer may deem suitable.

Section 92 as it existed prior to its amendment, was not sufficient to deal with complex cases of transfer pricing. Its primary shortcomings were:

- The section applied only to 'businesses' between a resident and a non-resident. Since business demands a continuity of relationship, isolated transactions were outside its purview.
- The section was not wide enough in its scope to cover cases of transfer of services or intangibles.
- The section was not applicable in the case where a non-resident entered into a transaction with another non-resident. Therefore, business transactions between a permanent

establishment of a non-resident company and a non-resident were not covered.

- The section provided for adjustment of profits instead of adjustment of prices and the rules prescribed for estimating profits were not scientific.
- The concept of 'close connection' was not defined, leading to arbitrariness in applying the said provisions.
- No detailed rules for necessary documentation were prescribed to defend actions by the Revenue authorities.

In March 1999, the Standing Committee on Finance realised that the existing transfer pricing policy framework may not be effective to curb transfer pricing abuse in India. In view of the above, the Central Board of Direct Taxes (CBDT) set up an Expert Group on Transfer Pricing in November, 1999 to determine whether any amendments were necessary in the Act and if so to suggest a regulatory framework for the same.

The Group submitted its report in January, 2001 to the CBDT. The Ministry of Finance after considering the report introduced exhaustive legislative framework to deal with transfer pricing issues vide the Finance Act, 2001.

Post 2001 scenario: The Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing. Specifically, the memorandum to the Finance Act, 2001 stated that:

"*The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act.*"

Accordingly, sections 92 to 92F had been included in Chapter X of the Income-tax Act, 1961, through the Finance Act, 2001, providing for a transfer pricing mechanism based on computation of income from cross-border transactions. The following conditions must be satisfied in order to attract the special provisions of Chapter X relating to avoidance of tax:

(i) There must be an international transaction;

(ii) Such international transaction should be between two or more associated enterprises either or both of whom are non-residents;

(iii) Such international transaction should be in the nature of:

  (a) purchase, sale or lease of tangible or intangible property; or

(b) provision of service; or

(c) lending or borrowing money; or

(d) any other transaction having a bearing on the profits, income, losses or assets of such enterprise.

(iv) Further, such transaction may also involve allocation or apportionment of, or any contribution to any cost or expenses incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of the associated enterprises on the basis of mutual agreement or arrangement between such associated enterprises.

(v) Such international transaction must be done at arm's length price and if such international transaction has been done at less than the arm's length price, it shall require determination of income or apportionment of cost or expense on the basis of arm's length price.

(vi) The above adjustment should either result in an increase of income or decrease of loss returned by the assessee. In other words, the adjustment should not have the effect of reducing the income chargeable to tax or increasing the loss.

The provisions of Chapter X apply to international transactions entered into with effect from 1st April, 2001. Rules 10A to 10E have been inserted in the Income-tax Rules, 1962 by a notification dated 21st August, 2001. These sections and rules of the Income-tax Act, 1961 and the Income-tax Rules, 1962 respectively, will affect all non-corporate and corporate assessees who have dealings with non-residents for import or export of goods, properties or services. In other words, price paid for import of goods, properties or services and price received for export of goods, properties or services will be subject to scrutiny by the Assessing Officer. Therefore, it is necessary to make a detailed study of these provisions. All assessees who have such dealings with non-residents will have to keep detailed records as prescribed under the Rules and will have to furnish audit report every year with the return of income about their international transactions.

1.7 COMPUTATION OF INCOME FROM TRANSACTION WITH NON-RESIDENT [SECTION 92]

Section 92 provides that any income arising from an "international transaction" shall be computed having regard to "the arm's length price". For this purpose, the allowance for any expense or interest shall be determined on the basis of arm's length price. The section further provides that in an international transaction between two or more 'associated enterprises" when there is a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expenses in connection with a benefit, service or facility provided to any one or more of such enterprises, the allocation of cost, expenses etc. shall be determined having regard to arm's length price of such benefit, service or facility. Similarly, the price received for exports and amounts received for services rendered to associated enterprise will be determined on the basis of arm's length price. It will be noticed that in the international transaction, the income or expense will have to be at arm's length price, if the transaction is between associated enterprises.

The objective of transfer pricing provisions is to protect the tax base of India and to ensure that due to inter-company transactions, there is no reduction in the taxable profits or the taxes paid by the Indian taxpayer. The reverse, however, does not hold true.

Section 92(3) provides that the transfer pricing provisions contained in Section 92 shall not apply if the same has the effect of reducing the income chargeable to tax or increasing the loss of the assessee for the year under consideration.

The same can be understood with the help of the following example:

Example:

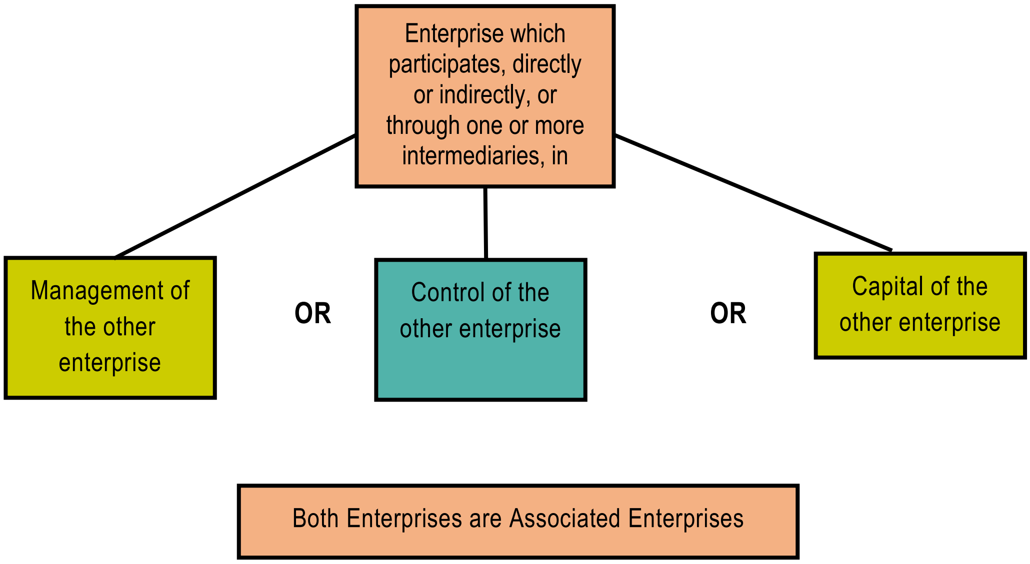
Case	Income as determined by assessee	Income as per ALP	Expenses claimed by assessee	Expenses as per ALP	Profit/ Loss as per assessee	Profit/ Loss after applying TP provisions	Has TP resulted in reduction of taxable income/ increase of losses?	Will TP provisions apply?
1	100	150	70	70	30	80	No	Yes
2	100	90	70	70	30	20	Yes	No
3	100	90	110	110	(10)	(20)	Yes	No
4	100	100	70	110	30	(10)	Yes	No

1.8 ASSOCIATED ENTERPRISES

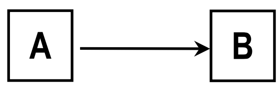
Associated enterprises are those which are owned or controlled by the same or common entity/ person. Section 92A of the Act defines the term 'Associated Enterprises' for the purpose of provisions relating to Transfer Pricing. As per Section 92A(1) of the Act, associated enterprise refers to:

a) an enterprise which participates, directly or indirectly, or through one or more intermediaries, in:

- management of the other enterprise, or
- control of the other enterprise, or
- capital of the other enterprise.

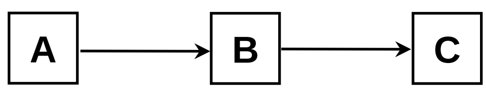


Example: *A Ltd. directly participates in management of B Ltd.*



Therefore, both A Ltd. & B Ltd. are associated enterprises.

Now, consider a situation where A Ltd. directly participates in management of B Ltd. and B Ltd. directly participates in management of C Ltd. In such situation, A Ltd. has direct participation in management of B Ltd. but has an indirect participation in management of C Ltd.



Therefore, in such scenario, C Ltd. is also an associated enterprise of A Ltd.

b) If one or more persons participates, directly or indirectly, or through one or more intermediaries in:

- management of the two different enterprises
- control of two different enterprises
- capital of two different enterprises

Then, those two enterprises are associated enterprises.

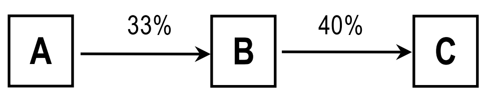
***Example**: Mr. A directly has control in A Ltd. and B Ltd. In such a scenario, both A Ltd. & B Ltd. are associated enterprises since they have a common person i.e. Mr. A, who controls both entities A Ltd. & B Ltd.*

Deemed Associated Enterprises

Two enterprises are deemed to be associated enterprises if they fall under any one or more of the situations contained in section 92A(2). This section provides 13 such situations during which associated enterprise relationship is deemed to be established. Two enterprises are deemed to be associated enterprise if:

(i) **Enterprise ownership -** One enterprise holds 26% or more of the voting power, directly or indirectly, in the other enterprise.

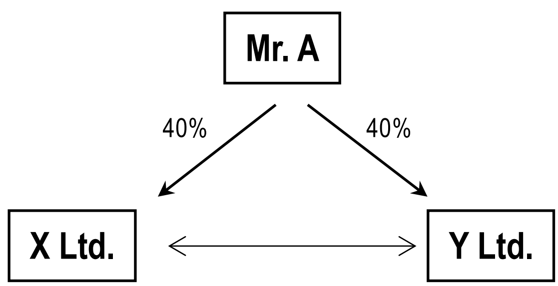
***Example:** A Ltd. holds 33% of voting power in B Ltd. and B Ltd. holds 40% voting power in C Ltd.*



In above situation, A Ltd. holds 33% of voting power in B Ltd. directly and 40% of voting power in C Ltd. indirectly (i.e. through B Ltd.). Therefore, both B Ltd. & C Ltd. are deemed associated enterprises of A Ltd.

(ii) **Voting power by common person -** Any person or enterprise holds 26% or more of the voting power, directly or indirectly, in each of two different enterprises.

***Example:** Mr. A holds 40% of voting power in both X Ltd. and Y Ltd. where neither X Ltd. has any holding in Y Ltd. nor Y Ltd. has any holding in X Ltd.*



In this situation, since Mr. A directly holds 40% of voting power in both X Ltd. and Y Ltd., X Ltd. & Y Ltd. will be deemed associated enterprises.

(iii) **Lender -** One enterprise advances loan to the other enterprise of an amount of 51% or more of the book value of the total assets of such other enterprise.

***Example:** Book value of total assets of Y Ltd. is ₹ 100 crores. X Ltd. advances loan of ₹ 60 crores to Y Ltd.*

Since, in this case, X Ltd. advances loan of ₹ 60 Crores to Y Ltd, which is 60% of the book value of total assets of Y Ltd. Hence, X Ltd. & Y Ltd. are deemed associated enterprises.

(iv) **Guarantor** - One enterprise guarantees 10% or more of the total borrowings of the other enterprise.

***Example**: P Inc. has total loan of 1 million dollars from XYZ Bank of America. Out of that, A Ltd., an India company, guarantees 20% of total borrowings in case of any default made by P Inc.*

In such scenario, since, A Ltd. guarantees 20% of total borrowings of P Inc., P Inc. and A Ltd. are deemed associated enterprises.

(v) **Appointment of Board by other enterprise** - One Enterprise appoints more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of another enterprise, or

***Example**: X Ltd. has 15 directors on its Board. Out of that, Y Ltd. has appointed 8 directors. In such case, X Ltd. and Y Ltd. are deemed associated enterprises.*

(vi) **Appointment of Board of two different enterprises by same person(s)** - More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.

***Example**: Mr. A appointed 9 directors out of 15 directors of X Ltd. and appointed 2 executive directors on the board of Y Ltd. In such case, since a common person i.e. Mr. A appointed more than half of the directors in X Ltd. and appointed 2 executive directors in Y Ltd., both X Ltd. and Y Ltd. are deemed associated enterprises.*

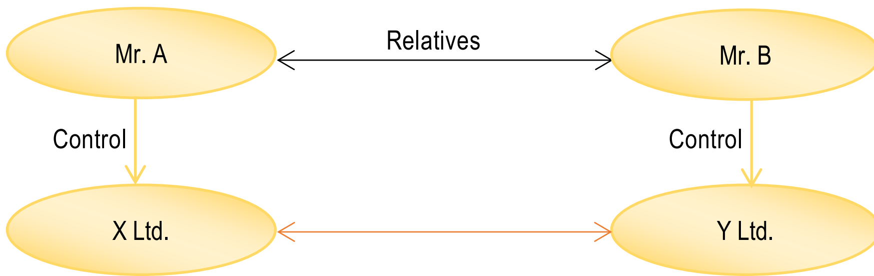
(vii) **Dependence on intangibles** - The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent (i.e. 100%) on the know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other entity is the owner or in respect of which the other enterprise has exclusive rights.

(viii) **Dependence on supply in manufacturing process** - 90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.

(ix) **Dependence on sale** - The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise.

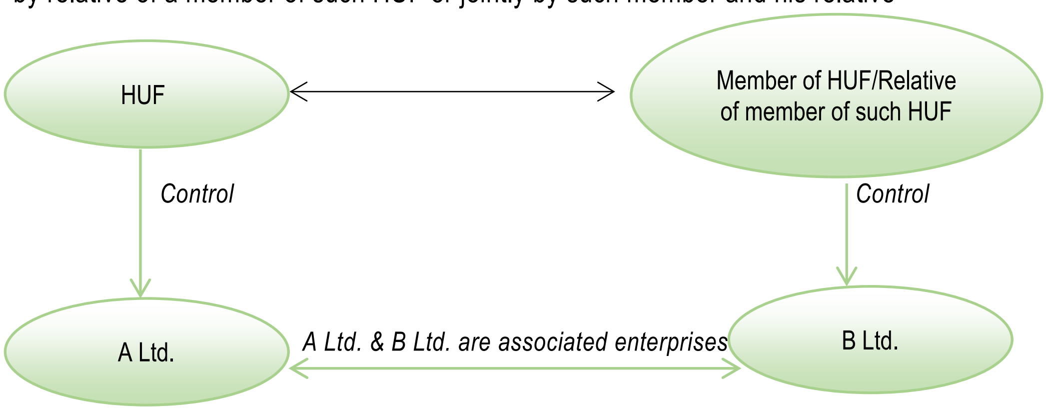
(x) **Individual control** - Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and his relatives.

Example: *Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.*



X Ltd. & Y Ltd. are deemed to be associated enterprises

(xi) **Control by Hindu Undivided Family** - Where one enterprise is controlled by a Hindu undivided family (HUF) and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative



(xii) **Holding in a firm, association of persons or body of individuals** – Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.

(xiii) **Mutual interest relationship** - There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Meaning of Enterprise: The term "enterprise" is defined in section 92F(iii) to mean a person (including its certain specified Permanent Establishment) who is, or has been, or is proposed to be, engaged in any activity,

- relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copy rights, trade-marks, licences, franchises or any other business or commercial rights of similar nature or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or
- the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate,

whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

For this purpose, the term **"Permanent establishment"** is defined in section 92F(iiia) to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

1.9 INTERNATIONAL TRANSACTION

(1) International transaction [Section 92B(1)]

As per section 92B of the Act, an international transaction means:

(i) a transaction between two or more associated enterprises, either or both of whom are non-residents; and

(ii) transaction in the nature of:

(a) sale/ purchase/ lease of tangible property; or

(b) sale/ purchase/ lease of intangible property; or

(c) provision of services; or

(d) lending/ borrowing money; or

(e) any other transaction having a bearing on profits, income, losses or assets of such enterprises; or

(f) mutual agreement or arrangement between two or more associated enterprise for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) Deemed international transaction [Section 92B(2)]

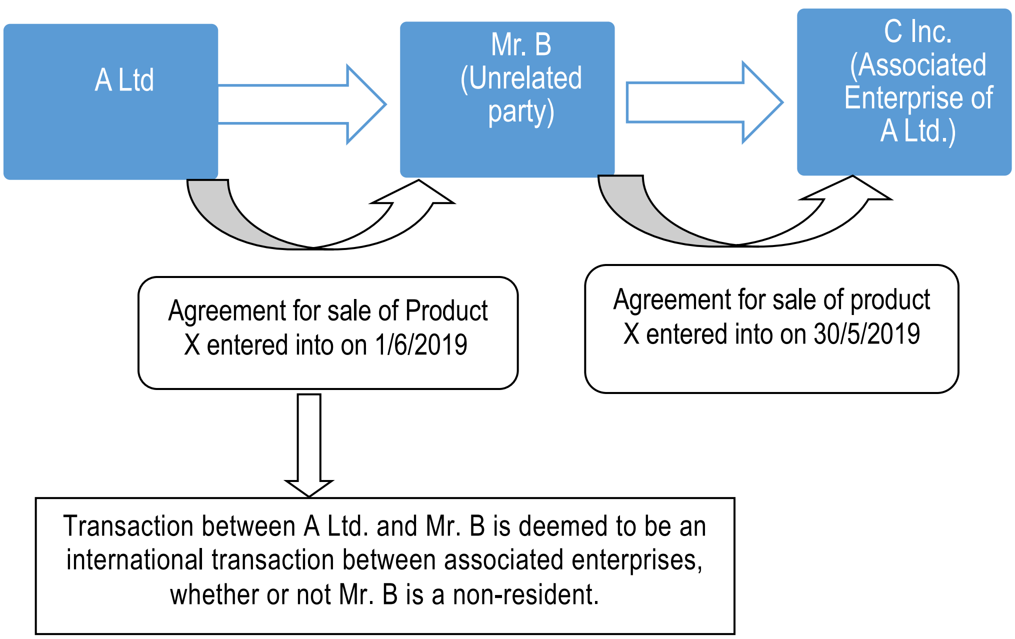
Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as "other person"),

- there exists a prior agreement in relation to the relevant transaction between the other person and the associated enterprise **or**,
- where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; **and**
- either the enterprise or the associated enterprise or both of them are non-residents,

then such transaction entered into between the enterprise and the other person shall be **deemed to be an international transaction** entered into between two associated enterprises, **whether or not such other person is a non-resident.**

Example:

If A Ltd., an Indian company, has entered into an agreement for sale of product X to Mr. B, an unrelated party, on 1/6/2019 and Mr. B has entered into an agreement for sale of product X with C Inc., a non-resident entity, which is a specified foreign company in relation to A Ltd., on 30/5/2019, then, the transaction between A Ltd. and Mr. B shall be deemed to be an international transaction entered into between two associated enterprises, irrespective of whether or not Mr. B is a non-resident.



Note – *C Inc. is deemed to be an associated enterprise of A Ltd. since it is a specified foreign company in relation to A Ltd., which means that A Ltd. holds 26% or more in the nominal value of the equity share capital of C Inc.*

(3) The scope of "international transaction" shall include:

	Transactions	Amplification of scope of terms used
(1)	Purchase, sale, transfer, lease or use of tangible property	Tangible property includes - • building, • transportation vehicle, • machinery, equipment, tools, plant, • furniture, • commodity or • any other article, product or thing;
(2)	Purchase, sale, transfer, lease or use of intangible property, including transfer of ownership or the provision of use of certain rights	"Use of certain rights" refer to – • land use, • copyrights, patents, trademarks, licences, franchises, • customer list, marketing channel, brand, commercial secret, • know-how, • industrial property right, • exterior design or practical and new design or • any other business or commercial rights of similar nature.
(3)	Capital financing	• any type of long-term or short-term borrowing, • lending or guarantee, • purchase or sale of marketable securities or • any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.
(4)	Provision of services	• provision of market research, • market development, • marketing management, • administration, • technical service, • repairs, • design, • consultation, • agency, • scientific research, • legal or accounting service.

(5)	Business restructuring or reorganization entered into by an enterprise with an associated enterprise	All such transactions are included in the definition of "international transaction", whether or not it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

(4) Further, the expression "intangible property" shall include

	Type of intangible asset in relation to	Examples of each type of intangible asset
(1)	Marketing	• Trademarks • trade names • brand names • logos
(2)	Technology	• Process patents • patent applications • technical documentation such as laboratory notebooks • technical know-how
(3)	Artistic	• literary works and copyrights • musical compositions • copyrights • maps • engravings
(4)	Data processing	• proprietary computer software • software copyrights • automated databases • integrated circuit masks and masters
(5)	Engineering	• industrial design • product patents • trade secrets • engineering drawing and schematics • blueprints • proprietary documentation
(6)	Customer	• customer lists • customer contracts • customer relationship • open purchase orders

(7)	Contract	• favourable supplier • contracts, • licence agreements • franchise agreements • non-compete agreements
(8)	Human	• trained and organised work force • employment agreements • union contracts
(9)	Location	• leasehold interest • mineral exploitation rights • easements • air rights • water rights
(10)	Goodwill	• institutional goodwill • professional practice goodwill • personal goodwill of professional • celebrity goodwill • general business going concern value
(11)	methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, or technical data;	
(12)	any other similar item that derives its value from its intellectual content rather than its physical attributes.	

(5) Meaning of Transaction

As per section 92F(v) of the Act, "transaction" includes an arrangement, understanding or action in concert –

(a) whether or not such arrangement, understanding or action is formal or in writing; or

(b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Section 92F(v) provides an inclusive definition of the term "transaction". Based on the reading of the section, it is evident that it is not necessary that for a transaction undertaken between two enterprises there needs to be a formal written agreement between them. It is only relevant whether a transaction has been entered into in substance. The section also negates the requirement as to the legal enforceability of agreement or understanding.

1.10 SPECIFIED DOMESTIC TRANSACTIONS

It is common knowledge that the under invoicing of sales and over invoicing of expenses is ordinarily revenue neutral in case of a domestic transaction. However, shifting of profits from a profit making entity to related entity which is into losses or from one group entity to another to take undue advantage of tax incentive (tax holiday or any other), can create unwarranted situation of significant revenue loss to the Government.

To understand such situations in a greater detail, following examples can be referred to:

Example 1: *Profit shifting from a domestic tariff area (DTA) unit to a tax holiday unit*

Actual situation

Particulars	Tax Holiday Unit	DTA Unit
Tax Rate	-	30%
Income from related party transaction ('RPT')	100	-
Other income	300	300
Expenses in relation to RPT	-	100
Other expenses	200	50
Profit / (loss)	200	150
Tax	0	45 (i.e. 150 * 30%)

Shifting of profits

Particulars	Tax Holiday Unit	DTA Unit
Tax Rate	-	30%
Income from related party transaction ('RPT')	250	-
Other income	300	300
Expenses in relation to RPT	-	250
Other expenses	200	50
Profit / (loss)	350	0
Tax	0	0

Example 2: *Profit shifting from a profit making entity to a related loss making concern*.

Actual situation

Particulars	ABC Ltd.	XYZ Ltd.
Tax Rate	30%	30%
Income from related party transaction ('RPT')	100	-
Other income	300	300
Expenses in relation to RPT	-	100
Other expenses	700	50
Profit / (loss)	(300)	150
Tax	0	45 (i.e. 150 * 30%)

Tax planning to shift profits

Particulars	ABC Ltd.	XYZ Ltd.
Tax Rate	30%	30%
Income from related party transaction ('RPT')	250	-
Other income	300	300
Expenses in relation to RPT	-	250
Other expenses	700	50
Profit / (loss)	(150)	0
Tax	0	0

In order to provide objectivity in determination of income from domestic related party transactions and determination of reasonableness of expenditure between related domestic parties, the provisions of section 92 have been extended to include within its ambit the specified domestic transactions.

The transfer pricing provisions and other related provisions pertaining to Specified Domestic Transaction are discussed in detail in "Chapter 1: Transfer pricing and other provisions to check avoidance of tax" of Module 4: Part II- International Taxation of Paper 7: Direct Tax Laws and International Taxation.

1.11 COMPUTATION OF ARM'S LENGTH PRICE (SECTION 92C)

"Arm's length price" is defined in section 92F(ii) to mean price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.

Section 92C deals with the method for determining arm's length price and the factors which are to be considered for applicability or non-applicability of a particular method to a given situation. The factors as well as methods incorporated in this section are not exhaustive and the CBDT may prescribe further factors and methods.

It provides that the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely -

(a) comparable uncontrolled price method;

(b) resale price method;

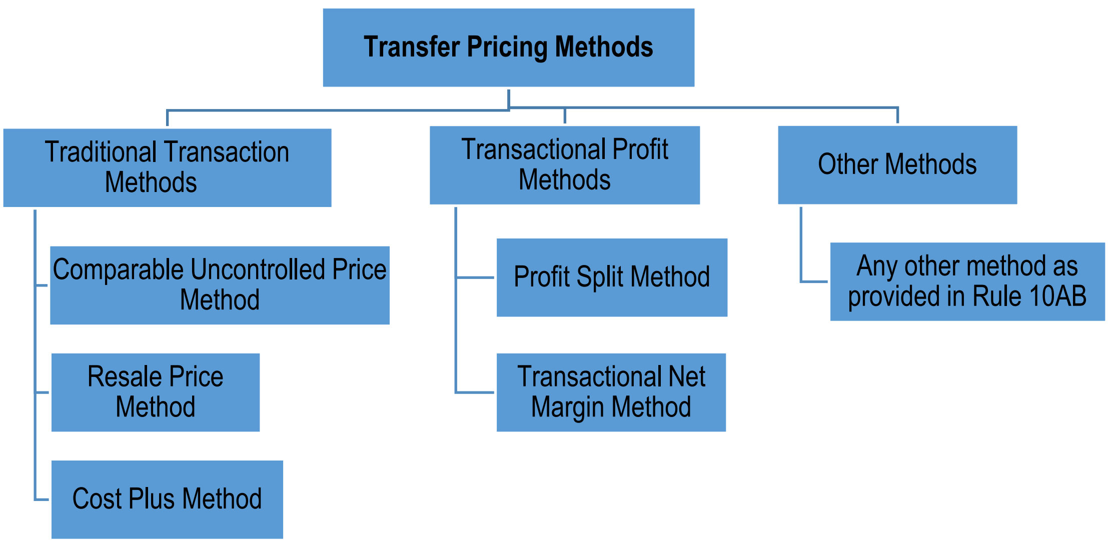
(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

Accordingly, the Board has prescribed that the other method for determination of arm's length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. [Rule 10AB]



Section 92C(2) provides that the most appropriate method out of the above methods has to be applied for determination of arm's length price, in the prescribed manner.

Rule 10B(1) prescribed the manner to determine the arm's length price under the five methods as stated in above diagram in respect of any goods, property or services purchased or sold under any international transaction.

(1) Comparable uncontrolled price method:

A comparable uncontrolled price is the price agreed between unconnected parties for the transaction of goods or services under similar circumstances.

Mechanism to determine CUP is as follows:

(i) Identification of price charged or paid for property transferred or services provided under any comparable uncontrolled transaction(s).

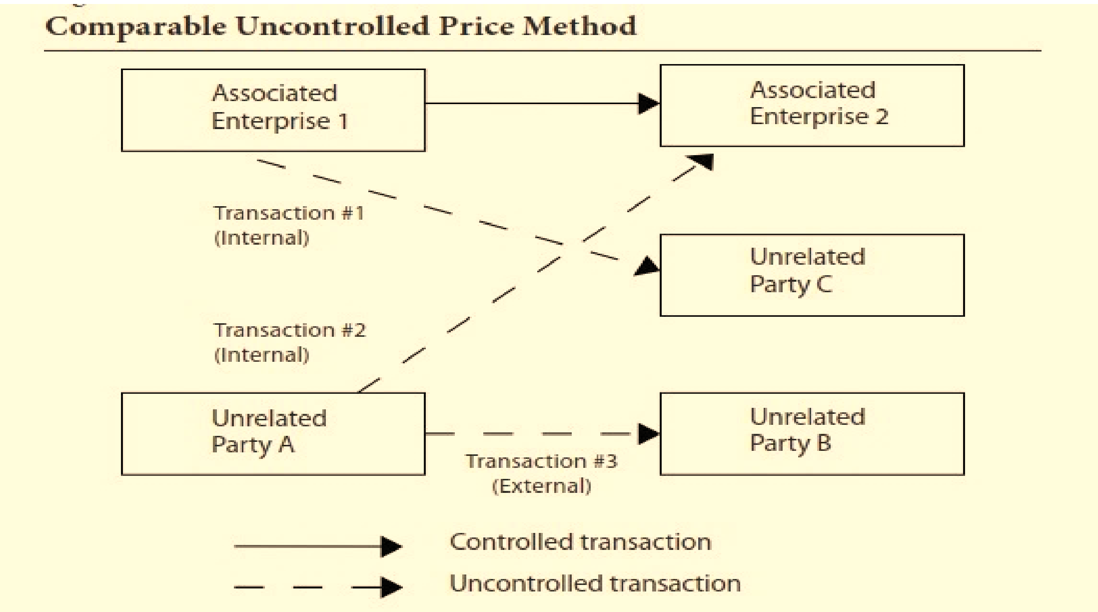
(ii) Such price is adjusted to account for differences, if any, between the international transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market can be made.

(iii) Adjusted price arrived above taken to be as arm's length price in respect of the property transferred or services provided in the international transaction.

Meaning of "Uncontrolled transaction": Uncontrolled transaction means a transaction between enterprises other than associated enterprises, whether resident or non-resident.

The comparable uncontrolled price method requires a high degree of comparability of products, services and functions and such comparability can be improved by carrying out necessary reasonable adjustments, in respect of differences arising on account of various factors such as quality of the product or service, contractual terms, credit terms, transport terms, level of the market (i.e. wholesale, retail, etc.), geographic market in which the transaction takes place, etc.

A Comparable uncontrolled price can be determined as follows:



Transaction between AE1 and AE2 are subject to transfer pricing. Transaction #1 and #2 are internal transaction since it is entered by AEs with unrelated parties and Transaction #3 is external transaction since it is entered between unrelated parties. Hence, controlled transaction need to be compared with either Transaction #1 (If AE1 is the tested party) or Transaction #2 (If AE2 is the tested party) or Transaction #3.

In the given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex *vis-à-vis* the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile. Accordingly, controlled transaction need to be compared with Transaction #1 i.e., between unrelated party and AE1.

ILLUSTRATION 1

US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND. Ltd. at ₹ 11,000 per unit. The price fixed for CMI Ltd. is ₹ 10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of ₹ 1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?

SOLUTION

US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd. is the holding company of IND Ltd. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells identical computer monitors to CMI Ltd., which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is, therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm's length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm's length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	₹
Sale price charged by US Ltd. to CMI Ltd.		10,000

Less: Cost of warranty included in the price charged to CMI Ltd. (₹ 1,000 x 3 /12)		250
Arm's length price		**9,750**
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		**1,250**
No. of units supplied by US Ltd. to IND Ltd.	50,000	
Addition required to be made in the computation of total income of IND Ltd. (₹ 1,250 × 50,000)		6,25,00,000

No deduction under chapter VI-A would be allowable in respect of the enhanced income of ₹ 6.25 crores.

Note: *It is assumed that IND Ltd. has not entered into an advance pricing agreement or opted to be subject to Safe Harbour Rules.*

(2) Resale price method

The resale price method (RPM) is a method which compares the gross margins (i.e. gross profit over sales) earned in transactions between related and unrelated parties for the determination of the ALP. The RPM **requires high level of functional comparability** and is mainly applicable where the controlled party is a distributor.

The RPM evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realised in comparable uncontrolled transactions. RPM can be computed as follows:

(i) Identification of resale price by tested party i.e., the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or provided to an unrelated enterprise.

(ii) Resale price is reduced by normal gross profit margin with reference to uncontrolled transaction(s).

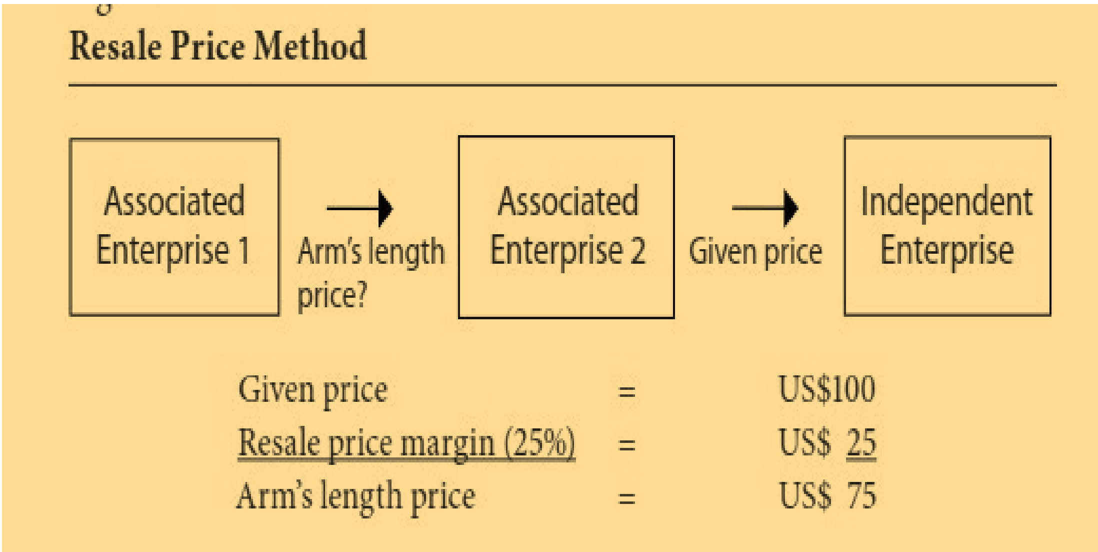
(iii) Such price reduced by expenses incurred (customs duty etc.) in connection with purchase of the product/ services.

(iv) This price may be adjusted to account for functional and other differences, if any, including differences in accounting practices which could materially affect the gross profit margin in the open market.

(v) Adjusted price arrived above taken to be as arm's length price

RPM is generally used to test transactions involving distribution function, i.e. when the tested party purchases products/ acquires services from related party and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/ services. Where the transactions are not comparable in all ways and the differences have a material effect on price, one has to make adjustments to eliminate the effect of those differences. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses.

Using RPM as the most appropriate method, ALP can be computed as follows:



AE2 has purchased goods from AE1 and re-sold to independent enterprise at USD 100. A similar transaction is entered into by unrelated parties with resale price margin of USD 25. Thus, the arm's length price arrived at is USD 75 (i.e. market value of goods at which AE2 should have purchased from AE1 (assuming no other costs for AE2 for simplicity purposes).

(3) Cost plus method

The Cost Plus Method ('CPM') determines an arm's-length price by adding an appropriate gross profit margin to an associated entity's costs of producing goods or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks assumed by the entity.

Mechanism to compute ALP based on CPM is as follows:

(i) Identification of direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise.

(ii) Determination of amount of normal gross profit mark-up to such costs arising from the transfer or provision of the same or similar property or services by the enterprise or by an unrelated enterprise in comparable uncontrolled transaction or transactions.

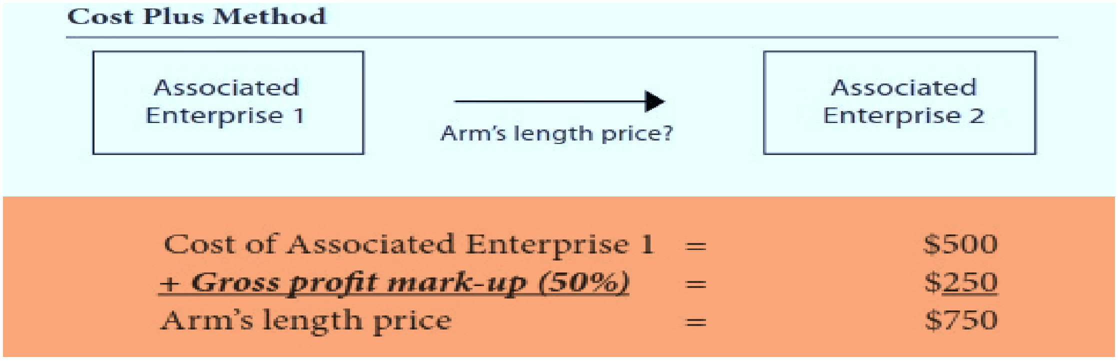
(iii) The normal gross profit mark-up determined above is adjusted to account for functional and other differences, if any, which could materially affect such profit mark-up in the open market.

(iv) Adjusted gross profit mark-up added to total costs identified in (i) above.

(v) Sum arrived above is taken to be arm's length price in relation to the supply of property or provision of services by the enterprise.

This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

Using CPM as the most appropriate method, ALP can compute as follows:



AE2 has purchased manufactured goods from AE1. A similar transaction is entered into by unrelated parties with gross profit margin of USD 250. Thus, the arm's length price arrived at is USD 750 i.e. market value of goods at which AE2 should have purchased from AE1.

If there are differences between the controlled and uncontrolled transactions that would affect the gross profit mark-up, adjustments should be made to the gross profit mark-up earned in the comparable uncontrolled transaction. For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses.

(4) Profit split method

This is a method which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction.

The Profit Split Method (PSM) evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length with reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most prominently identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

Profit split method, generally, is applied as per following steps:

(i) Determination of combined net profit of the associated enterprises arising out of international transaction in which they are engaged.

(ii) Evaluation of relative contributions by each enterprise to the earning of such combined net profit on the basis of functions performed, risks assumed and assets employed by each enterprise. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.

(iii) Splitting of combined net profit amongst the enterprises in proportion to their relative contributions, as evaluated above.

(iv) Profit thus apportioned to the assessee is taken into account to arrive at the arm's length price in relation to the international transaction.

Allocation of profits must be made in accordance with one of the following allocation methods:

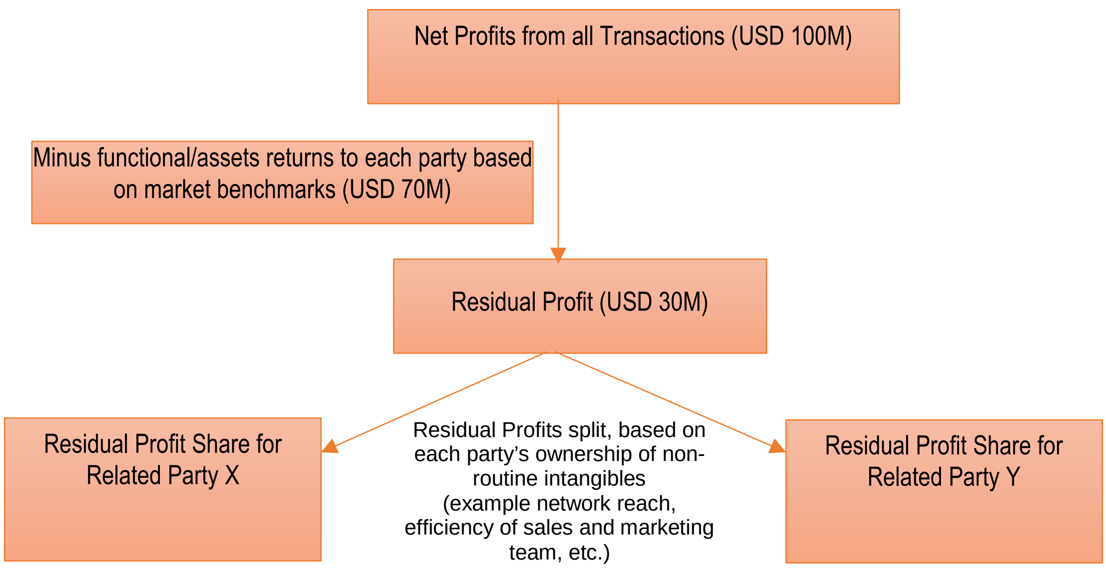
(a) Comparable profit split - Under this method, uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(b) Residual profit split - Following the two-step process:

i. Allocate income to routine contributions

ii. Allocate residual profit

The following example explains the PSM:



Suppose in the above example, Net profit margins from all transactions were USD 100M. Depending on the contribution of each AE, the net profit of USD 70M will be distributed to all AEs (i.e. Allocate income to routine contributions). Further, after the respective contribution is allocated specifically, the residual profit of USD 30M will be distributed among AEs based on various factors.

Total profit for Related Party X:

1. Income for specific contribution (suppose 40% by X and 60% by Y) made by X: USD 28M (i.e. USD 70M x 40%)
2. Income as residual profit (i.e. 50:50) (allocated considering various factors): USD 15M (i.e. 30M x 50%)

Total Arm's length profit of related party X: USD 43M (USD 28M + USD 15M)

(5) Transactional net margin method

Under the Transactional net margin method (TNMM), an arm's-length price is determined by comparing the net profit margin in relation to an appropriate base (example costs, sales, assets) of the tested party with the net profit margin in relation to the same base, of an uncontrolled party engaged in comparable transactions.

The following steps are required to determine ALP using TNMM:

(i) Computation of net profit margin realized by the enterprise from the international transaction with an AE having regard to costs incurred or sales effected or assets employed or having regard to any other relevant base.

(ii) Computation of net profit margin realized by the enterprise or an unrelated enterprise in a comparable uncontrolled transaction by applying the same base as above.

(iii) Net profit margin realized from uncontrolled transaction is adjusted to account for differences, if any, which could materially affect the net profit margin in the open market.

(iv) The net profit margin realized by the enterprise referred in (i) above is established to be the same as net profit margin referred in (iii) above.

(v) The net profit margin thus established is taken into account to arrive at an arm's length price for the international transaction.

The following example explains the TNMM:

Given price	=	$10 000	
Cost of goods sold	=	$_____?	
Gross profit	=	?	
Operating expenses	=	$ 2 000	
Net profit (5% of price)	=	$ 500	*Comparable*

AE1 has purchased raw materials from its AE2 and manufactures goods for sale to third parties. The similar transaction is entered into by unrelated parties with net margin of 5% of sale price.

Thus, if AE1 earns net margin of 5% of sale price, then its transaction of purchase of raw materials from AE2 will be at arm's length.

The following table summarises the application of method and its preferences on a general basis (The below table is illustrative only and not binding – Applicability of methods can change depending on the facts of each case):

Transactions	Methods				
	Comparable Uncontrolled Price Method	Resale Price Method	Cost-plus Method	Transactional Net Margin Method	Profit Split Method
Commodities/Oil	√				
Payment of Interest	√				
Distribution of goods		√			
Provision of Services			√	√	
Contract manufacturing			√	√	
Manufacturing			√	√	
Payment of Royalty	√				
Multiple transactions involving intangibles					√
Management Charges	No Specified Method Benefit test and acceptable allocation				
Sales of shares, Intangible Assets (trademark, brand name etc.)	No Specified Method Can rely on valuation report under the other method				

(6) Other Method as may be prescribed by the CBDT

The Other method allows the use of 'any method' which takes into account

(i) the price which has been charged or paid or

(ii) would have been charged or paid for the same or similar uncontrolled transactions with or between non-associated enterprises, under similar circumstances.

The various data which may possibly be used for comparability purposes under this method could be third party quotations, valuation reports, tender/Bid documents, documents relating to the negotiations, standard rate cards, commercial & economic business models; etc.

For applying the above methods, the comparability of the international transaction with an uncontrolled transaction is to be judged with reference to the following factors:

(i) The specific characteristics of the property transferred or services provided in either transaction;

(ii) The functions performed, taking into account assets employer or to be employer and the risks assumed, by the respective parties to the transactions;

(iii) The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(iv) Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

Rule 10B(3) provides that an uncontrolled transaction shall be comparable to an international transaction

- if none of the differences between the transactions being comparable or between the enterprises entering into such transactions is likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market or
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction

The data to be used for analyzing the comparability of an uncontrolled transaction and an international transaction should relate to the financial year (current year) in which the international transaction has been entered into.

In case the most appropriate method for determination of ALP of a transaction entered into on or after 1.4.2014 is the **resale price method** or **cost plus method** or **the transactional net margin method**, then, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction shall be –

(a) the data relating to the current year; or

(b) the data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year.

However, where the data relating to the **current year is subsequently available** at the time of determination of arm's length price of an international transaction **during the course of any assessment proceeding** for the assessment year relevant to the current year, then, **such data shall be used** for such determination **irrespective of the fact that the data was not available** at the time of furnishing the return of income of the relevant assessment year.

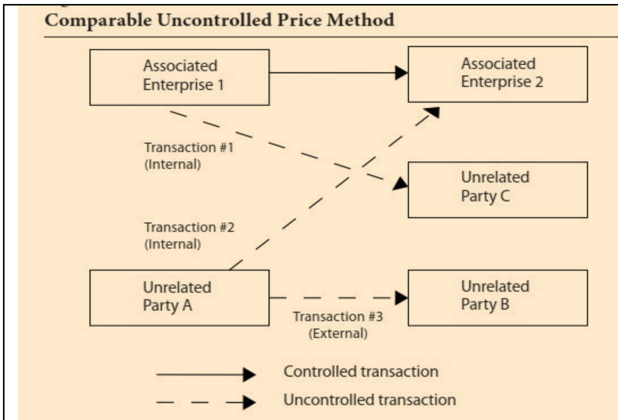
Methods for computing ALP [Section 92C]

CUP Method	Resale Price Method(RPM)	Cost Plus Method (CPM)	Profit Split Method (PSM)	Transactional Net Margin Method (TNMM)
This method is applied where there are similar transaction(s) b/w unconnected parties	This method is applied where item obtained from AE is resold to unrelated party	This method is generally applied where semi-finished goods are sold to AEs	This method is applied where there is transfer of unique intangibles or in multiple International Transaction	Compute NP margin of the enterprise from International Transaction with AE having regard to cost incurred/sales effected/assets employed
Identify price in a comparable uncontrolled transaction (CUCT)	Identify the RP at which the item is resold to unrelated party	Identify direct & indirect COP incurred for property transferred or services provided to AE	Determine combined NP of the AEs arising out of International Transaction	Compute the NP margin realised by the enterprise or unrelated enterprise in a CUCT by applying the same base
	Reduce the RP by the normal GP margin on CUCT & expenditure incurred (customs duty) w.r.t. purchase	Determine normal GP mark up to such costs by an unrelated enter in CUCT	Evaluate the relative contribution of each enterprise to the earning of combined NP on the basis of FAR	Adjust NP margin realised from CUCT to a/c for differences affecting NP margin in the OM
Adjust the price for material differences in terms of contract, credit, transport etc.	Adjust the price for functional & other differences materially affecting GP margin in open market (OM)	Adjust the normal GP mark-up for functional and other differences materially affecting GP mark-up in OM	Split the combined NP amongst the enterprise in proportion to market returns; & residual profits in proportion to their relative contribution	Compare NP margin relative to costs/sales/assets of the AE with NP margin of uncontrolled party in comparable transactions
Adjusted price is ALP	Adjusted price is ALP	Total Costs ↑d by adjusted mark up = ALP	ALP to be determined on the basis of profit apportioned.	Adjusted NP margin taken into A/c to arrive at ALP

(7) Selection of tested party

The tested party will be the participant in the controlled transaction whose profitability/ pricing attributable to the controlled transactions can be verified based on the most appropriate data and requiring the fewest & most reasonable adjustments, and for which reliable data regarding uncontrolled comparables can be located.

Consequently, in most cases the tested party will be the "least complex" of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.



In the given example, AE1 and AE2 are parties to a controlled transaction. Assume, AE1 provides back office support services to AE 2 (i.e. engaged in manufacturing of goods). The functions performed, assets deployed and risk assumed for back office support services is less complex *vis-à-vis* the functions performed, assets deployed and risk assumed in manufacturing activities. Hence, AE1 must be selected as tested party which has least complex functional profile

(8) Selection of Profit Level Indicator

A profit level indicator (PLI) is selected to test the profitability of tested party. PLIs are ratios that measure relationships between profits and costs incurred or resources employed. A variety of PLI's can be calculated in any given case.

PLI should always have an untainted base (denominator) like adopting cost as base for export transactions and revenue as base for import transactions

It is a practice to adopt the denominator of the PLI as being un-tainted or less-tainted. A tainted income or expense would mean one that is received from an AE or paid to an AE and therefore cannot be considered to be independent or at arm's length. Untainted on the other hand would mean revenue or costs which relate to transactions with independent third parties and are therefore more reliable.

In above example, the revenue from back support services will be tainted because it is received from related party. So, the PLI, in the above case, should be costs.

The following table briefly summarises the various PLIs used:

Overview of Various Profit Level Indicators	
Return on Assets (ROA)	Operating profit divided by the operating assets (normally only tangible assets)
Return on Capital Employed (ROCE)	Operating profit divided by capital employed which is usually computed as the total assets minus cash and investments *Johnson Matthey India (P.) Ltd. Vs Deputy Commissioner of Income-tax ([2016] 380 ITR 43 (Delhi))* – It was held that reliability of ROCE as a PLI depends upon extent to which composition of assets/capital deployed by tested party and their valuation is similar to that of comparables and if balance sheet does not accurately reflect average use of capital throughout year, ROCE would be less reliable.
Operating Margin (OM)	Operating profit divided by sales
Return on Total Costs (ROTC)	Operating profit divided by total costs
Return on Cost of Goods Sold	Gross profit divided by cost of goods sold
Berry Ratio	Gross profit divided by operating expenses

(9) Most Appropriate Method

Rule 10C deals with the determination of most appropriate method. Under this Rule, the method which is best suited to the facts and circumstances and which provides the most reliable measure of an arm's length price in relation to the international transaction will be considered to be the most appropriate method.

For the purpose of selecting the most appropriate method, the following factors should be taken into account.

(i) The nature and class of the international transaction;

(ii) The class, or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(iii) The availability, coverage and reliability of data necessary for application of the method;

(iv) The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

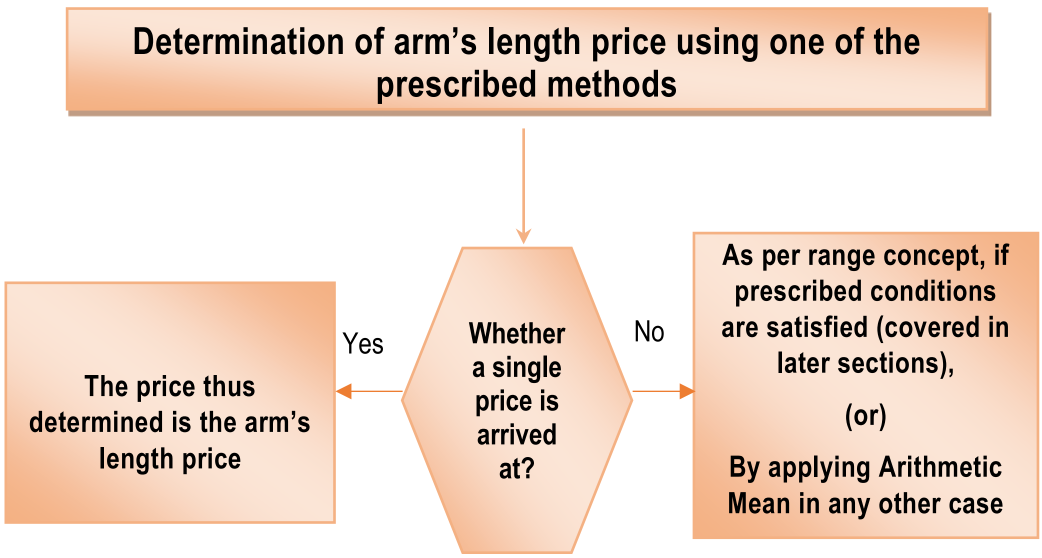
(v) The extent to which reliable and accurate adjustments can be made to account for difference, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(vi) The nature, extent and reliability of assumptions required to be made in application of a method.

(10) Manner of computation of Arm's length price (Applicable for international transactions undertaken on or after 1.4.2014) [Third proviso to section 92C(2)]

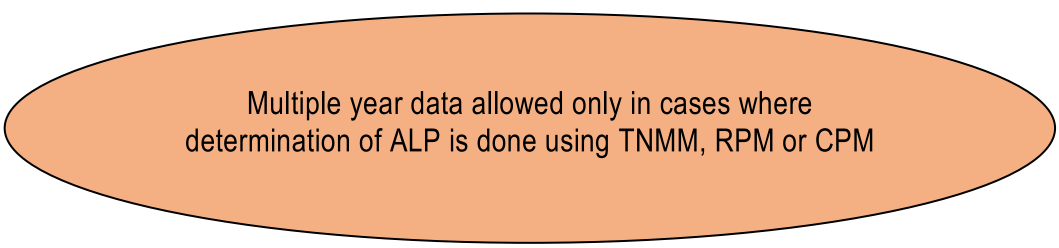
In case of an international transaction undertaken on or after 1.4.2014, where more than one price is determined by the most appropriate method, the ALP shall be computed in the prescribed manner specified in Rule 10CA.

Computation of arm's length price in certain cases (Rule 10CA)



Rule 10CA(1) provides that where in respect of an international transaction, the application of the most appropriate method referred to in section 92C(1) results in determination of more than one price, then, the arm's length price in respect of such international transaction has to be computed on the basis of the dataset constructed by placing such prices in an ascending order as provided in Rule 10CA(2).

Application of multiple year data for construction of dataset



Where the most appropriate method is the resale price method or cost plus method or transactional net margin method and the comparable uncontrolled transaction has been identified on the basis of data relating to the current year and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction referred to in sub-rule (1)], has in either or both of the two financial years immediately preceding the current year undertaken the same or similar comparable uncontrolled transaction then,-

(i) the most appropriate method used to determine the price of the comparable uncontrolled transaction undertaken in the current year shall be applied in similar manner to the comparable uncontrolled transaction or transactions undertaken in the aforesaid period and the price in respect of such uncontrolled transactions shall be determined; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it shall be included in the dataset instead of the price referred to in sub-rule (1).

Further, where the most appropriate method is the resale price method or cost plus method or transactional net margin method where the comparable uncontrolled transaction has been identified **on the basis of the data relating to the financial year immediately preceding the current year** and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction referred to in sub-rule (1)], has in the financial year immediately preceding the said financial year undertaken the same or similar comparable uncontrolled transaction then, -

(i) the price in respect of such uncontrolled transaction shall be determined by applying the most appropriate method in a similar manner as it was applied to determine the price of the comparable uncontrolled transaction undertaken in the financial year immediately preceding the current year; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the aforesaid period of two years shall be included in the dataset instead of the price referred to in sub-rule (1).

Also, in such cases, where the use of data relating to the current year for determination of ALP subsequently at the time of assessment establishes that,-

(i) the enterprise has not undertaken same or similar uncontrolled transaction during the current year; or

(ii) the uncontrolled transaction undertaken by an enterprise in the current year is not a comparable uncontrolled transaction,

then, irrespective of the fact that such an enterprise had undertaken comparable uncontrolled transaction in the financial year immediately preceding the current year or the financial year immediately preceding such financial year, the price of comparable uncontrolled transaction or the weighted average of the prices of the uncontrolled transactions, as the case may be, undertaken by such enterprise shall **not** be included in the dataset.

Rule 10CA(3) provides that where an enterprise has undertaken comparable uncontrolled transactions in more than one financial year, then for the purposes of sub-rule (2) the weighted average of the prices of such transactions shall be computed in the following manner, namely:-

	Method used to determine the prices	Manner of computation of weighted average of the prices
(i)	The resale price method	By assigning weights to the quantum of sales which has been considered for arriving at the respective prices
(ii)	The cost plus method	By assigning weights to the quantum of costs which has been considered for arriving at the respective prices
(iii)	The transactional net margin method	By assigning weights to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be, any other base which has been considered for arriving at the respective prices.

Range Concept: Rule 10CA(4) provides that where the most appropriate method applied is –

(i) a method other than the profit split method or a method prescribed by the CBDT under section 92C(1)(d)/(f); and

(ii) the dataset constructed in accordance with sub-rule (2) consists of six or more entries,

an arm's length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset shall be constructed.

If the price at which the international transaction has actually been undertaken is within the said range, then, the price at which such international transaction has actually been undertaken shall be deemed to be the arm's length price [Rule 10CA(5)].

If the price at which the international transaction has actually been undertaken is outside the said arm's length range, the arm's length price shall be taken to be the median of the dataset [Rule 10CA(6)].

When to apply range concept?

- Most appropriate method selected is Comparable uncontrolled price method, resale price method, cost plus method or transactional net margin method and
- The dataset constructed has six or more entries.

How to apply?

- Arrange the values in the dataset in the ascending order.
- Where the actual transaction price falls within 35th and 65th percentile of the dataset, the value of transaction will be accepted to be arm's length price.
- Where the transfer price does not fall within the above range, then median of dataset shall be taken as the Arm's Length price.

Meaning of certain terms [Rule 10CA(8)]

	Term	Meaning
(a)	the thirty-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 35% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the thirty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(b)	the sixth-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 65% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the sixty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(c)	the median of the dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 50% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the median shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.

Example 1: *Where the data set comprises 7 data points (arranged in ascending order), and the percentiles computed are not whole numbers*

Percentile	Formula	Result	Value to be selected
35^{th}	Total no. of data points in dataset x 35% = [7 x 35%]	2.45	3^{rd} value*
65^{th}	Total no. of data points in dataset x 65% = [7 x 65%]	4.55	5th value*
Median	Total no. of data points in datasets x 50% = [7 x 0.5]	3.50	4th value*

* Value referred to here is the place value in the data set as arranged in ascending order.

Example 2: *Where the data set comprises 20 data points (arranged in ascending order), and the percentiles computed are whole numbers.*

Percentile	Formula	Result	Value to be selected
35^{th}	Total no. of data points in dataset x 35% = [20 x 35%]	7	Mean of 7th & 8th value
65^{th}	Total no. of data points in dataset x 65% = [20 x 65%]	13	Mean of 13th & 14th value

Median	Total no. of data points in datasets x 50% = [20 x 0.5]	10	Mean of 10th & 11th value

If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the Median of the data set.

Range concept not applicable:

In a case where the provisions of Rule 10CA(4) are not applicable, the arm's length price shall be the arithmetical mean of all the values included in the dataset. However, if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed such percentage not exceeding 3% of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price [Rule 10CA(7)].

1.12 FUNCTIONS, ASSETS AND RISK (FAR) ANALYSIS

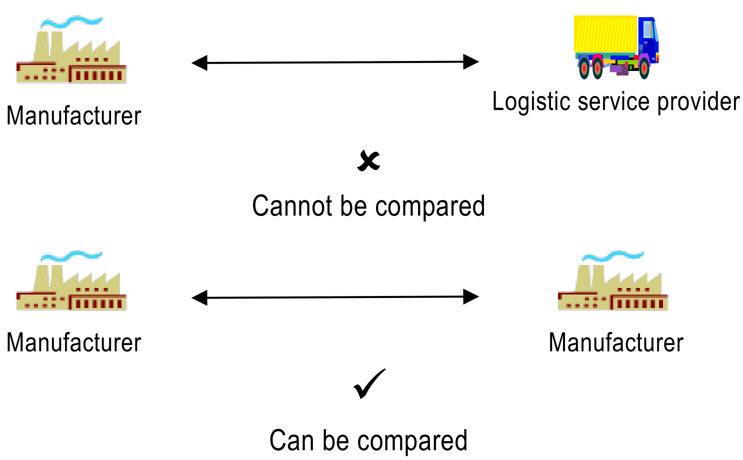
Functions, Assets and Risk ('FAR') analysis is an analysis of the functions performed, taking into account assets used and risks assumed by associated enterprises (AEs) in controlled transactions.

A method of finding and organizing facts about a business in terms of the functions performed, assets used (including intangible property) and risks assumed by such business to:

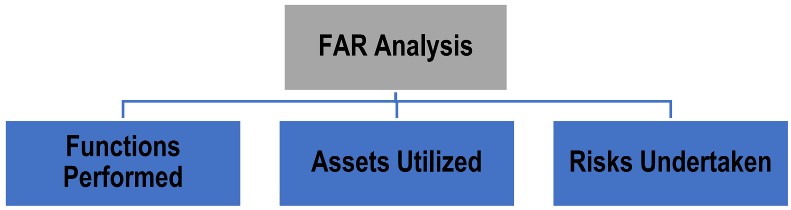
- identify how they are divided among the AEs; and
- assess the importance of each function in the overall value chain.

FAR analysis is the starting point in determining the arm's length price of an international transaction.

Let us take an example. Can we compare a manufacturer with a logistic service provider? The answer is "No". Both of them will perform different functions, employ different kind of assets and undertake different type of risks. How would one determine whether the entity is a manufacturer or a logistic service provider? Simply, by undertaking FAR analysis.



Components of a FAR analysis



The FAR analysis should direct the reader unambiguously to the correct conclusion about the characterization of the entity. For understanding the FAR, it is important to understand the entire value chain of the business that one is analyzing. A detailed discussion of the three elements of the FAR is as under:

(a) Functions performed: Functions performed are the activities that are carried out by each of the parties to the transaction. In performing functional analysis, important and significant functions are considered. Such functions add more value to the transactions and therefore, are expected to fetch higher returns for the entity performing such functions. Thus, the focus should not only be on identifying the maximum number of functions but on identification of critical functions performed by the related parties.

While functions performed depends on the facts of the case, some of the important functions that are generally observed and examined in a transaction are:

- Research and development
- Budgeting
- Purchasing and materials management
- Manufacturing, production or assembly work
- Warehousing and inventory
- Marketing and distribution
- Business process management/ administrative functions
- Scheduling
- Supervision

The above may differ based on the kind of entity for which one is undertaking FAR analysis. For example, in case of trading entity, the research & development related functions, or manufacturing related functions may not be present.

Having identified the principle functions performed by the parties in the controlled transaction, the next step is to compare the same with the functions performed in the uncontrolled transactions to determine the extent of comparability.

(b) Assets employed: As regards assets employed, one needs to identify the assets (tangible as well as intangible) used by the entities being compared in relation to the transaction under consideration. The analysis of assets employed into tangible assets and intangible assets is of vital importance.

The existence of intangible assets in the form of technical knowhow, trademarks, patents, etc. contribute to the super normal growth in profits of an enterprise.

However, an entity which owns only tangible assets which are used in normal course of operations such as computers, furniture & fixture, plant and machinery, etc. is expected to earn routine/normal profits as earned by other companies engaged in similar business.

(c) Risks assumed: Risk study involves identification of various risks that are assumed by each of the parties to the transaction. It is commonly understood that risk and return go hand in hand. In the open market, more the risks assumed by an enterprise, higher the returns that it expects. Conversely, in case where the risks undertaken by the enterprise in a transaction are minimal, the returns expected to be generated from such transactions should also normally be lower. An illustrative list of risks is provided below:

Nature of risks	Description
Market risk	Risk relating to increased competition and relative pricing pressures, change in demand patterns and needs of customers, inability to develop/penetrate in a market, etc.
Inventory risk	Risk associated with management of inventory in case of overstocking or slow/non-moving inventory. As a result, the enterprise may be forced to bear a loss of margin on the inventory, or incur additional costs to dispose-of the same.
Credit risk	Risk relating to default in receivables by customers.
Product liability risk	Risk associated with product failures including non-performance to generally accepted or regulatory standards. This could result in product recalls and possible injuries to end-users.
Foreign exchange risk	Risk relating to the potential impact on profits that may arise because of changes in foreign exchange rates.
R&D risk	Risk associated with loss incurred due to unsuccessful R&D expenditure
Capacity Utilization risk	Risk associated with loss of profits due to unutilized capacity
Attrition risk	Risk associated with losing trained personnel which contribute to the success of the enterprise

Risk study is an important exercise as it facilitates adjustments based on differences in risks that are undertaken in a controlled transaction as compared to uncontrolled transactions. A careful analysis of the risks assumed by the transacting entities would determine the true characterization of each of the parties to the transaction. For instance, a distributor solely engaged in purchasing goods for the purpose of resale without performing any value addition may be characterized as a low risk distributor whereas a distributor who performs significant value addition in terms of packing goods, holding inventory, incurring advertisement and promotional expenditure, undertaking market risk, etc. may be characterized as a 'full-fledged distributor'.

Conclusion

In practice, one cannot compare all the functions, risks and assets employed. Hence, a crucial step in the comparability analysis is the comparison of the "economically significant" functions performed, risks assumed and assets employed (i.e. such functions, assets and risks that are likely to have an impact on cost/expenses, prices, profits arising in a transaction) by the associated enterprises with those by the independent parties which have been selected as potentially comparable for benchmarking the arm's length price of the controlled transactions.

To summarize, FAR analysis is central/core to the transfer pricing analysis. It helps in:

- Determining the nature of functions performed by the taxpayer and AE(s);
- On the basis of the above, determining true and correct characterization of the entities;
- Providing guidance on selection of most appropriate method for transfer pricing analysis; and
- Determining parameters for establishing comparability and undertaking economic adjustments.

An illustrative list of functions, assets and risks for a different entities is provided below:

Type of entity	Functions	Assets	Risks
Manufacturer	- Budgeting - Administration - Product strategy and design - R&D - Purchasing - Product manufacturing - Quality control - Inventory management - Logistics - Marketing	- Intangibles – Patents, technical knowhow, trademarks, etc. - Plant & Machinery - Storage/ warehouse - Office equipment - Land & Building - Vehicles	- Business risk - Inventory risk - Scheduling risk - Product liability risk - Credit and collection risk - Foreign exchange fluctuation risk

	- Sales - Customer support		
Trader	- Budgeting - Administration - Purchasing - Inventory management - Logistics - Marketing - Sales - Customer support	- Storage/ warehouse - Office equipment - Land & Building - Vehicles	- Business risk - Inventory risk - Credit and collection risk - Foreign exchange fluctuation risk
Service provider	- Budgeting - Quality control - Conceptualization and design of services - Project management - Training - Invoicing	- Intangibles –, trademarks, brand name, etc. - Office equipment - Land & Building - Vehicles	- Business risk - Service liability risk - Utilization and idle time risk - Credit and collection risk - Foreign exchange fluctuation risk

The above list is only illustrative and will depend totally on the facts of the case. There can be further difference within the types of entities, such as Manufacturer (full-fledged manufacturer, contract manufacturer, and toll manufacturer), Trader (full-fledged trader, limited risk distributor), etc.

1.13 CONCEPT OF COMPARABILITY ADJUSTMENTS

An uncontrolled transaction should be considered comparable to the controlled transaction only if there are no material differences (in terms of functions, assets and risks) between the transactions being compared or the enterprises entering into such transactions which would materially affect the prices or costs charged or margins arising in such transactions in the open market.

Comparability adjustments can take various forms. Some examples of prevalent comparability adjustments are provided below:

Nature of comparable adjustment	Description
Working capital adjustment	The levels of inventories, cash on hand, debtors, creditors, other current assets and liabilities impact the level of free reserves that the company has to fulfill its day-to-day working capital requirements and the consequent levels of borrowings it needs to make to fund its working capital requirements. The extent to which companies extend and receive credit in the form of accounts payable and receivable affects their sales and cost of sales. The

	selling price incorporates two elements: the price of the product and the time value of money lent. Presumably, if a company were to make all sales on a cash basis, it would be willing to accept a slightly lower price for its products than if the company were to allow its customers to pay at a later date. Of course, the argument works in reverse for companies that hold accounts payable For example, two companies sell the same product for the same base price, but one company sells the product on a cash basis while the other extends credit and charges a slightly higher price above the base price to cover the time value of money lent to the customer. Without an adjustment for the different terms of sale, it would appear that the company that sold its product for cash earned a lower gross margin than the other firm When different terms of purchase and sale distort the cost of goods sold, analysis of related party transactions can also be distorted. As a result, the cost of goods sold and sales of the comparable companies needs to be adjusted so that the terms of purchase and sale are same across all the companies A working capital adjustment is undertaken to adjust the margins of the comparable companies and align them with the tested party
Capacity Utilization adjustment	This adjustment is to bring entities with different level of capacity utilization at par with each other for comparison purpose. Capacity utilization by enterprises is an essential factor affecting net profit margin in open market because lower capacity utilization results in higher per unit cost, which, in turn results in lower profits. For example, if an entity A Ltd. is utilizing 50% of its capacity while entity B Ltd. is operating at full capacity, it may not be appropriate to compare A Ltd. and B Ltd. without undertaking this adjustment. The level of capacity utilization of the resources (plant and machinery, fixed assets, etc.) impacts the direct and fixed costs of the company. For example, if a company has high installed capacity but less utilized capacity, it shall be incurring heavy fixed costs and not earning proportionate revenue for the same. This in effect, impacts the profitability of the company. A capacity utilization adjustment is undertaken to eliminate such differences in the profitability of the tested party and the comparable companies.
Risk adjustments	Risk adjustment is mainly relevant in case of captive entities (entities providing services or selling goods **only** to its associated enterprises) or low risk bearing entities. For comparison of tested party with comparable companies, risk profiles of each of them should ideally be similar. The comparables that would be identified might have different risk profiles as compared to tested party and in case the difference is material, adjustment would be required. Accordingly, risk adjustment is made to

	adjust for the difference in the level of risks assumed by the tested party and comparables.
Accounting adjustments	This adjustment is carried out to bring the entity being compared at par with the taxpayer in terms of differences in accounting policies being followed.

1.14 DOCUMENTATION AND COMPLIANCES

(1) Documentation requirement under the Income-tax Act, 1961

Transfer pricing documentation is the documentation maintained to review Transfer Pricing arrangements for transactions taking place between different entities of the same group (also known as intra-group transactions). The primary objective of the transfer pricing documentation is to review the arm's length (fair price) nature of the transactions taking place between different entities of an Multi National Company.

(1) Persons responsible for keeping and maintaining prescribed information and document - *Section 92D imposes responsibility on every person*

(i) who ***enters into an international transaction*** *to keep and maintain such information and documents in respect thereof as may be prescribed by CBDT*

(ii) being a ***constituent entity of an international group****, to keep and maintain the prescribed information and document* ***in respect of an international group****.*

The constituent entity is required to keep and maintain the information and document irrespective of the fact ***whether or not any international transaction is undertaken*** *by such constituent entity.*

The constituent entity has to furnish the information and document to the authority prescribed under section 286(1), i.e., Director General of Income-tax (Risk Assessment) in the prescribed manner, on or before prescribed date

(2) Information and documents to be kept and maintained for prescribed period *- The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained.*

(3) Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to furnish prescribed information and documents *- The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of* ***30 days*** *from the date of receipt of a notice issued in this regard. The requisition period may, on request, be extended further for a period not exceeding thirty days by the Assessing Officer or the Commissioner (Appeals).*

(2) Information and documents to be kept and maintained under section 92D [Rule 10D]

As per Rule 10D(1) of the Income-tax Rules, 1962, the transfer pricing documentation requirement under section 92D(1)(i) should contain the following details:

(a) Ownership structure of the assessee with details of shares or other ownership interest held therein by other enterprise;

(b) Profile of the multinational group and basic details of associated enterprises with whom assessee has entered into international transaction;

(c) Business description of the business of the assessee and associated enterprises and the industry in which the assessee operates;

(d) Nature and terms (including price) of the international transactions, details of property transferred or services provided and quantum and value of each such transaction;

Entity Related

(e) Description of functions performed, risks assumed and assets employed by the assessee and associated enterprises;

(f) Records of economic and market analysis, budgets, forecasts, financial estimates for the business as a whole and for each division or product separately which may have a bearing on such transaction;

(g) Record of uncontrolled transaction (if any) for analysing comparability of international transaction with such uncontrolled transaction(s);

(h) Record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction or specified domestic transactions.

(i) Description of method considered for determining ALP, most appropriate method along with the explanations as to why such method was selected and applied;

(j) Analysis performed to determine the arm's length price of the transactions between related parties, etc.

Price Related

(k) Assumptions, policies and price negotiations, if any, which critically affected the determination of the arm's length price;

(l) Details of transfer pricing adjustment(s) made (if any) and consequent adjustment made to the total income for tax purposes.

(m) Any other information, data or document including information or data relating to associated enterprise which may be relevant for determining ALP.

Transaction Related

Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed ₹ 1 crore, it will not be obligatory for the assessee to maintain the above information and documents.

However, it is provided that in the above cases also the assessee will have to substantiate that the income arising from the international transactions with associated enterprises, as disclosed by the accounts, is in accordance with section 92. This will mean that, even if the aggregate value of the international transactions is less than ₹ 1 crore, the assessee will have to maintain adequate records and evidence to show that the international transactions with associated enterprises are on the basis of arm's length principle.

Information to be supported by authentic documents [Rule 10D(3)]

The information to be maintained by the assessee, is to be supported by authentic documents. These documents may include the following:

(i) Official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;

(ii) Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;

(iii) Price publications including stock exchange and commodity market quotations;

(iv) Published accounts and financial statements relating to the business affairs of the associated enterprises;

(v) Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

(vi) Letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

(vii) Documents normally issued in connection with various transactions under the accounting practices followed.

It is also provided that the information and documents to be maintained should be contemporaneous and should exist latest by the date specified for getting the audit report. In the case of international transactions which continue to have effect over more than one financial year, fresh documents will not be required to be maintained for each year if there are no significant change which may affect the determination of arm's length price.

The above information and documents are required **to be maintained for a period of eight years** from the end of the relevant assessment year.

(3) Structure of Transfer Pricing documentation

The illustrative structure of Transfer Pricing Study can be summarized as below:

Executive Summary	Group Overview	Industry analysis	Functional analysis	Economic analysis	Conclusion
• Brief description of the business profile of the overall group • Brief description of the business profile of the assesse including AE with whom the company has undertaken international taxation • Overview of international and specified domestic transactions	• Brief description of the Group's business activities/operations/division • Brief overview of the nature of business operations of the assesse • Factual informational of the Group during relevant period such as turnover, number of employees etc. • Information pertaining to various products and services offered by the group • Significant development during the year and etc.	• Background of the industry • Key drivers • Challenges • Future outlook	• Functions performed • Assets utilized • Risks assumed	• Search process • Comparable details	• High level summary of the Transfer Pricing study including transact-tions involving Most appropriate method etc.

(a) Executive Summary

The Executive summary section of the Transfer Pricing documentation captures high level analysis of the entire Transfer Pricing documentation and summarizes the results of benchmarking analysis performed to determine arm's length price of the international transaction(s) undertaken during the relevant period.

(b) Group Overview

This section includes a brief description of Group's as well as the taxpayer's business operations.

How to source the information?

- The annual report of the Group is considered to be the most reliable and authentic source for information pertaining to nature of business operations, shareholding structure, products and services offered, etc.
- In case of unavailability of annual report, reliance could be placed upon other sources such as website of the Group, reference websites, publicly available databases like Prowess, Capitaline, etc.

The Group overview could be illustrated by way of the following example:

Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

In the instant case, the Group overview would include the following broad headings:

Brief description of the business operations of the Group – including range of products/services offered, geographical presence, sales trend during past years, etc.

Brief description of business operations of Associated Enterprise 1 and Associated Enterprise 2 – including details of products/services offered, date of incorporation, regional presence, shareholding pattern/structure, etc.

(c) Industry Overview

This section provides an understanding of the taxpayer/company's relative positioning in the industry *vis-à-vis* other players and overall justification of the taxpayer's financial results. The key objectives of industry overview are to:

- Determine taxpayer's position within the industry;
- Provide information about the market share of the client;
- Establish linkage of industry overview with functional and economic analysis;
- Highlight the key growth drivers of the industry;
- Determining threats/challenges and opportunities pertaining to the industry; and
- Provide information about past trends and future projections of the industry.

The industry overview could be illustrated by way of following example:

Continuing the same example as above, where Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2, the following broad heads could be included while drafting the industry overview:

Industry structure – Types of bicycles produced and sold in the market, market size, demand-supply gap analysis, etc.

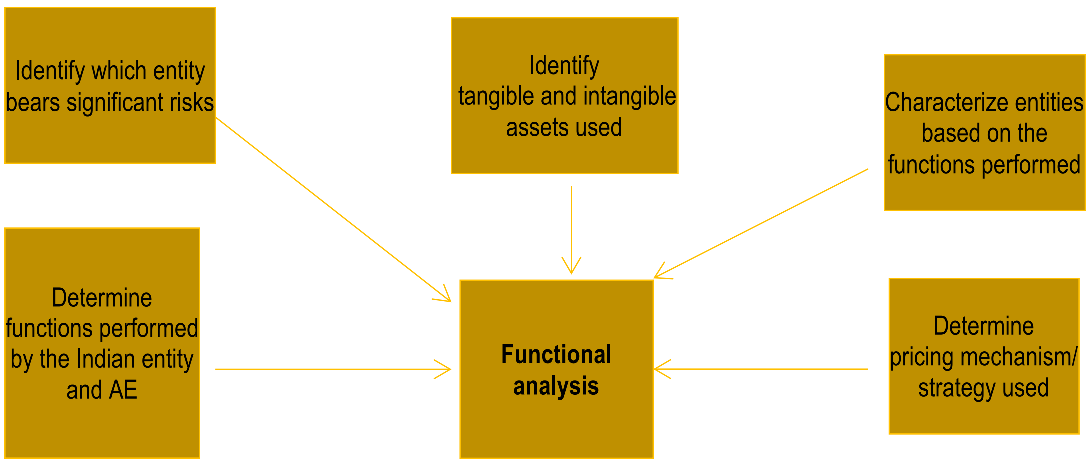
Characteristics of bicycle industry – Distribution channels, brief overview of legal regulations affecting the industry, factors affecting demand, sales trend of each category of bicycles relating to past 5-6 years, factors affecting demand, etc.

Key growth drivers of the industry and the potential regulatory as well as competitive threats affecting the industry, complete SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the industry

Way forward – Future projections pertaining to industry growth and potential challenges anticipated

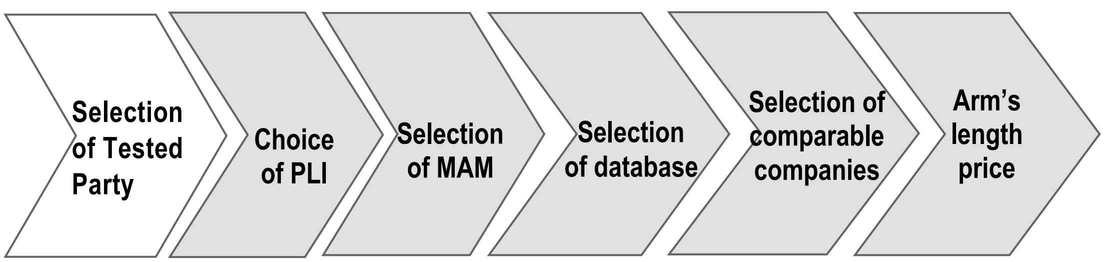
(d) Functional Analysis

As discussed earlier in detail, for every international transaction, the following analysis needs to be undertaken:



(e) Economic Analysis

Economic (or Benchmarking) analysis means analyzing or comparing the transfer price i.e. prices set in controlled environment with that of uncontrolled environment. This would broadly involve the following steps:



The entire benchmarking process is illustrated with the help of following example:

Facts of the case: AE 1, a bicycle manufacturer in Country 1, sells bicycles to AE 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2.

Let AE 2 be selected as the tested party and TNMM be selected as the most appropriate method. The most appropriate PLI is 'Operating Profit/Sales'.

For benchmarking the international transaction pertaining to import of bicycle by AE 2, the following steps need to be undertaken:

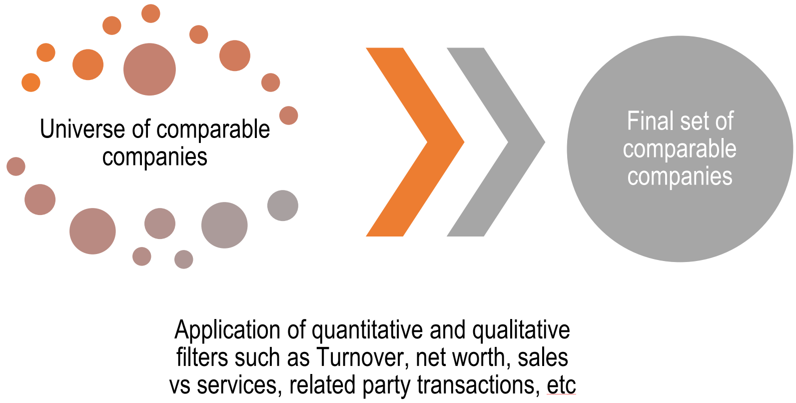
- **Selection of time period:** The Act prescribes the use of current year data in which the transaction has been undertaken. However, if the data for current year is not available for comparable companies at the time of furnishing return of income by the assesse for the assessment year, the taxpayer may consider data relating to the financial year immediately preceding the current year.

- **Undertaking search for comparables:** Assuming that in the above case study, Associated Enterprise 2 i.e. the tested party is situated in India, the search for comparable companies engaged in the business of distribution of bicycles could be undertaken by using databases such as Prowess, Capitoline, etc. Illustratively, the selection of comparables would involve application of common filters such as:

    1. Selection of comparables having sales greater than ₹ 1 crore;
    2. Selection of comparables having net worth greater than 0 (zero);
    3. Selection of comparables having trading sales/total sales greater than 50%;
    4. Selection of comparables having segment related to bicycle sales;
    5. Rejection of comparables having Related party transactions/Sales > 25%; and/or (Illustrative)
    6. Qualitative criteria: Selection of comparables engaged in distribution of bicycles.

If required, the appropriate adjustments could be carried out to account for differences in the type and quality of products, risk incurred, geographical factors, etc.

The process of selection of comparables can be illustrated as under:

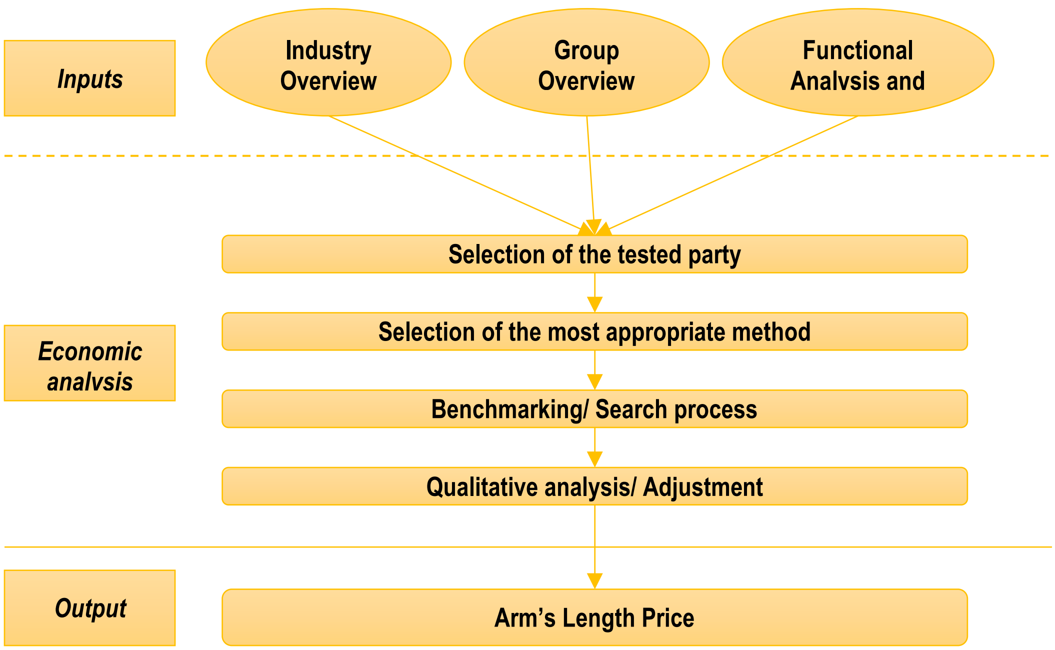


(f) Conclusion

The Conclusion section of Transfer Pricing documentation captures high level summary of the Transfer Pricing documentation, primarily including the transactions involved, most appropriate method and PLI used and the results of the benchmarking analysis.

In case the tested party is incurring losses, the justification for the same is included in this section.

Summary of Transfer Pricing Documentation



(4) Audit Report [Section 92E]:

Under section 92E, every person who enters into an international transaction during a previous year is required to obtain a report from a chartered accountant and furnish such report on or before the specified date on the prescribed form.

Rule 10E provides that the auditor's report shall be in Form No.3CEB. It requires the auditor to state that he has examined the accounts and records of the assessee relating to the international transactions entered into by the assessee during the relevant year. He has also to give his opinion whether the prescribed information and documents relating to the above transactions have been kept by the assessee. Further, he has to state that the particulars stated in the Annexure to his report are true and correct. The Annexure is in two parts.

In the first part of the Annexure, general information of the assessee is required to be reported. In the second part of the Annexure, the particulars about the international transactions are required to be stated. Broadly stated these particulars include list of associated enterprises, particulars and description of transactions relating to purchase, sales, provisions of service, loans, advances, etc.

"Specified date" shall have the same meaning as assigned to due date in *Explanation 2* below sub-section (1) of section 139. The due date for filing of transfer pricing report under section 92E in Form 3CEB is 30th November of the assessment year.

(5) Penalties

Stringent penalties are provided in various sections for non-compliance with the above provisions. These are as under:

Penalty for failure to report any international transaction or any transaction deemed to be an international transaction: Under section 270A, penalty@50% of tax payable on under-reported income is leviable. However, the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer would not be included within the scope of under-reported income under section 270A, where the assessee had maintained information and documents, as prescribed under section 92D, declared the international transactions under Chapter X and disclosed all material facts relating to the transaction.

Failure to report any international transaction or any transaction deemed to be an international transaction to which the provisions of Chapter X applies would constitute **'misreporting of income'** under section 270A(9), in respect of which penalty@200% would be attracted.

Penalty for failure to keep and maintain information and documentation [Section 271AA]: In order to ensure compliance with the transfer pricing regulations, section 271AA provides that, the Assessing Officer or Commissioner (Appeals) may direct the person entering into an international transaction to pay a penalty@2% of the value of each international transaction entered into by him, if the person:

(1) fails to keep and maintain any such document and information as required by section 92D(1) or section 92D(2);

(2) fails to report such international transaction which is required to be reported; or

(3) maintains or furnishes any incorrect information or document.

Penalty for failure to furnish information or document under section 92D [Section 271G]

Section 271G provides that if any person who has entered into an international transaction fails to furnish any such information or document as required by Assessing Officer or TPO or Commissioner (Appeals) within a period of 30 days from the date of receipt of a notice issued in this regard, then such person shall be liable to a penalty up to 2% of the value of each international transaction.

Penalty for failure to furnish report under section 92E [Section 271BA]

If any person fails to furnish a report from an accountant, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of ₹ 1 lakh.

	Penalty for failure to comply with TP provisions : A Summary	
Section	**Nature of default**	**Penalty**
270A(9)	Failure to report any International transaction or deemed International transaction to which the provision of Chapter X applies would constitute 'misreporting of income'	200% of the tax payable on under-reported income
271BA	Failure to furnish a report from an accountant as required under section 92E	₹ 1 lakh
271G	Failure to furnish info or doc as required by Assessing Officer or CIT(A) u/s 92D(3) within 30 days from the date of receipt of notice or extended period not exceeding 30 days, as the case may be.	2% of the value of the International transaction for each failure
271AA	(1) Failure to keep and maintain any such document and information as required by section 92D(1)/(2); (2) Failure to report such International transaction which is required to be reported; or (3) Maintaining or furnishing any incorrect information or document.	2% of the value of each such International transaction

Notes:

- ***The penalty u/s 271AA shall be in addition and not in substitution of penalty u/s 271BA.***
- ***If the assessee proves that there was reasonable cause for the failure, no penalty would be leviable under section 271BA, 271G and 271AA.***

1.15 SPECIFIC REPORTING REQUIREMENTS – COUNTRY BY COUNTRY REPORTING

(i) Requirements as per OECD report on Action 13 of BEPS Action Plan

The report provides for:

(a) revised standards for transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

(ii) Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

	Document	Information
(1)	Master File	Standardised information relevant for all multinational enterprises (MNE) group members
(2)	Local file	Specific reference to material transactions of the local taxpayer
(3)	Country-by-country report	Information relating to the global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group.

(iii) Advantages of the three tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;

(b) Tax administrations would get useful information to assess transfer pricing risks;

(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

(iv) Country-by-country Report: Reporting Requirements of MNEs

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:

(1) the amount of revenue;

(2) profit before income tax; and

(3) income tax paid and accrued.

(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

(c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

(v) Master File: Objective & Features

(a) The master file would provide an overview of the MNE groups business, including:

(1) the nature of its global business operations,

(2) its overall transfer pricing policies, and

(3) its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

(vi) Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

(vii) Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [Section 286]

(a) **Threshold limit for applicability of CbC reporting [Sub-section (7)]:** The reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement (CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed i.e., ₹ 5,500 crore.

Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the calculation of the value in rupees of such total consolidated group revue shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year preceding the accounting year [Rule 10DB(7)].

(b) **Time limit for furnishing CbC report [Sub-section (2)]:** The parent entity of an international group or the alternate reporting entity, if it is resident in India shall be required to furnish the report in respect of the group to the Director General of Income-tax (Risk Assessment) for every reporting accounting year, within a period of twelve months from the end of the said reporting accounting year for which the report is being furnished, in Form No. 3CEAD.

(c) **Details to be furnished by constituent entity resident in India [Sub-section (1)]:** Every constituent entity, resident in India, of an international group having parent entity that is not resident in India, shall notify the Director General of Income-tax (Risk Assessment) at least two months prior to the due date for furnishing Cbc report –

(1) whether it is the alternate reporting entity of the international group; or

(2) the details of the parent entity or the alternate reporting entity, if any of the international group, and the country of territory of which the said entities are resident.

The report shall be furnished in Form No. 3CEAC.

(d) **Details/ information to be included in CbC report [Sub-section (3)]:** It should contain aggregate information in respect of:

(1) the amount of revenue,

(2) profit and loss before income-tax,

(3) amount of income-tax paid and accrued,

(4) details of stated capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent's incorporation country and residential status, nature and details of main business activity or activities of each constituent entity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13.

(e) **Furnishing of CbC report by resident constituent entity [Sub-section (4):** A constituent entity of an international group resident in India, other than the parent entity or the alternate reporting entity, shall be required to furnish CbC report in Form No. 3CEAE within the **twelve months from the end of the reporting accounting year** to the Director General of Income-tax (Risk Assessment), if the parent entity of the group is resident of a country or territory,-

(1) in which it is not obligated to file report of the nature of CbC report;

(2) with which India does not have an arrangement for exchange of the CbC report; or

(3) there has been a systemic failure of the country or territory i.e., such country is not exchanging information with India even though there is an agreement and this fact has been intimated to the entity by the prescribed authority.

However, in case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report would be ***six months from the end of the month in which said systemic failure has been intimated****.*

(f) **Nomination of one constituent entity for furnishing CbC report [Proviso to sub-section (4)]:** If there are more than one such constituent entity of the group, resident in India, other than the parent entity or the alternate reporting entity, then the group can nominate (under intimation in writing on behalf of the group to the prescribed authority), then, one constituent entity that shall furnish the report on behalf of the group. This entity would then furnish the report.

(g) **No obligation to furnish CbC report in certain cases [Sub-section (5)]:** If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident and such alternate entity has furnished such report on or before the date specified by that country or territory, then, the entities of such group operating in India would not be obliged to furnish report if

- the report is required to be furnished under the law for the time being in force in the said country or territory
- the report can be obtained under the agreement of exchange of such reports by Indian tax authorities
- No systemic failure in respect of the said country or territory has been conveyed to any constituent entity of the group that is resident in India
- the said country or territory has been informed in writing by the constituent entity that it is the alternative reporting entity on behalf of the international group
- the same has been informed to the prescribed authority by the entity in accordance with section 286(1).

(h) **Entity to furnish documents and information called for [Sub-section (6)]:** The DGIT (Risk Assessment) may call for such document and information from the entity furnishing the report as it may specify in notice in writing for the purpose of verifying the accuracy. The entity shall be required to make submission within thirty days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.

(viii) Penalty for non-furnishing of the report by any reporting entity which is obligated to furnish such report [Section 271GB(1) & (3)]

	Period of delay/default	Penalty
(a)	Not more than a month	₹ 5,000 per day
(b)	beyond one month	₹ 15,000 per day for the period exceeding one month
(c)	Continuing default even after service of order levying penalty either under (a) or under (b)	₹ 50,000 per day of continuing failure beginning from the date of service of order

(ix) Penalty for failure to produce information and documents within prescribed time [Section 271GB(2) & (3)]

	Default	Penalty
(a)	Failure to produce information and documents before prescribed authority within the period allowed u/s 286(6)	₹ 5,000 per day of continuing failure, from the day immediately following the day on which the period for furnishing the information and document expires.
(b)	Continuing default even after service of penalty order	₹ 50,000 per day for the period of default beyond the date of service of order.

(x) Penalty for submission of inaccurate information in the CBC report [Section 271GB(4)]

If the reporting entity has provided any inaccurate information in the report, the penalty would be ₹ 5,00,000 if ,-

(a) the entity has knowledge of the inaccuracy at the time of furnishing the report but does not inform the prescribed authority; or

(b) the entity discovers the inaccuracy after the report is furnished and fails to inform the prescribed authority and furnish correct report within a period of fifteen days of such discovery; or

(c) the entity furnishes inaccurate information or document in response to notice of the prescribed authority under section 286(6).

(xi) Non-levy of penalty if reasonable cause for failure is proved [Section 273B]

Section 273B provides for non-levy of penalty under various sections if the assessee proves that there was reasonable cause for such failure. Section 271GB has been included within the scope of section 273B. Therefore, the entity can offer reasonable cause defence for non-levy of penalties mentioned above.

(xii) Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961

	Section	Provision
(1)	92D(1)(ii)	***Every person, being constituent entity of an international group, has***

		to keep and maintain the prescribed information and document in respect of the international group. Constituent entity has to keep and maintain such prescribed information and document irrespective of the fact whether or not any international transaction is undertaken by such constituent entity. The rules shall, thereafter, prescribe the information and document as mandated for master file under OECD BEPS Action 13 report;
(2)	92D(4)	The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules
(3)	271AA(2)	For non-furnishing of the information and document to the prescribed authority, a penalty of ₹ 5 lakh shall be leviable.
(4)	273B	Reasonable cause defence against levy of penalty shall be available to the entity.

(xiii) Meaning of certain terms [Section 286(9)]

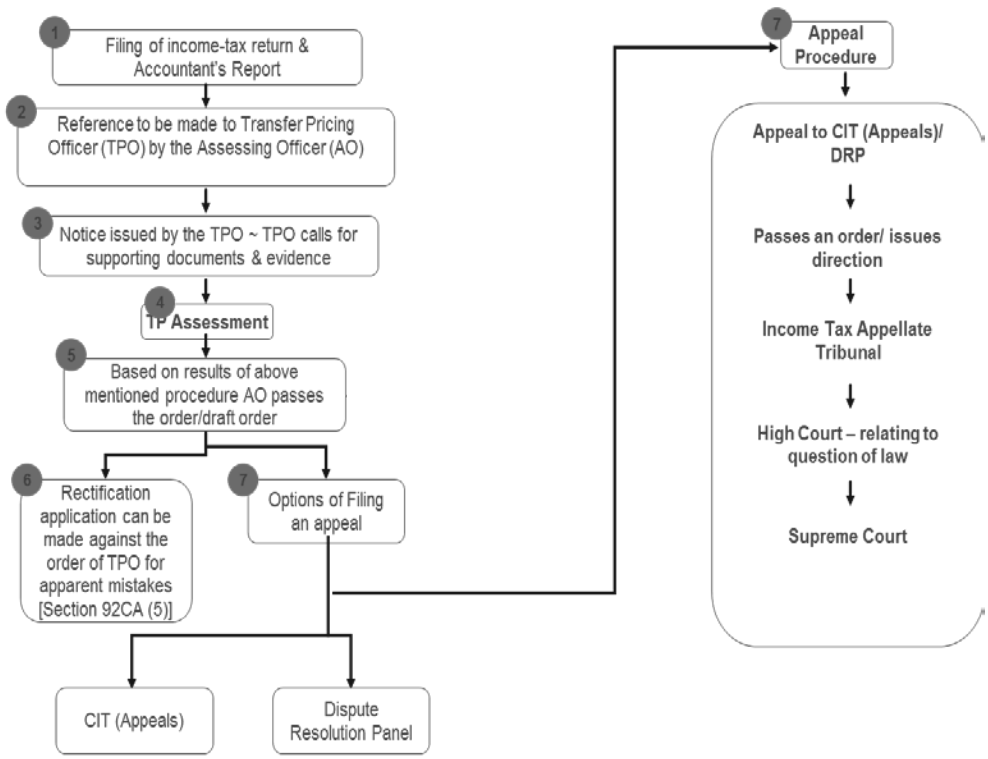
<table>
<tr><th></th><th>Term</th><th>Meaning</th></tr>
<tr><td>(a)</td><td>Accounting year</td><td><table><tr><th>Case</th><th>Accounting year</th></tr><tr><td>In a case where the parent entity is resident in India; or</td><td>A previous year</td></tr><tr><td>In any other case</td><td>An annual accounting period, with respect to which the parent entity of the international group prepares its financial statements under any law for the time being in force or the applicable accounting standards of the country or territory of which such entity is resident</td></tr></table></td></tr>
<tr><td>(b)</td><td>Agreement</td><td>A combination of all of the following agreements, namely –
(i) an agreement referred to in section 90(1) or section 90A(1); or
(ii) an agreement for exchange of the CbC report referred to in section 286(2) as may be notified by the Central Government.</td></tr>
<tr><td>(c)</td><td>Alternate reporting entity</td><td>Any constituent entity of the international group that has been designated by such group, in the place of the parent entity, to furnish the CbC report in the country or territory in which the said constituent entity is resident on behalf of such group.</td></tr>
<tr><td>(d)</td><td>Constituent entity</td><td>(i) any separate entity of an international group that is included in the consolidated financial statement of the said group for financial reporting purposes, or may be so included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange;
(ii) any such entity that is excluded from the consolidated financial statement of the international group solely on the basis of size or materiality; or</td></tr>
</table>

		(iii) any permanent establishment of any separate business entity of the international group included in sub clause (i) or sub clause (ii), if such business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting or internal management control purposes
(e)	Group	This includes a parent entity and all the entities in respect of which, for the reason of ownership or control, a consolidated financial statement for financial reporting purposes,— (i) is required to be prepared under any law for the time being in force or the accounting standards of the country or territory of which the parent entity is resident; or (ii) would have been required to be prepared had the equity shares of any of the enterprises were listed on a stock exchange in the country or territory of which the parent entity is resident.
(f)	Consolidated financial statement	The financial statement of an international group in which the assets, liabilities, income, expenses and cash flows of the parent entity and the constituent entities are presented as those of a single economic entity
(g)	International group	Any group that includes,— (i) two or more enterprises which are resident of different countries or territories; or (ii) an enterprise, being a resident of one country or territory, which carries on any business through a permanent establishment in other countries or territories;
(h)	Parent entity	A constituent entity, of an international group holding, directly or indirectly, an interest in one or more of the other constituent entities of the international group, such that,— (i) it is required to prepare a consolidated financial statement under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or (ii) it would have been required to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange, and, there is no other constituent entity of such group which, due to ownership of any interest, directly or indirectly, in the first mentioned constituent entity, is required to prepare a consolidated financial statement, under the circumstances referred to in sub clause (i) or sub clause (ii), that includes the separate financial statement of the first mentioned constituent entity.
(i)	Permanent establishment	Meaning assigned to it in clause (iiia) of section 92F i.e., includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.
(j)	Reporting accounting	The accounting year in respect of which the financial and operational results are required to be reflected in the report to be furnished every year by the parent entity or the alternate reporting entity, resident in India, in respect of

	year	the international group of which it is a constituent under section 286(2) or by a constituent entity of an international group referred to in section 286(4).
(k)	Reporting entity	The constituent entity including the parent entity or the alternate reporting entity, that is required to furnish a report referred to in section 286(2) and 286(4).
(l)	Systemic failure	Systemic failure, with respect to a country or territory, means that the country or territory has an agreement with India providing for exchange of report of the nature referred to in section 286(2), but— (i) in violation of the said agreement, it has suspended automatic exchange; or (ii) has persistently failed to automatically provide to India the report in its possession in respect of any international group having a constituent entity resident in India

1.16 TRANSFER PRICING ASSESSMENT

Transfer pricing assessment procedure in India is captured graphically as below:



(1) Power of Assessing Officer to determine ALP [Section 92C(3) & (4)]

Section 92C(3) and (4) gives power to the Assessing Officer to determine the arm's length price under the following circumstances and also empowers the Assessing Officer to re-compute total income of the assessee having regard to arm's length price determined by him. It also provides that deduction under section 10AA and Chapter VI-A shall not be allowed from the additional income computed by him.

For example, if the total income declared by the assessee in his return of income is, say ₹ 7 lakhs and the total income computed by the Assessing Officer applying the arm's length principle is, say ₹ 9 lakhs, the difference of ₹ 2 lakhs will not qualify for deduction under section 10AA or Chapter VI-A.

The Assessing Officer may invoke the power to determine arm's length price if during the course of any proceeding, he is of the opinion that, on the basis of material or information or documents in his possession:

(a) The price charged or paid in an international transaction has not been determined in accordance with section 92C(1) and (2); or

(b) Any information and documents relating to an international transaction has not been kept and maintained by the assessee in accordance with the provisions contained in section 92D(1) and the rules made in this behalf (Rule 10D); or

(c) The information or data used in computation of the arm's length price is not reliable or correct; or

(d) The assessee has failed to furnish within the specified time, any information or documents which he was required to furnish by a notice issued under section 92D(3).

Before invoking the power to determine arm's length price, an opportunity of being heard is to be given to the assessee.

Second proviso to section 92C(4) provides that if the total income of an associated enterprise is computed under this section on the determination of arm's length price paid to another associated enterprise, from which tax is deducted or deductible at source, the income of the other associated enterprise shall not be recomputed on this count.

For example, if "A" Ltd. has paid royalty to "B" Ltd. (Non-Resident) @10% of sales and tax is deducted at source, "B" Ltd. cannot claim refund if the Assessing Officer has determined 8% as arm's length price in the case of "A" Ltd. and disallowed 2% of the royalty amount.

Bright Line Test – To cater to the Indian market, MNC sets up subsidiaries in India. The Indian subsidiaries act as a distributor/provider of goods/services and generally incurred certain expenses, which are popularly known as Advertisement, marketing and sale promotion expenditure (**"AMP expenses"**) for marketing and promotion of the products imported by them.

The intellectual property rights (**"IPR"**) in products/services and the brands lies with the parent entities. To test that whether the transaction is at ALP or not and to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India, Revenue Authorities' sometimes adopt the Bright Line Test (**"BLT"**). The issue under consideration is whether bright line test can be used by the Assessing Officer to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India.

The Delhi High Court, in *Bausch & Lomb Eyecare (India) (P.) Ltd. v. Addl. CIT [2016] 381 ITR 227*, held that advertisement expense is not an international transaction and there is no machinery provision for computation of AMP expense adjustment.

In *Sony Ericsson Mobile Communications India (P) Ltd v. CIT (2015) 374 ITR 118*, the Delhi High Court held that bright line test has no statutory mandate and a broad-brush approach is not mandated or prescribed. It further opined that the exercise to separate “routine” and “non-routine” advertising, marketing and promotion or brand building exercise by applying the bright line test of non-comparables should not be sanctioned.

Applying the rationale of the above rulings of the High Court, the Revenue Authorities' are not justified in adopting the “Bright Line Test” for disallowing or adjusting the advertisement expenditure in computing arm’s length price.

(2) Reference to Transfer Pricing Officer [Section 92CA]

This section provides for a procedure for reference to a Transfer Pricing Officer (TPO) of any issue relating to computation of arm’s length price in an international transaction. The procedure is as under -

(i) The option to make reference to TPO is given to the Assessing Officer. Where the assessee has entered into an international transaction in any previous year and if Assessing Officer considers it necessary or expedient to do so he may refer the computation of the arm’s length price in relation to the said international transaction to the TPO. This option is not, however, available to the assessee.

(ii) The Assessing Officer has to take the approval of the Principal Commissioner of Income-tax (PCIT)/Commissioner of Income-tax (CIT) before making such a reference.

(iii) Any Joint/ Deputy/Assistant Commissioner of Income-tax, authorised by CBDT, can be appointed as TPO.

(iv) When such reference is made, TPO would serve a notice to the assessee requiring him to produce on a date specified in the notice, any evidence on which the assessee relied in support of the computation of arm’s length price made by him in relation to the international transaction.

(v) The TPO can also determine the ALP of other international transactions identified subsequently in the course of proceedings before him as if such transaction is referred to the TPO by the Assessing Officer under section 92CA(1) [Sub-section (2A)].

(vi) Where in respect of an international transaction, the assessee has not furnished the report under section 92E and such transaction comes to the notice of the TPO during the course of proceeding before him, the transfer pricing provisions shall apply as if such transaction is referred to the TPO by the Assessing Officer under section 92CA(1) [Sub-section (2B)].

(vii) The TPO has to pass an order determining the arm's length price after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. He has to send a copy of his order to Assessing Officer as well as the assessee.

(viii) The order of the Transfer Pricing Officer determining the arm's length price of an international transaction is binding on the Assessing Officer and the Assessing Officer shall proceed to compute the total income in conformity with the arm's length price determined by the Transfer Pricing Officer [Sub-section (4)].

(ix) In order to provide sufficient time to the Assessing Officer to complete the assessment in a case where reference is made to the Transfer Pricing Officer, section 92CA(3A) provides for determination of arm's length price of international transactions by the Transfer Pricing Officer at least 60 days before the expiry of the time limit under section 153 or section 153B for making an order of assessment by the Assessing Officer. This provision would apply in a case where reference is made on or after 1.6.2007 or in a case where reference is made before that date but the order of the Transfer Pricing Officer is pending on that date [Sub-section (3A)].

(x) In many cases, it becomes necessary to seek information from foreign jurisdictions for the purpose of determining the arm's length price by the TPO. At times, proceedings before the TPO may also be stayed by a court order.

Taking into consideration such cases, it has been provided that where assessment proceedings are stayed by any court or where a reference for exchange of information has been made by the competent authority under an agreement referred to in section 90 or 90A, the time available to the Transfer Pricing Officer for making an order after excluding the time for which assessment proceedings were stayed or the time taken for receipt of information, as the case may be, is less than 60 days, then, such remaining period shall be extended to 60 days.

(xi) The TPO has power to rectify his order under section 154 if any mistake apparent from the record is noticed. If such rectification is made, the Assessing Officer has to rectify the assessment order to bring it in conformity with the same.

(xii) The TPO can exercise all or any of the powers specified in clause (a) to (d) of section 131(1) or section 133(6) or section 133A for determination of arm's length price once the above reference is made to him.

(3) Secondary adjustment [Section 92CE]

(i) Meaning of Primary Adjustment and Secondary Adjustment

"Primary adjustment" to a transfer price means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the assessee.

"Secondary adjustment" means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee.

(ii) **Forms of Secondary Adjustment** - As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD transfer pricing guidelines), secondary adjustment may take the form of constructive dividends, constructive equity contributions, or constructive loans.

(iii) **Alignment of economic benefit of the transaction with the arm's length position** - The provisions of secondary adjustment are internationally recognised and are already part of the transfer pricing rules of many leading economies in the world. Whilst the approaches to secondary adjustments by individual countries vary, they represent an internationally recognised method to align the economic benefit of the transaction with the arm's length position.

(iv) **Cases where secondary adjustment has to be made** - In order to align the transfer pricing provisions in line with OECD transfer pricing guidelines and international best practices, section 92CE provides that the assessee shall be required to carry out secondary adjustment where the primary adjustment to transfer price:

(a) has been made *suo motu* by the assessee in his return of income; or

(b) made by the Assessing Officer has been accepted by the assessee; or

(c) is determined by an advance pricing agreement entered into by the assessee under section 92CC ***on or after the 1.4.2017***; or

(d) is made as per the safe harbour rules framed under section 92CB; or

(e) is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or 90A for avoidance of double taxation.

(v) **No requirement of secondary adjustment in certain cases -** Such secondary adjustment, however, shall not be carried out if, the amount of primary adjustment made in the case of an assessee in any previous year does not exceed ₹ 1 crore **or** the primary adjustment is made in respect of A.Y.2016-17 or an earlier assessment year.

(vi) **Non-repatriation of excess money by the associated enterprise deemed to be an advance -** Where, as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the assessee, the excess money ***or part thereof, as the case may be***, which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed as the income of the assessee, in the prescribed manner.

Such excess money or part thereof may be repatriated from any of the associated enterprises of the assessee which is not resident in India.

*"**Excess money**" means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually taken place.*

(vii) **Time limit for repatriation of excess money or part thereof**

Rule 10CB(1) prescribes the time limit for repatriation of excess money i.e., on or before **90 days** from the date given in column (3) in the cases mentioned in column (2) of the table below:

	Case	Date
(1)	**(2)**	**(3)**
(i)	Where primary adjustments to transfer price has been made *suo-moto* by the assessee in his return of income	the due date of filing of return u/s 139(1)
(ii)	If primary adjustments to transfer price as determined in the order of the Assessing Officer or the appellate authority has been accepted by the assessee	the date of the said order

(iii)	Where agreement for advance pricing has been entered into by the assessee under section 92CD	the due date of filing of return u/s 139(1)
(iv)	Where option has been exercised by the assessee as per the safe harbour rules under section 92CB	the due date of filing of return u/s 139(1)
(v)	Where agreement under the Mutual agreement procedure under a DTAA has been entered into u/s 90 or 90A	the due date of filing of return u/s 139(1)

(viii) **Rate of interest for the purpose of computation on interest on excess money or part thereof, if not repatriated within the prescribed time**

Rule 10CB(2) prescribes the rate at which the per annum interest income shall be computed in case of failure to repatriate the excess money within the above time limit. The interest would be computed at the rates mentioned in column (3) in respect of the cases mentioned in column (2) of the table below:

	Case	Rate
(1)	**(2)**	**(3)**
(i)	Where the international transaction is denominated in Indian rupee	At the one year marginal cost of fund lending rate of SBI as on 1st April of the relevant previous year + 3.25%
(ii)	Where the international transaction is denominated in foreign currency	At six month London Interbank Offered Rate (LIBOR) as on 30th September of the relevant previous year + 3.00%

(ix) ***Option to pay additional income-tax, if the excess money not repatriated:*** *In a case where the excess money or part thereof has not been repatriated within the prescribed time as mentioned above, the assessee has the option to pay additional income-tax @* ***20.9664%*** *(i.e., tax@18%* ***plus*** *surcharge@12%* ***plus*** *cess@4%) on such excess money or part thereof, as the case may be.*

Where additional income-tax is so paid by the assessee, he will ***not*** *be required to make secondary adjustment and compute interest from the date of payment of such tax. This implies that he would, in any case, be required to compute interest upto the date of payment of such additional tax.*

The additional income-tax so paid by the assessee shall be treated as the final payment of tax in respect of excess money or part thereof not repatriated and no further credit would be allowed to the assessee or to any other person in respect of the amount of additional income-tax so paid.

Further, no deduction in respect of the amount on which such additional income-tax has been paid, would be allowed under any other provision of the Act.

(4) Dispute Resolution Mechanism

The evolving tax dispute resolution mechanism in India consists of the following forums:

- Filing of objections before the Dispute Resolution Panel or Appeal before the Commissioner of Income Tax (Appeals);
- Appeal before the Income Tax Appellate Tribunal;
- Appeal before the High Court / Supreme Court;
- Safe Harbour Rules;
- Advance Pricing Agreement; and
- Mutual Agreement Procedure

Each of the above dispute resolution mechanisms have been explained in the subsequent paragraphs.

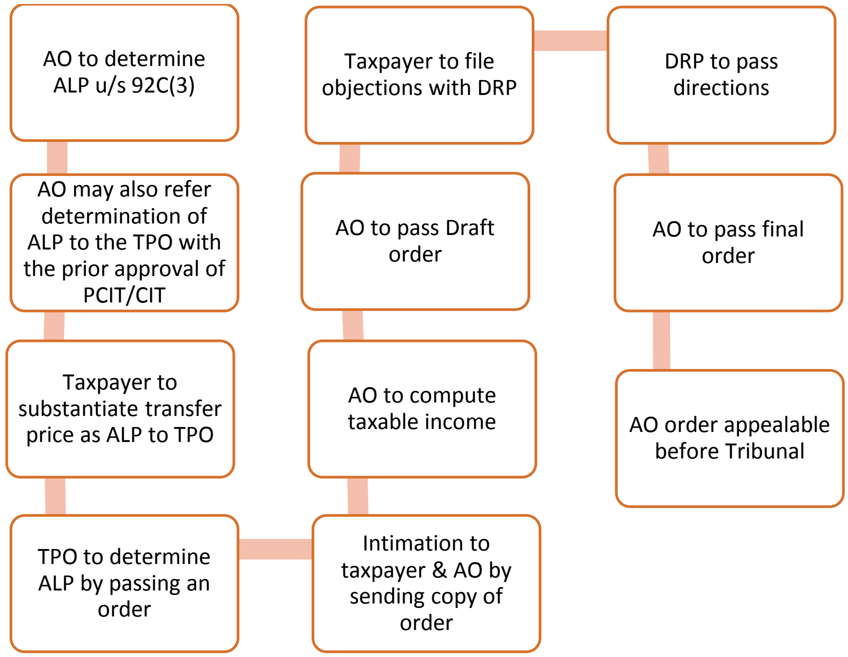
(i) Filing of objections before the Dispute Resolution Panel [Section 144C]

Key features of the DRP process is listed below:

- To facilitate expeditious resolution of disputes, a collegium comprising of three Principal Commissioners or Commissioners of Income-tax has been constituted by the CBDT.
- The following assessees are eligible for filing objections before the DRP:-
  - ➢ A Foreign Company
  - ➢ Any person in whose case variation arises on account of order of Transfer Pricing Officer
- The Assessing Officer shall, forward a draft of the proposed order of assessment to the eligible assessee if he proposes to make, on or after 1st October, 2009, any variation in the income or loss returned which is prejudicial to the interest of such assessee.
- Assessee can file his acceptance to the Assessing Officer or can file his objections against the draft assessment order with the DRP and the Assessing Officer within **thirty days** of the receipt of the draft order.
- Upon acceptance by assessee or no objection received from assessee within the specified time, the Assessing Officer, notwithstanding anything contained in section 153 or section 153B, shall complete the assessment and pass the assessment order **within one month from the end of the month** in which the acceptance is received or 30 days expires.

- The Dispute Resolution Panel shall, in a case where any objections are received, issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.
- After considering draft order, all objections, evidence etc., the DRP issues binding directions to the Assessing Officer.
- The Dispute Resolution Panel may, before issuing any such directions make such further enquiry, as it thinks fit; or cause any further enquiry to be made by any income tax authority and report the result of the same to it.
- In a case where the proposed direction are prejudicial to the interest of the assessee or the interest of the revenue, the direction cannot be issued without giving an opportunity of being heard to the assessee and the Assessing Officer, as the case may be.
- The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order. However, it cannot set aside any proposed variation or issue any direction for further enquiry and passing of the assessment order.
- The power of the DRP to enhance the variation includes the power to consider any matter arising out of the assessment proceeding relating to the draft order. This power to consider any issue shall be irrespective of whether the matter was raised by the eligible assessee or not.
- If the members of the DRP differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members.
- Every direction issued by the DRP shall be binding on the Assessing Officer.
- Such direction has to be issued within **nine months** from the end of the month in which the draft order is forwarded to the eligible assessee.
- Upon receipt of such direction, the Assessing Officer has to complete the assessment in accordance with the same, within **one month** from the end of the month in which the direction is received. There is no requirement of providing any further opportunity of being heard to the assessee.
- The order of the Assessing Officer is directly appealable before the Tribunal.
- The CBDT may make rules for the purpose of efficient functioning of the DRP and expeditious disposal of the objections filed by the eligible assessee.
- DRP does not have jurisdiction over the assessment orders are passed by the Assessing Officer declaring based on the provisions of GAAR and with the prior approval of Principal Commissioner or Commissioner, as referred under section 144BA(12).

The procedure to be followed by the assessee under DRP route is depicted below:



(ii) Appeal before the Commissioner of Income Tax (Appeals) – [Sections 246A, 249 & 250]

Key features of the appeal before CIT (A) is listed below:

- First Appellate Authority
- Appeal may be against the orders including:
  - Assessment order passed u/s 143(3) or 144 of the Income-tax Act
  - Intimation passed u/s 143(1)
  - Reassessment order passed u/s 147 or 150 (re-computation)
  - Assessment or reassessment of search cases u/s 153(A)
  - Rectification Order made u/s 154
  - Order made under section 92CD(3)
- Time Limit - Appeal has to be filed within 30 days of date of service of the notice of demand related to assessment order issued by the Assessing Officer
- Prescribed filing fee is to be paid at the time of filing appeal
- The CIT(A) cannot set-aside the order passed by the Assessing Officer

The following table enumerates the key differences between the DRP and the appeal process before the CIT (A):

Aspect	DRP	CIT(A)
Constitution	Case heard by 3 Principal Commissioner or Commissioners	Case heard by a single Commissioner
Time limit for filing objections/ appeal	Objections need to be filed along with all necessary submissions within 30 days of receipt of the draft order.	An appeal filed within 30 days of date of service of demand notice or the date on which intimation of order sought to be appealed against is served, as the case may be.
Condonation of delay	No power to condone delay	Discretion of CIT(A)
Filing Fees	No filing fees	₹ 250 to ₹ 1,000, depending upon assessed income
Stay of demand	Automatic stay of demand as the order is a draft order.	A stay application to be filed with the Income-tax Officer requesting for a stay of demand. In case the stay is rejected, the demand to be paid off is decided by the Income-tax Officer.
Time limit for completion	To be completed within a period of 9 months from the end of the month in which the draft order is forwarded to the assessee.	The Commissioner (Appeals) may decide the appeal within a period of one year from the end of the financial year in which such appeal is filed before him.
Penalty Proceedings	No penalty proceedings can be initiated until the matter is disposed	Typically penalty proceedings are initiated by the ITO and a stay of penalty would need to be filed.
Next steps on completion of proceedings	Once the order of the DRP is passed, the same is sent to the assessing officer who will pass a final assessment order.	Once the order of the CIT(A) is passed, the same is sent to the assessing officer who will pass an order giving effect to the order of the CIT(A).

The CBDT has issued a press release dated 30.12.2015 stating that as part of the endeavor of the Income-tax Department to digitize various functions of the Department for providing efficient taxpayer services, electronic filing of appeal before CIT(Appeals) is being made mandatory for persons who are required to file the return of income electronically.

(iii) Appeal before the Income Tax Appellate Tribunal [Sections 253 & 254]

Key features of the appeal process before the Income Tax Appellate Tribunal is listed below:

- Once the order of the Assessing Officer after giving effect to DRP directions or CIT(A) are issued, an appeal can be filed with the Income-tax Appellate Tribunal ('the Tribunal') within a period of 60 days from the date on which the order sought to be appealed against is communicated to the assessee.
- If the revenue authorities have filed an appeal on a matter where the CIT(A) has held in favor of the assessee, then Principal Commissioner or Commissioner of Income-tax can direct Assessing officer to file an appeal on order of CIT(A) filed before the Tribunal;
- In the case of an order arising pursuant to directions of the DRP, the demand becomes payable and a stay application will need to be filed with the AO requesting for a stay of demand;
- In case the stay application is rejected by the AO, the demand is to be paid by the assessee. Alternatively, the assessee can prefer a stay application before the Tribunal;
- An order is passed by the Tribunal after hearing arguments from both the assessee and the Revenue authorities.
- Once the order of the Tribunal is issued, an order giving effect will need to be passed by the AO and consequential demands paid off /refunds issued.

(iv) Appeal before the High Court / Supreme Court [Sections 260A & 260B/ Sections 261 & 262]

Key features of the appeal process before the High Court is listed below:

- Appeal lies to High Court against decision given by Appellate tribunal
- Appeal can be filed by the aggrieved –
  - ➢ Principal Chief Commissioner; or
  - ➢ Chief Commissioner; or
  - ➢ Principal Commissioner; or
  - ➢ Commissioner; or
  - ➢ Assessee
- Condition precedent
  - ➢ Appeal shall be heard by not less than 2 judges of the High Court
  - ➢ If HC satisfied that the case involves a 'substantial question of law'

- Substantial Question of Law means:
  - Issue must be debatable
  - Not previously settled by Law of Land
  - Should not be settled by a binding precedent
  - Must have a material bearing on decision of the case
- Time Limit for filing an appeal - Appeal to be preferred within 120 days from the date of receipt of the Tribunal's order
- Filing Fee and Jurisdiction
  - Fee is decided as per relevant court rules and Code of Civil Procedure
  - Jurisdiction is decided on the basis of the location of AO who framed the disputed order

Key features of the appeal process before the Supreme Court is listed below:

- Appeal lies to Supreme Court against decision given by the High Court.
- Condition precedent
  - High Court should certify that the case is fit for appeal
  - If High Court refuses – application to Supreme Court can be made under Article 136 of the Constitution for special leave
- Decision of Supreme Court becomes the Law of the Land

The monetary tax limits for Departmental appeal filing before ITATs, HCs and SCs are as follows:

Sr. No.	*Appeals in income-tax matters*	*Monetary Limits (in ₹)*
1.	*Before ITAT*	*50,00,000*
2.	*Before High Court*	*1,00,00,000*
3.	*Before Supreme Court*	*2,00,00,000*

(v) Safe Harbour Rules

In order to reduce the increasing number of transfer pricing audits and prolonged disputes, the Finance (No. 2) Act, 2009 with retrospective effect from 1.4.2009 inserted section 92CB to provide that determination of arm's length price under section 92C or Section 92CA shall be subject to Safe Harbour rules. Section 92CB(2) empowers the CBDT to prescribe safe harbour rules[1].

Safe Harbour means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.

[1] *The Safe Harbour Rules relevant for A.Y. 2020-21 are yet to be notified by the CBDT as on the date of release of the Study Material. These rules, when notified, will form part of the webhosted Statutory Update.*

(vi) Advance Pricing Agreements

What is APA?

In order to gain certainty prior to entering into an international transaction with an AE, the taxpayers have an option of applying for an Advance Pricing Agreement (APA) and obtaining results before the transaction is actually undertaken. The same has the potential to reduce litigation for the taxpayer and provide certainty for a longer period of time.

An APA is an agreement between a tax payer/ applicant and the CBDT, which determines the arm's length price of future intercompany transactions. It can also be used for existing intercompany transactions. The tax payer /applicant mutually agree on the transfer pricing methodology to be applied and its application, in relation to the taxpayer's international transactions for certain future period of time.

The Finance Act, 2012 had inserted Section 92CC and Section 92CD in the Income-tax Act, 1961 introducing the provisions of APA. The Ministry of Finance notified the Rules 10F to 10T of the Income-tax Rules, 1962 for this purpose.

Once an APA has been entered into with respect to an international transaction, the arm's length price with respect to that international transaction, for the period specified in the APA, will be determined only in accordance with the APA. The APA shall be binding on the person as well as the Income-tax authorities for the specified transaction and period as covered in the APA.

Types of APA

The APA scheme envisages three types of APA's, viz.

- Unilateral APA – Agreement between the assessee and CBDT
- Bilateral APA – Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authority in the other country regarding appropriate transfer pricing method or the ALP
- Multilateral APA - Agreement between the assessee and CBDT subsequent to and based on agreement between competent authorities of India with the competent authorities in the other countries regarding appropriate transfer pricing method or the ALP

Request for bilateral or multilateral APA can be accepted by the Indian competent authority where:

- A tax treaty exists between India and other contracting state containing an article on 'Mutual Agreement Procedure';
- The corresponding APA program exists in the other country.

  [In case of international transactions leading to economic double taxation arising out of TP adjustments; presently it seems Indian Competent Authority accepts bilateral/ multilateral

APA only if the said tax treaty contains provisions similar to article 9(2) of the OECD model convention on 'Associated Enterprises]

Advantages of APA program

The APA program is designed to:

- Provide certainty with regard to determination of ALP of the international transaction (viz. transactions covered by the APA);
- Impart flexibility in developing practical approaches for complex transfer pricing issues;
- Reduce the risk of potential double taxation through bilateral and multi-lateral APA;
- Reduce compliance costs by eliminating the risk of transfer pricing audit and resolving long drawn and time consuming litigation;
- Reduce the burden of record keeping, as the taxpayer knows in advance the required documentation to be maintained to substantiate the agreed terms and conditions of the agreement.

Applicability of APA

Section 92CC enables the Board (with the approval of the Central Government), to enter into an APA with any person undertaking an international transaction.

(i) **Purpose of APA:** The APA shall relate to an international transaction to be entered into by such person. The APA shall be entered into for the purpose of determination of the arm's length price or specifying the manner in which arm's length price shall be determined, in relation to such international transaction.

(ii) **Manner of determination of Arm's Length Price in APA:** The manner for determination of arm's length price referred above may include methods referred to in section 92C(1) or any other method with necessary adjustments or variations.

(iii) **Non-applicability of section 92C or section 92CA:** In case an APA has been entered into in respect of any international transaction, the arm's length price in relation to that transaction shall be determined in accordance with that APA notwithstanding any contrary provisions contained in section 92C or section 92CA i.e., the provisions of the APA shall apply overriding the provisions of section 92C or section 92CA, which are normally applicable for determination of arm's length price.

(iv) **Validity of APA:** The APA shall be valid for such period as specified in the agreement, which shall in no case exceed five consecutive previous years.

(v) **Binding nature of APA:** The APA so entered into shall be binding on:

  (a) the person in whose case, and in respect of the transaction in relation to which, the APA has been entered into; and

(b) the Principal Commissioner or Commissioner and the income-tax authorities subordinate to him, in respect of the said person and the said transaction.

(vi) **Not binding of APA:** The APA shall not be binding if there is any change in law or facts having bearing on such APA.

(vii) **Conditions to declare APA as *void ab initio*:** In case the Board finds that the APA so entered into has been obtained by the person by way of fraud or misrepresentation of facts, the Board is empowered to pass an order declaring any such APA to be void ab initio, with the approval of Central Government.

(viii) **Consequences of declaration of an APA as *void ab initio*:** As a result of declaration of an APA as *void ab initio*:

(a) all the provisions of the Act shall apply to such person as if such APA had never been entered into.

(b) The period beginning with the date of such APA and ending on the date of order declaring the APA as *void ab initio*, shall be excluded for the purpose of computation of any period of limitation under this Act (for example period of limitation specified in the section 153, 153B etc). This is irrespective of anything contained in any other provision of the Act.

(c) In case the period of limitation after exclusion of the above mentioned period is less than 60 days, such remaining period of limitation shall be extended to 60 days.

(ix) If an application is made by a person for entering into an APA, then, the proceeding, in respect of such person for the purpose of the Act, shall be deemed to be pending.

(x) **Prescribed scheme for APA:** The Board is empowered to prescribe a scheme specifying the manner, form, procedure and any other matter generally in respect of the APA.

Prescribed Advance Pricing Agreement Scheme for the purpose of section 92CC [Rule 10F to 10T]: In exercise of the powers conferred in section 92CC(9) read with section 295 of the Income-tax Act, 1961, the CBDT has prescribed rules specifying an Advance Pricing Agreement (APA) Scheme. Some of the important provisions of the scheme are briefed hereunder –

(1) **Persons eligible to apply [Rule 10G]:** Any person who has undertaken an international transaction or is contemplating to undertake an international transaction, shall be eligible to enter into an agreement under these rules.

(2) **Pre-filing Consultation [Rule 10H]:**

(a) Any person proposing to enter into an agreement under these rules may, by an application in writing, make a request for a pre-filing consultation in the prescribed form to the Director General of Income-tax (International Taxation).

(b) The pre-filing consultation shall, among other things,-

(i) determine the scope of the agreement;

(ii) identify transfer pricing issues;

(iii) determine the suitability of international transaction for the agreement;

(iv) discuss broad terms of the agreement.

(c) The pre-filing consultation shall –

(i) not bind the Board or the person to enter into an agreement or initiate the agreement process;

(ii) not be deemed to mean that the person has applied for entering into an agreement.

(3) Application for advance pricing agreement [Rule 10-I]

(a) Any person who is eligible to apply may enter into agreement may, if such person desires to enter into an agreement furnish an application in the prescribed form along with proof of payment of requisite fee as specified, to the Director General of Income-tax (International Taxation) in case of unilateral agreement and to the competent authority in India in case of bilateral or multilateral agreement.

(b) The application may be filed at any time -

(i) before the first day of the previous year relevant to the first assessment year for which the application is made, in respect of transactions which are of a continuing nature from dealings that are already occurring; or

(ii) before undertaking the transaction in respect of remaining transactions.

Note - The applicant may withdraw the application for agreement at any time before the finalisation of the terms of the agreement. However, application fees paid shall not be refunded on withdrawal of application by the applicant.

(4) Approval of Central Government: The agreement shall be entered into by the Board with the applicant after its approval by the Central Government.

(5) Terms of the agreement [Rule 10M]

(a) An agreement may among other things, include –

(i) the international transactions covered by the agreement;

(ii) the agreed transfer pricing methodology, if any;

(iii) determination of arm's length price, if any;

(iv) definition of any relevant term to be used in item (ii) or (iii);

(v) critical assumptions i.e., the factors and assumptions that are so critical and significant that neither party entering into an agreement will continue to be bound by the agreement, if any of the factors or assumptions is changed;

(vi) rollback provision referred to in Rule 10MA;

(vii) the conditions, if any, other than provided in the Act or these rules.

(b) The agreement shall not be binding on the Board or the assessee if there is a change in any of critical assumptions or failure to meet conditions subject to which the agreement has been entered into.

(c) The binding effect of agreement shall cease only if any party has given due notice of the concerned other party or parties.

(d) In case there is a change in any of the critical assumptions or failure to meet the conditions subject to which the agreement has been entered into, the agreement can be revised or cancelled, as the case may be.

(6) Furnishing of Annual Compliance Report [Rule 10-O]: The assessee shall furnish an annual compliance report in quadruplicate in the prescribed form to Director General of Income-tax (International Taxation) for each year covered in the agreement, within 30 days of the due date of filing income-tax return for that year, or within 90 days of entering into an agreement, whichever is later.

(7) Compliance Audit of the agreement [Rule 10P]:

(a) The Transfer Pricing Officer having the jurisdiction over the assessee shall carry out the compliance audit of the agreement for each of the year covered in the agreement. For this purpose, the Transfer Pricing Officer may require –

(i) the assessee to substantiate compliance with the terms of the agreement, including satisfaction of the critical assumptions, correctness of the supporting data or information and consistency of the application of the transfer pricing method;

(ii) the assessee to submit any information, or document, to establish that the terms of the agreement has been complied with.

(b) The compliance audit report shall be furnished by the Transfer Pricing Officer within six months from the end of the month in which the Annual Compliance Report is received by the Transfer Pricing Officer.

(8) Revision of an agreement [Rule 10Q]:

(a) An agreement, after being entered, may be revised by the Board either *suo moto* or on request of the assessee or the competent authority in India or the Director General of Income-tax (International Taxation), if–

(i) there is a change in critical assumptions or failure to meet a condition subject to which the agreement has been entered into;

(ii) there is a change in law that modifies any matter covered by the agreement but is not of the nature which renders the agreement to be non-binding; or

(iii) there is a request from competent authority in the other country requesting revision of agreement, in case of bilateral or multilateral agreement.

(b) Except when the agreement is proposed to be revised on the request of the assessee, the agreement shall not be revised unless an opportunity of being heard has been provided to the assessee and the assessee is in agreement with the proposed revision.

(c) The revised agreement shall include the date till which the original agreement is to apply and the date from which the revised agreement is to apply.

(9) Cancellation of an agreement [Rule 10R]:

(a) An agreement shall be cancelled by the Board for any of the following reasons:

(i) the compliance audit has resulted in the finding of failure on the part of the assessee to comply with the terms of the agreement;

(ii) the assessee has failed to file the annual compliance report in time;

(iii) the annual compliance report furnished by the assessee contains material errors; or

(iv) the assessee is not in agreement with the revision proposed in the agreement or the agreement is to be cancelled under rule 10RA(7);.

(b) The Board shall give an opportunity of being heard to the assessee, before proceeding to cancel an application.

(c) The order of cancellation of the agreement shall be in writing and shall provide reasons for cancellation and for non-acceptance of assessee's submission, if any.

(d) The order of cancellation shall also specify the effective date of cancellation of the agreement, where applicable.

(e) The order under the Act, declaring the agreement as void ab initio, on account of fraud or misrepresentation of facts, shall be in writing and shall provide reason for such declaration and for non-acceptance of assessee's submission, if any.

(10) Mere filing of an application for an agreement under these rules shall not prevent the operation of Chapter X of the Act for determination of arms' length price under that Chapter till the agreement is entered into. [Rule 10T(1)].

(11) The negotiation between the competent authority in India and the competent authority in the other country or countries, in case of bilateral or multilateral agreement, shall be carried out in accordance with the provisions of the tax treaty between India and the other country or countries. [Rule 10T(2)].

(ix) **Provision for Roll back in APA Scheme [Section 92CC]**

(a) In order to reduce current pending as well as future litigation in respect of the transfer pricing matters, section 92CC(9A) provides roll back mechanism in the APA scheme.

(b) Accordingly, the APA may, subject to such prescribed conditions, procedure and manner, provide for determining the ALP or for specifying the manner in which ALP is to be determined in relation to an international transaction entered into by a person during any period not exceeding four previous years preceding the first of the previous years for which the APA applies in respect of the international transaction to be undertaken.

The CBDT has, vide *Notification No.23/2015 dated 14.3.2015*, in exercise of the powers conferred by 92CC(9A) read with section 295, following conditions, procedure and manner for determining the arm's length price or for specifying the manner in which arm's length price is to be determined in relation to an international transaction:

Rule	Particulars	Conditions, Procedure & Manner of determination of ALP
10F(ba)	Definition of Applicant	A person who has made an application.
10F(ha)	Definition of Rollback year	Any previous year, falling within the period **not exceeding four previous years,** preceding the first of the five consecutive previous years referred to in section 92CC(4).
10MA	Roll back of the agreement	The said rule provides the following: 1. The agreement may provide for determining the arm's length price or specify the manner in which arm's length price shall be determined in relation to the international transaction entered into by the person during the rollback year (hereinafter referred as "rollback provision"). **2. Conditions for applying for rollback provisions:** The agreement shall contain rollback provision in respect of an international transaction subject to the following, namely:- (i) the international transaction is same as the

international transaction to which the agreement (other than the rollback provision) applies;

(ii) the return of income for the relevant rollback year has been or is furnished by the applicant before the due date as specified in *Explanation 2* of section 139(1).

(iii) the report in respect of the international transaction had been furnished in accordance with section 92E;

(iv) the applicability of rollback provision, in respect of an international transaction, has been requested by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant; and

(v) the applicant has made an application seeking rollback in Form 3CEDA in accordance with sub-rule (5);

3. **Non-applicability of Rollback provision**: Rollback provision shall not be provided in respect of an international transaction for a rollback year, if,-

(i) the determination of arm's length price of the said international transaction for the said year has been subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement; or

(ii) the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year.

4. **Manner for determining arm length price to be the same for rollback years and other previous years:** Where the rollback provision specifies the manner in which arm's length price shall be determined in relation to an international transaction undertaken in any rollback year then such manner shall be the same as the manner which has been agreed to be provided for determination of arm's length price of the same international transaction to be undertaken in any previous year to which the agreement applies, not being a rollback year.

5. **Fees for filling application for rollback provision:** The applicant may furnish along with the application for advance pricing agreement, the request for rollback provision in Form No. 3CEDA with proof of payment of an additional fee of ₹ 5 lakh.

10RA	Procedure for giving effect to rollback provision of an Agreement	Rule 10RA has been inserted to provide the "Procedure for giving effect to rollback provision of an Agreement" as follows: (i) The applicant shall furnish modified return of income referred to in section 92CD in respect of a rollback year to which the agreement applies along with the proof of payment of any additional tax arising as a consequence of and computed in accordance with the rollback provision. (ii) The modified return in respect of rollback year shall be furnished along with the modified return to be furnished in respect of first of the previous years for which the agreement has been requested for in the application. (iii) If any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is the subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant before furnishing the modified return for the said year. (iv) If any appeal filed by the Assessing Officer or the Principal Commissioner or Commissioner is pending before the Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement, shall be withdrawn by the Assessing Officer or the Principal Commissioner or the Commissioner, as the case may be, within three months of filing of modified return by the applicant. (v) The applicant, the Assessing Officer or the Principal Commissioner or the Commissioner, shall inform the Dispute Resolution Panel or the Commissioner (Appeals) or the Appellate Tribunal or the High Court, as the case may be, the fact of an agreement containing rollback provision having been entered into along with a copy of the same as soon as it is practicable to do so. (vi) In case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled.

Subsequent to the notification of the rules, the CBDT has issued *Circular No. 10/2015 dated 10.6.2015* adopting a Question and Answer format to clarify certain issues arising out of the said Rules. The questions raised and answers to such questions as per the said Circular are given hereunder:

Question 1

Under rule 10MA(2)(ii) there is a condition that the return of income for the relevant roll back year has been or is furnished by the applicant before the due date specified in Explanation 2 to section 139(1). It is not clear as to whether applicants who have filed returns under section 139(4) or 139(5) of the Act would be eligible for roll back.

Answer

The return of income under section 139(5) can be filed only when a return under section 139(1) has already been filed. Therefore, the return of income filed under section 139(5) of the Act, replaces the original return of income filed under section 139(1). Hence, if there is a return which is filed under section 139(5) to revise the original return filed before the due date specified in *Explanation 2* to sub-section (1) of section 139, the applicant would be entitled for rollback on this revised return of income.

However, rollback provisions will not be available in case of a return of income filed under section 139(4) because it is a return which is not filed before the due date.

Note – *A belated return filed under section 139(4) can also be revised under section 139(5). In such a case, the revised return would replace the belated return. Therefore, an applicant would not be entitled for roll back provisions on a revised return which replaces a belated return*.

Question 2

Rule 10MA(2)(i) mandates that the rollback provision shall apply in respect of an international transaction that is same as the international transaction to which the agreement (other than the rollback provision) applies. It is not clear what is the meaning of the word "same". Further, it is not clear whether this restriction also applies to the Functions, Assets, Risks (FAR) analysis.

Answer

The international transaction for which a rollback provision is to be allowed should be the same as the one proposed to be undertaken in the future years and in respect of which the agreement has been reached. There cannot be a situation where rollback is finalised for a transaction which is not covered in the agreement for future years. The term same international transaction implies that the transaction in the rollback year has to be of same nature and undertaken with the same associated enterprise(s), as proposed to be undertaken in the future years and in respect of which agreement has been reached. In the context of FAR analysis, the restriction would operate to ensure that rollback provisions would apply only if the FAR analysis of the rollback year does not differ materially from the FAR validated for the purpose of reaching an agreement in respect of international transactions to be undertaken in the future years for which the agreement applies.

The word "materially" is generally being defined in the Advance Pricing Agreements being entered into by CBDT. According to this definition, the word "materially" will be interpreted consistently with its ordinary definition and in a manner that a material change of facts and circumstances would be understood as a change which could reasonably have resulted in an agreement with significantly different terms and conditions.

Question 3

Rule 10MA(2)(iv) requires that the application for rollback provision, in respect of an international transaction, has to be made by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant. Clarification is required as to whether rollback has to be requested for all four years or applicant can choose the years out of the block of four years.

Answer

The applicant does not have the option to choose the years for which it wants to apply for rollback. The applicant has to either apply for all the four years or not apply at all. However, if the covered international transaction(s) did not exist in a rollback year or there is some disqualification in a rollback year, then the applicant can apply for rollback for less than four years. Accordingly, if the covered international transaction(s) were not in existence during any of the rollback years, the applicant can apply for rollback for the remaining years. Similarly, if in any of the rollback years for the covered international transaction(s), the applicant fails the test of the rollback conditions contained in various provisions, then it would be denied the benefit of rollback for that rollback year. However, for other rollback years, it can still apply for rollback.

Question 4

Rule 10MA(3) states that the rollback provision shall not be provided in respect of an international transaction for a rollback year if the determination of arm's length price of the said international transaction for the said year has been the subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement. Further, Rule 10 RA(4) provides that if any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant.

There is a need to clarify the phrase "Tribunal has passed an order disposing of such appeal" and on the mismatch, if any, between Rule 10MA(3) and Rule 10RA(4).

Answer

The reason for not allowing rollback for the international transaction for which Appellate Tribunal has passed an order disposing of an appeal is that the ITAT is the final fact finding authority and hence, on factual issues, the matter has already reached finality in that year. However, if the ITAT has not decided the matter and has only set aside the order for fresh consideration of the matter by the lower authorities with full discretion at their disposal, the matter shall not be treated as one having reached finality and hence, benefit of rollback can still be given.

There is no mismatch between Rule 10MA(3) and Rule 10RA(4).

Question 5

Rule 10MA(3)(ii) provides that rollback provision shall not be provided in respect of an international transaction for a rollback year if the application of rollback provision has the effect of *reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year. It may be clarified whether the rollback provisions in such situations can be applied in a manner so as to ensure that the returned income or loss is accepted as the final income or loss after applying the rollback provisions.*

Answer

It is clarified that in case the terms of rollback provisions contain specific agreement between the Board and the applicant that the agreed determination of ALP or the agreed manner of determination of ALP is subject to the condition that the ALP would get modified to the extent that it does not result in reducing the total income or increasing the total loss, as the case may be, of the applicant as declared in the return of income of the said year, the rollback provisions could be applied. For example, if the declared income is ₹ 100, the income as adjusted by the TPO is ₹ 120, and the application of the rollback provisions results in reducing the income to ₹ 90, then the rollback for that year would be determined in a manner that the declared income ₹ 100 would be treated as the final income for that year.

Question 6

Rule 10RA(7) states that in case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled. It is to be clarified as to whether the entire agreement is to be cancelled or only that year for which roll back fails.

Answer

The procedure for giving effect to a rollback provision is laid down in Rule 10RA. Sub-rules (2), (3), (4) and (6) of the Rule specify the actions to be taken by the applicant in order that effect may be given to the rollback provision. If the applicant does not carry out such actions for any of the rollback years, the entire agreement shall be cancelled.

This is because the rollback provision has been introduced for the benefit of the applicant and is applicable at its option. Accordingly, if the rollback provision cannot be given effect to for any of the rollback years on account of the applicant not taking the actions specified in sub-rules (2), (3), (4) or (6), the entire agreement gets vitiated and will have to be cancelled.

Question 7

If there is a Mutual Agreement Procedure (MAP) application already pending for a rollback year, what would be the stand of the APA authorities? Further, what would be the view of the APA Authorities, if MAP has already been concluded for a rollback year?

Answer

If MAP has been already concluded for any of the international transactions in any of the rollback year under APA, rollback provisions would not be allowed for those international transactions for that year but could be allowed for other years or for other international transactions for that year, subject to fulfilment of specified conditions in Rules 10MA and 10RA. However, if MAP request is pending for any of the rollback year under APA, upon the option exercised by the applicant, either MAP or application for roll back shall be proceeded with for such year.

Question 8

Rule 10MA(1) provides that the agreement may provide for determining ALP or manner of determination of ALP. However, Rule 10MA(4) only specifies that the manner of determination of ALP should be the same as in the APA term. Does that mean the ALP could be different?

Answer

Yes, the ALP could be different for different years. However, the manner of determination of ALP (including choice of Method, comparability analysis and Tested Party) would be same.

Question 9

Will there be compliance audit for roll back? Would critical assumptions have to be validated during compliance audit?

Answer

Since rollback provisions are for past years, ALP for the rollback years would be agreed after full examination of all the facts, including validation of critical assumptions. Hence, compliance audit for the rollback years would primarily be to check if the agreed price or methodology has been applied in the modified return.

Question 10

Whether applicant has an option to withdraw its rollback application? Can the applicant accept the rollback results without accepting the APA for the future years?

Answer

The applicant has an option to withdraw its roll back application even while maintaining the APA application for the future years. However, it is not possible to accept the rollback results without accepting the APA for the future years. It may also be noted that the fee specified in Rule 10MA(5) shall not be refunded even where a rollback application is withdrawn.

Question 11

For already concluded APAs, will new APAs be signed for rollback or earlier APAs could be revised?

Answer

The second proviso to Rule 10MA(5) provides for revision of APAs already concluded to include rollback provisions.

Question 12

For already concluded APAs, where the modified return has already been filed for the first year of the APA term, how will the time-limit for filing modified return for rollback years be determined?

Answer

The time to file modified return for rollback years will start from the date of signing the revised APA incorporating the rollback provisions.

Question 13

In case of merger of companies, where one or more of those companies are APA applicants, how would the rollback provisions be allowed and to which company or companies would it be allowed?

Answer

The agreement is between the Board and a person. The principle to be followed in case of merger is that the person (company) who makes the APA application would only be entitled to enter into the agreement and be entitled for the rollback provisions in respect of international transactions undertaken by it in rollback years. Other persons (companies) who have merged with this person (company) would not be eligible for the rollback provisions.

To illustrate, if A, B and C merge to form C and C is the APA applicant, then the agreement can only be entered into with C and only C would be eligible for the rollback provisions. A and B would not be eligible for the rollback provisions. To illustrate further, if A and B merge to form a new company C and C is the APA applicant, then nobody would be eligible for rollback provisions.

Question 14

In case of a demerger of an APA applicant or signatory into two or more companies (persons), who would be eligible for the rollback provisions?

Answer

The same principle as mentioned in the previous answer, i.e., the person (company) who makes an APA application or enters into an APA would only be entitled for the rollback provisions, would continue to apply. To illustrate, if A has applied for or entered into an APA and, subsequently, demerges into A and B, then only A will be eligible for rollback for international transactions covered under the APA. As B was not in existence in rollback years, availing or grant of rollback to B does not arise.

Section 92CD provides for the following procedure for giving effect to an APA

(i) In case a person has entered into an APA and prior to the date of entering into such APA, he has furnished the return of income under the provisions of section 139 in respect of any assessment year relevant to a previous year to which the APA applies, then, such person shall, within a period of three months from the end of the month in which the said agreement was entered into, furnish a modified return, notwithstanding any contrary provision contained in section 139.

(ii) Such modified return shall be in accordance with and limited to the provisions of such APA i.e., modifications can only be made on account of such APA in the return to be filed.

(iii) All other provisions of this Act shall apply as if the modified return is a return furnished under section 139, unless anything to the contrary is provided in this section.

(iv) If the assessment or reassessment proceedings for an assessment year relevant to a previous year to which the APA applies have been completed before the expiry of period allowed for furnishing of modified return, the Assessing Officer shall, in a case where modified return is filed in accordance with the provisions of this section, proceed to assess or reassess or re-compute the total income of the relevant assessment year having regard to and in accordance with the APA.

However, with effect from 1.9.2019, Assessing Officer shall pass an order modifying the total income of the relevant assessment year determined in such assessment or reassessment, as the case may be, having regard to and in accordance with the APA, instead of proceeding to assess or reassess the total income.

Such order for assessment or reassessment or re-computation of total income shall be passed within a period of 1 year from the end of the financial year in which the modified return was furnished. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

The appeal against such order shall lie to Commissioner (Appeals) [Section 246A]

(v) Where the assessment or reassessment proceedings for an assessment year relevant to the previous year to which the APA applies, are pending on the date of filing of modified return, the Assessing Officer shall proceed to complete the assessment or reassessment proceedings in accordance with the APA taking into consideration the modified return so furnished.

In this case, the time period of completion of pending assessment or reassessment mentioned under section 153 or 153B or 144C shall be extended by 12 months. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

(vi) The assessment or reassessment proceedings for an assessment year shall be deemed to have been completed where -

(a) an assessment or reassessment order has been passed; or

(b) no notice has been issued under section 143(2) till the expiry of the limitation period provided under the said section.

(vii) Mutual Agreement Procedure (MAP)

The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of "taxation not in accordance with the provisions of the Convention" and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of "interpretation or application of the Convention" and "the elimination of double taxation in cases not otherwise provided for in the Convention". Paragraph 10 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9 (Article 9 – Associated enterprises).

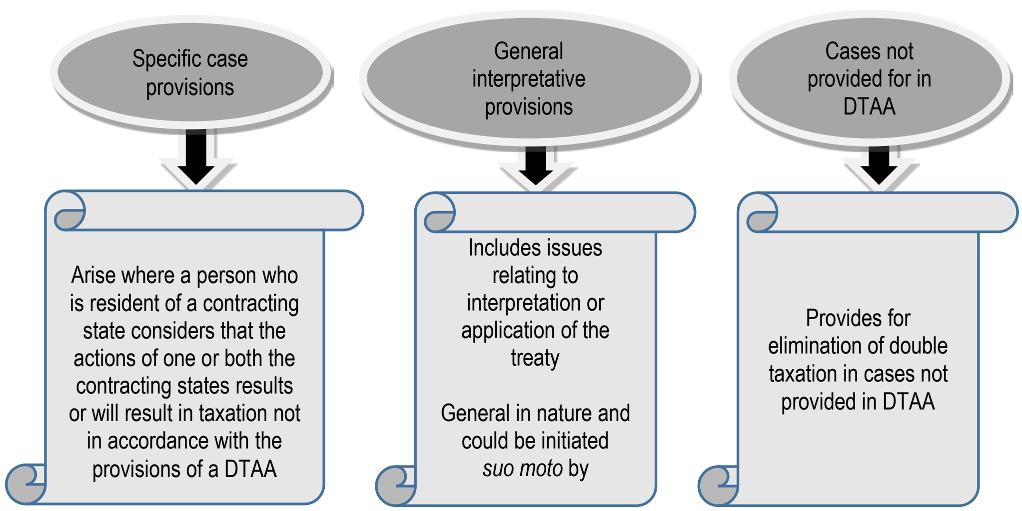
Juridical double taxation

When source rules overlap, double taxation may arise i.e. tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise in their respective jurisdictions. This is known as "juridical double taxation".

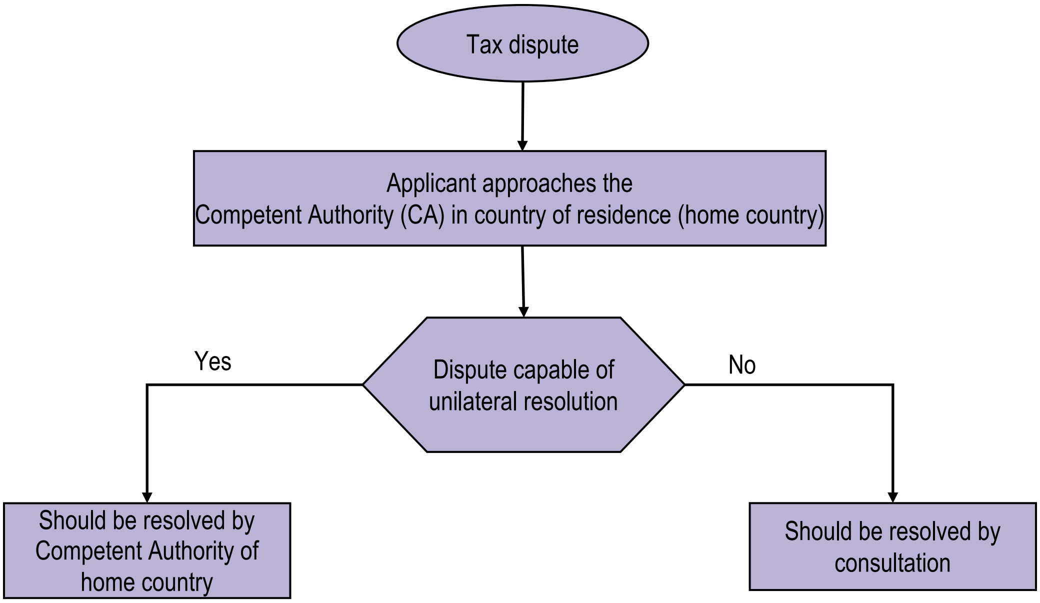
Economic double taxation

'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different person.

(a) Categories of Disputes covered under MAP



(b) Mechanism under MAP



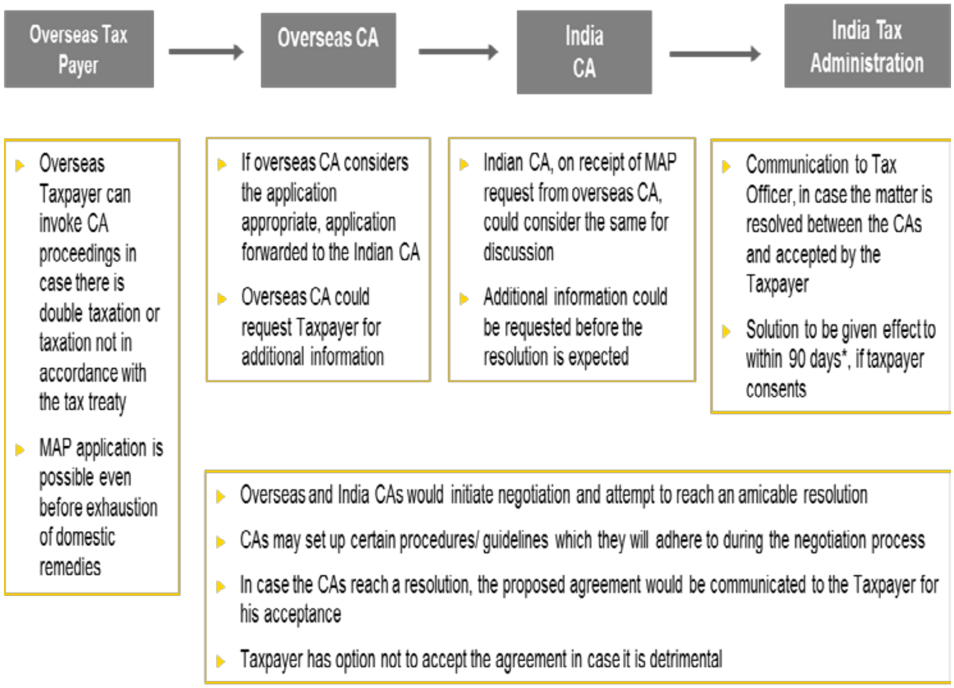
(c) Need for MAP

- Double Taxation Avoidance Agreements ('tax treaties') are available for capturing and curtailing juridical double taxation.
- Tax treaties generally do not cover instances of economic double taxation.
- MAP provides relief in cases of economic double taxation.
- MAP also provides relief in cases where automatic relief, such as tax credits, tax exemption, etc. are not available

(d) Steps involved in the MAP application process

- Brief facts and background of the case must be summarized
- Contentions of Indian Revenue must be summarized in the application
- The net tax and interest impact only by virtue of transfer pricing adjustment is computed
- Take note of transactions only relating to one country (in one application), e.g. USA, UK, etc.
- All documents including tax returns, TP study, notices, submissions, orders, etc. must be furnished.
- Relevant judicial precedence and their applicability to taxpayer's case must be demonstrated.

(e) Typical MAP process in India



(f) Outcome of MAP process:

- The Assessing Officer gives effect of the decision of the MAP, after receiving instructions from the CCIT / DGIT (within 90 days of receiving instructions)
- If taxpayer is aggrieved by decision of the Competent Authority, he may reject the decision and go ahead with the remedies under the domestic law.
- If remedies are not granted by the domestic law, the taxpayer may apply to the Competent Authorities again for subsequent years.
- Decision of a Competent Authority is generally case specific and not a precedent for the taxpayer for subsequent years or other taxpayers on same issues.

(g) Drawbacks of the MAP process

- Time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty.
- Mutual agreement procedures may take too long to complete.
- Taxpayer participation may be limited.
- Published procedures may not be readily available to instruct taxpayers on how the procedure may be used; and

- There may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure

Indian Statutory regime – MAP

MAP- Indian Statutory Regime	
Rule 44G	**Rule 44H**
Applicable to resident assessee	Indian Competent Authority receives a reference from Competent Authority outside India, he shall call for records and endeavor to arrive at a resolution.
Aggrieved by action of the tax authority outside India	Resolution arrived at shall be communicated to Chief Commissioner or Director General of Income-tax in writing.
Such action is not in accordance with the agreement or tax laws	Assessee can give his acceptance to the resolution and withdraw the appeal, if any, pending on the issue which was the subject matter for adjudication under MAP.
May make an application to Competent Authority in Form 34F in India to invoke MAP	Assessing Officer to give effect to MAP within 90 days of receipt of the same by Chief Commissioner or Director General of Income-tax, subject to conditions fulfilled.

1.17 TRANSFER OF INCOME TO NON RESIDENTS [SECTION 93]

Section 93 hits at transactions which are effected with a view to avoiding liability to taxation. For the purpose, the word “non-resident” also includes a person who is not-ordinarily resident. In order to attract the provisions of this section, all the following conditions must be satisfied:

(a) There is a transfer of assets - whether movable or immovable and whether tangible or intangible.

(b) The transfer is made by any person in India or outside irrespective of his residential status or citizenship.

(c) The transfer is made either alone or in connection with associated operations.

(d) The assets transferred directly yield income chargeable to tax under this Act.

(e) The transfer of assets is effected in such a manner that the income becomes payable to a person outside India who is either a non-resident or a not ordinarily resident in India.

(f) The transferor acquires any right by virtue of which he gets the power to enjoy the income whether immediately or in future.

(g) The Assessing Officer is satisfied that avoidance of liability to tax in India is the purpose of the transfers.

In particular, this section deems any income of a non-resident person which, if it were the income of a resident person, would be chargeable to tax in India (in the absence of this Section), as the income of the resident person in India for all purposes of the Act provided that all the conditions stated above are satisfied. This section also covers a variety of transactions constituting a transfer including cases where assets are transferred to a non-resident person and the transferor indirectly derives income under the guise of obtaining loans or repayment of loans. If the aforesaid conditions are fulfilled, the income from the assets transferred should be treated as the income of the transferor and would accordingly be taxable in his hands. Therefore, where assets are transferred to a body corporate outside India, in consideration of shares allotted by it to the transferor, he (the transferor), will become assessable under this section in respect of the income of the company derived by it from those assets. This section will not, however, apply to cases where it is shown to the satisfaction of the Assessing Officer that (i) neither the transfer nor any associated operation had for its purpose or for one of its purposes the avoidance of liability to taxation or (ii) it is provided to the satisfaction of the Assessing Officer that the transfer was effected for *bonafide* commercial purpose and with no intent to avoid tax.

The income which is deemed to be that of the transferor under this section may also arise as a result of the transfer in connection with associated operations. However, in this case also, the treatment of the income would be the same.

Meaning of "associated operation": The expression 'associated operation," in relation to a transfer, means an operation of any kind effected by any person in relation to:

(i) any of the assets transferred;

(ii) any assets representing, whether directly or indirectly, any of the assets transferred;

(iii) any income arising from such assets;

(iv) any assets representing, whether directly or indirectly, the accumulation of income arising from such assets.

Meaning of "Assets": It includes property or rights of any kind.

Meaning of "transfer": In relation to rights, transfer includes the creation of those rights.

Meaning of "benefit": It includes a payment of any kind.

In order to determine the liability of the assessee in respect of the deemed income it is immaterial if the income or benefits from the transfer (i) are actually received or not or (ii) are received or are receivable in cash or kind or (iii) are receivable directly or indirectly. For purposes of this section, a person is deemed to have the power to enjoy the income of a non-resident if:

(i) the income, in fact, so dealt with by any person as to be calculated at some point of time to enure for the benefit of the transferor, whether in the same form of the income or otherwise;

(ii) the receipt or accrual of the income operates to increase value of any assets held by the transferor or for his direct or indirect benefit;

(iii) the transferor receives or is entitled to receive at any time any benefit out of the income or out of any money available for the purpose by reason of the effect or successive effects of the associated operations on that income and the assets which represent that income;

(iv) the transferor is in a position to obtain for himself the beneficial enjoyment of the income by exercising any power of appointment or power of revocation or otherwise, whether with or without the consent of any other person, or

(v) the transferor is able to control directly or indirectly the application of the income in any manner whatsoever.

However, in determining whether a person has the power to enjoy the income due regard shall be had to the substantial result and effect of the transfer and any associated operations must be taken into consideration irrespective of the nature or form of the benefits.

It may be noted that where an assessee has been charged to tax in respect of a sum deemed to be his income under this section, the subsequent receipt of that sum by the assessee, whether as income or in any other form, shall not be liable to tax in his hands at the time of receipt.

1.18 INTRODUCTION OF SPECIFIC ANTI AVOIDANCE MEASURES IN RESPECT OF TRANSACTIONS WITH PERSONS LOCATED IN NOTIFIED JURISDICTIONAL AREA [SECTION 94A]

The objective of anti-avoidance measures is to discourage assessees from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. The following are the anti-avoidance measures introduced -

(i) The Central Government empowered to notify any such country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.

> ***Clarification on removal of Cyprus from the list of notified jurisdictional area under section 94A of the Income-tax Act, 1961 – [Circular No. 15/2017, dated 21-04-2017]***
>
> Cyprus was specified as a "notified jurisdictional area" (NJA) under section 94A of the Income-tax Act, 1961 vide Notification No. 86/2013 dated 01.11.2013. The said Notification No. 86/2013 was subsequently rescinded vide Notification No. 114 dated 14.12.2016 and Notification No. 119 dated 16.12.2016 with effect from the date of issue of the notification.
>
> The CBDT has, vide this Circular, clarified that Notification No. 86/2013 has been rescinded with effect from the date of issue of the said notification, thereby, removing Cyprus as a notified jurisdictional area with retrospective effect from 01.11.2013.

(ii) A transaction where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction then all parties to the transaction to be deemed as associated enterprises, and accordingly, all the provisions of transfer pricing to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price [provided for in the second proviso to section

92C(2)] based on the rate notified by the Central Government would not be available in respect of such transaction.

(iii) Such transaction may be in the nature of –

(1) purchase, sale or lease of tangible or intangible property or

(2) provision of service or

(3) lending or borrowing money or

(4) any other transaction having a bearing on the profits, income, losses or assets of the assessee. It may include a mutual agreement or arrangement for allocation or apportionment of, or contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided by or to the assessee.

(iv) Person located in a NJA shall include a person who is a resident of the NJA and a person, not being an individual, which is established in the NJA. It would also include a permanent establishment of any other person in the NJA.

(v) Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.

(vi) No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.

(vii) Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.

(viii) The rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –

(1) rates specified in the relevant provision of the Income-tax Act, 1961; or

(2) rate or rates in force; or

(3) 30%.

ILLUSTRATION 2

A Ltd., an Indian company, provides technical services to a company, XYZ Inc., located in a NJA for a consideration of ₹ 40 lakhs in October, 2019. It charges ₹ 42 lakhs for similar services rendered to PQR Inc., which is not located in a NJA. PQR Inc. is not an associated enterprise of A Ltd.

Discuss the tax implications under section 94A read with section 92C in respect of the above transaction of provision of technical services by A Ltd. to XYZ Inc.

SOLUTION

Since XYZ Inc. is located in a NJA, the transaction of provision of technical services by the Indian company, A Ltd., would be deemed to be an international transaction and XYZ Inc. and A Ltd. would be deemed to be associated enterprises. Therefore, the provisions of transfer pricing would be attracted in this case.

The price of ₹ 42 lakhs charged for similar services from PQR Inc, being an independent entity located in a non-NJA country, can be taken into consideration for determining the arm's length price (ALP) under Comparable Uncontrolled Price (CUP) Method.

Since the ALP is more than the transfer price, the ALP of ₹ 42 lakhs would be considered as the income arising from the international transaction between A Ltd. and XYZ Inc.

It may be noted that the benefit of permissible variation between the ALP and transfer price is not available in respect of a transaction entered into with an entity in NJA.

ILLUSTRATION 3

Mr. X, a non-resident individual, is due to receive interest of ₹ 5 lakhs during March 2020 from a notified infrastructure debt fund eligible for exemption under section 10(47). He incurred expenditure amounting to ₹ 10,000 for earning such income. Assuming that Mr. X is a resident of a NJA, discuss the tax implications under section 94A, read with sections 115A and 194LB.

SOLUTION

The interest income received by Mr. X, a non-resident, from a notified infrastructure debt fund would be subject to a concessional tax rate of 5% under section 115A on the gross amount of such interest income. Therefore, the tax liability of Mr. X in respect of such income would be ₹ 26,000 (being 5% of ₹ 5 lakhs *plus* health and education cess@4%).

Under section 194LB, tax is deductible @5% (*plus* health and education cess@4%) on interest paid by such fund to a non-resident. However, since X is a resident of a NJA, tax would be deductible@30% (*plus* health and education cess@4%) as per section 94A, and not @5% specified under section 194LB. This is on account of the provisions of section 94A(5), which provides that "**Notwithstanding anything contained in any other provision of this Act,** where a person located in a NJA is entitled to receive any sum or income or amount on which **tax is deductible under Chapter XVII-B,** the **tax shall be deducted at the highest of the following rates**, namely–

(a) at the rate or rates in force;

(b) at the rate specified in the relevant provision of the Act;

(c) at the rate of thirty per cent."

Mr. X can, however, claim refund of excess tax deducted along with interest.

1.19 LIMITATION OF INTEREST DEDUCTION IN CERTAIN CASES [SECTION 94B]

(1) **Preference of debt over equity as a measure to finance businesses:** Debt and equity are the instruments through which a company is generally financed or capitalized. The manner in which a company is capitalized has a major impact on the amount of taxable

profit as the tax laws of countries generally provide for a deduction in respect of interest paid or payable while arriving at the taxable profit. However, the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus, the amount of interest it pays, the lower will be its taxable income. Due to this reason, debt is considered a more tax efficient method of finance than equity. Multinational groups are often able to structure their financing arrangements to maximize tax benefits.

(2) **Tax Rules to prevent shifting of profits through excessive interest payments**: In order to address this issue, tax rules are in place in each country to fix a ceiling limit on the amount of interest deductible in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, with the objective of protecting a country's tax base.

(3) **Relevant Action Plan of BEPS**: Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action Plan 4 and recommended certain measures in its final report.

(4) **Insertion of provision in the Income-tax Act, 1961 in line with BEPS Action Plan 4**: Section 94B has, accordingly, been inserted in the Income-tax Act, 1961, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity to its associated enterprises shall not be deductible in computation of income under the "Profits and gains of business or profession" to the extent that it arises from excess interest.

Excess interest shall mean an amount of

- total interest paid or payable* in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or
- interest paid or payable to associated enterprise for that previous year

whichever is less.

**Total interest paid or payable may be interpreted as interest paid or payable to non-resident associated enterprise as per the intent expressed in section 94B(1) and also the Explanatory Memorandum to the Finance Bill, 2017.*

(5) **Applicability**: The provision shall be applicable to an Indian company, or a permanent establishment of a foreign company in India, being the borrower who incurs expenditure by way of interest or similar nature in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower.

However, the provision of this section would be applicable only where the expenditure by way of interest or of similar nature exceeds **₹ 1 crore,** in respect of any form of debt issued by a non-resident, being an 'associated enterprise' of such borrower.

(6) **Meaning of debt**: Any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income chargeable under the head "Profits and gains of business or profession".

(7) **Provision of guarantee and deposit of matching amount deemed to be debt issued**: Where the debt is issued by a lender which is not associated but an associated enterprise either

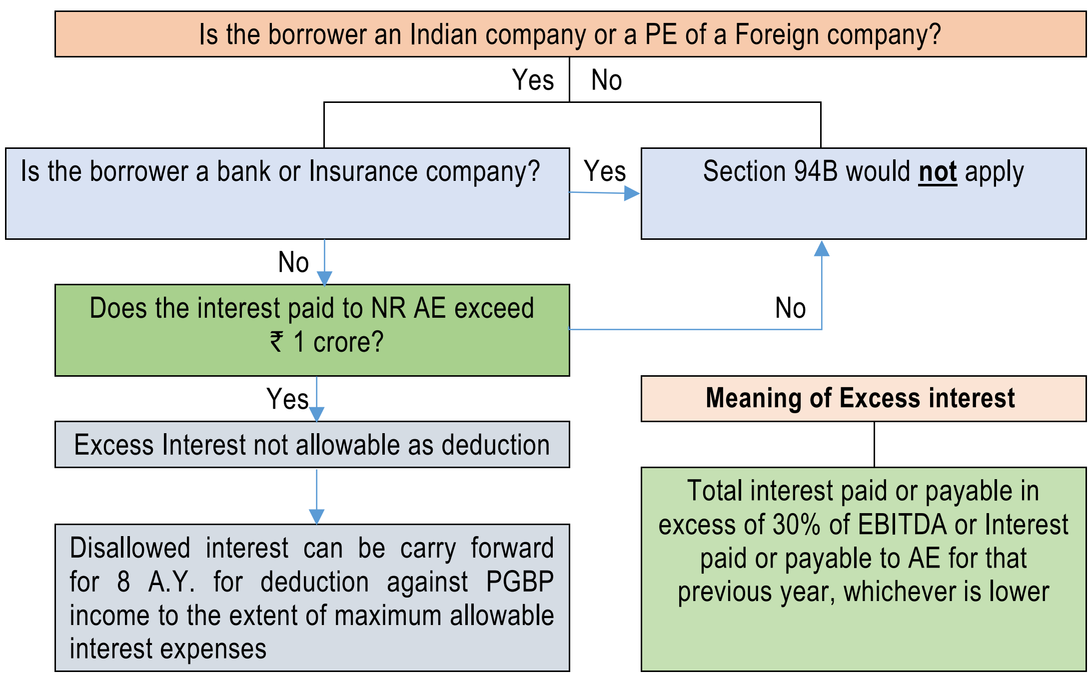
- provides an implicit or explicit guarantee to such lender or
- deposits a corresponding and matching amount of funds with the lender,

such debt shall be deemed to have been issued by an associated enterprise

(8) **Carry forward of excess interest**: The disallowed interest expense can be carried forward upto eight assessment years immediately succeeding the assessment year for which the disallowance was first made and claimed as deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

(9) **Businesses excluded from applicability of the provisions of section 94B**: Taking into consideration the special nature of business of Banks and Insurance business, an Indian company or permanent establishment of a foreign company which is engaged in these business have been excluded from the applicability of the provisions of this section.

Limitation of interest deduction (Section 94B): A Summary



CHAPTER 2

NON RESIDENT TAXATION

LEARNING OUTCOMES

After studying this Chapter, you will be able to –

- **determine** the residential status of different persons and **examine** the scope of income taxable in the hands of non-residents;
- **determine** the residential status of a company, other than an Indian company, based on Place of Effective Management (POEM);
- **identify** whether a particular income is exempt in the hands of a non-resident based on the provisions of the Income-tax Act, 1961;
- **compute** the profits and gains from shipping business, business of operation of aircraft, business of civil construction etc. in certain turnkey power projects in the case of non-corporate non-residents and foreign company applying the presumptive tax provisions under the Income-tax Act, 1961;
- **determine** the quantum of head office expenditure allowable as deduction, in the case of non-residents;
- **determine** the tax payable by non-residents on dividend, royalty and fees for technical service applying the special provisions of Chapter XII;
- **determine** the tax payable by non-residents applying the special provisions relating to certain incomes of non-residents prescribed under Chapter XII-A;

- **examine** the withholding tax provisions to determine the tax, if any, required to be deducted at source on certain payments made to non-residents;
- **compute** the total income of non-residents and tax payable thereon, applying the general provisions and special provisions applicable to non-residents under the Income-tax Act, 1961;
- **Integrate, analyse and apply** the relevant provisions of the Income-tax Act, 1961 to make computations and address related issues.

2.1 INTRODUCTION

Taxation of cross-border transactions are generally based on the two concepts:

1. Residence based taxation
2. Source based taxation

Residence based taxation: The concept of residence-based taxation asserts that natural persons or individuals are taxable in the country or tax jurisdiction in which they establish their residence or domicile, regardless of the source of income. In case of companies, the place of incorporation or the place of effective management is generally considered as its place of residence.

Source based taxation: According to this concept, a country considers certain income as taxable income, if such income arises within its jurisdiction. Such income is taxed in the country of source regardless of the residence of the taxpayer.

The overview of residence and source rules in India may largely be gathered from sections 5, 6 & 9 of the Income-tax Act, 1961. While residents are taxable on global income, non-residents are taxed on their India-source income or income that is received in India or has accrued or deemed to accrue in India.

2.2 IMPORTANT DEFINITIONS

Before we proceed further, it is important to have a recap of some basic definitions given in Section 2 of the Income-tax Act, 1961.

(1) Assessee [Section 2(7)]

"Assessee" means a person by whom any tax or any other sum of money is payable under this Act. In addition, it includes —

(i) every person in respect of whom any proceeding under the Income-tax Act, 1961 has been taken for the assessment of -

  (a) his income; or

  (b) the income of any other person in respect of which he is assessable; or

  (c) the loss sustained by him or by such other person; or

  (d) the amount of refund due to him or to such other person.

(ii) every person who is deemed to be an assessee under any provision of the Income-tax Act, 1961;

(iii) every person who is deemed to be an assessee-in-default under any provision of the Income-tax Act, 1961.

(2) Person [Section 2(31)]

The definition of 'assessee' leads us to the definition of 'person' as the former is closely connected with the latter. The term 'person' is important from another point of view also viz., the charge of income-tax is on every 'person'.

Person includes –

(i) an individual,

(ii) a Hindu undivided family (HUF),

(iii) a company,

(iv) a firm,

(v) an association of persons (AOPs) or a body of individuals (BOIs), whether incorporated or not,

(vi) a local authority, and

(vii) every artificial juridical person other than mentioned above e.g., idol, deity, University of Delhi, University of Calcutta.

(3) Assessment year [Section 2(9)]

"Assessment year" means the period of 12 months commencing on the 1st day of April every year. The year in which income is earned is previous year and such income is taxable in the immediately following year which is the assessment year.

Income earned in the previous year 2019-20 is taxable in the assessment year 2020-21.

(4) Previous year [Section 3]

"Previous year" means the financial year immediately preceding the assessment year.

Business or profession newly set up during the financial year - In such a case, the previous year shall be the period beginning on the date of setting up of the business or profession and ending with 31st March of the said financial year.

If a source of income comes into existence in the said financial year, then, the previous year will commence from the date on which the source of income newly comes into existence and will end with 31st March of the financial year.

(5) Domestic Company [Section 2(22A)]

"Domestic company" means an Indian company, or any other company which, in respect of its income liable to income-tax under this Act, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income.

(6) Foreign Company [Section 2(23A)]

"Foreign company" means a company which is not a domestic company.

(7) India [Section 2(25A)]

"India" means 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 specified maritime zone and the air space above its territory and territorial waters.

Specified maritime zone means the maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976.

(8) Resident [Section 2(42)]

Resident means a person who is resident in India within the meaning of section 6.

(9) Non-resident [Section 2(30)]

"Non-resident'' means a person who is not a "resident", and for the purposes of sections 92, 93 and 168 includes a person who is not ordinarily resident within the meaning of section 6(6).

Section	Provision
92	Computation of income from international transaction having regard to Arm's Length Price (ALP). International transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents.
93	Avoidance of income-tax by transfer of assets resulting in transfer of income to non-residents.
168	Determination of residential status of an Executor depending on the residential status of deceased person.

(10) Transfer [Section 2(47)]

"Transfer" in relation to a capital asset, includes,—

(i) the sale, exchange or relinquishment of the asset; or

(ii) the extinguishment of any rights therein; or

(iii) the compulsory acquisition thereof under any law; or

(iv) the owner of a capital asset may convert the same into the stock-in-trade of a business carried on by him. Such conversion is treated as transfer; or

(v) the maturity or redemption of a zero coupon bond; or

(vi) possession of an immovable property in consideration of part-performance of a contract referred to in section 53A of the Transfer of Property Act, 1882; or

(vii) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

2.3 CHARGE OF INCOME TAX [SECTION 4]

Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and subject to the provisions (including provisions for the levy of additional income-tax) of this Act in respect of the total income of the previous year of every person [Section 4(1)].

However, where by virtue of any provision of this Act income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly. Further, in respect of income chargeable under section 4(1), income-tax shall be deducted at source or paid in advance, where it is so deductible or payable under any provision of this Act.

Thus, the charging section provides that

(a) income-tax shall be charged at the rate or rates prescribed in the Finance Act for the relevant previous year

Rates of tax, surcharge and cess for foreign companies

Rate of Tax: Foreign companies are taxable at the rate of 40%. This would further be increased by surcharge, if applicable, and health and education cess (HEC)

Surcharge: Surcharge at the rate of 2% of such income-tax would be attracted, where the total income exceeds ₹ 1 crore but does not exceed ₹ 10 crores. Surcharge at the rate of 5% of such income tax would be attracted, where the total income exceeds ₹ 10 crores.

Health and Education Cess (HEC): Health and Education cess @4% of income-tax plus surcharge, if applicable, would be attracted irrespective of the level of total income.

Rates of tax, surcharge and cess for non-corporate non-residents

For non-corporate non-residents, the rates of tax, surcharge and cess are same as the rates applicable to residents [Refer to Chapter 1 of Study Material of Final Paper 7: Direct Tax Laws and International Taxation]. However, the higher basic exemption limit for resident individuals of the age of 60 years and above and 80 years and above at any time during the previous year would not be available for non-resident individuals.

(b) the charge of tax is on various persons specified in Section 2(31).

(c) the income sought to be taxed is that of the previous year and not of the of assessment year (there are certain exceptions provided by sections 172, 174, 174A, 175 and 176); and

(d) the levy of tax on the assessee is on his total income computed in accordance with and subject to the appropriate provisions of the Income-tax Act, including provisions for the levy of additional income-tax.

2.4 RESIDENTIAL STATUS AND SCOPE OF TOTAL INCOME

(1) Residential Status [Section 6]

The tax incidence and imposition of tax is dependent upon the residential status of a person. Therefore, the identification and classification of the residence of a person is one of the first steps to be carried out in order to proceed with the assessing of income of a person. The rules for determining the residential status of a person is governed by section 6 of Income-tax Act. For all purposes of income-tax, taxpayers are classified into three broad categories on the basis of their residential status viz.

(i) Resident and ordinarily resident (ROR)

(ii) Resident but not ordinarily resident (RNOR)

(iii) Non-resident

(i) Residential status of an individual

As per section 6(1), an individual is said to be resident in India in any previous year if he satisfies any one of the following conditions:

(a) He has been in India during the previous year for a total period of 182 days or more; or

(b) He has been in India during the 4 years immediately preceding the previous year for total period of 365 days or more and has been in India for at least 60 days in the previous year.

If the individual satisfies any one of the conditions mentioned above he is a resident. If the individual does not satisfy both the conditions he is said to be non-resident.

Exceptions:

The following categories of individuals will be treated as resident in India only if the period of their stay during the relevant previous year amounts to 182 days. In other words, even if such persons were in India for 60 days or more (but less than 182 days) in the relevant previous year, they will not be treated as resident due to the reason that their stay in India was for 365 days or more during the 4 immediately preceding years.

(a) Indian citizen, who leaves India during the previous year as a member of the crew of an Indian ship or for the purposes of employment outside India, or

(b) Indian citizen or a person of Indian origin[1], who, being outside India and comes on a **visit**[2] to India during the previous year.

Resident and ordinarily resident/ Resident but not ordinarily resident

Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assessees can be either a resident or non-resident. A not-ordinarily resident person is one who satisfies any one of the conditions specified under section 6(6).

(i) If such individual has been non-resident in India in any 9 out of the 10 previous years preceding the relevant previous year, or

(ii) If such individual has during the 7 previous years preceding the relevant previous year been in India for a period of 729 days or less.

Note: In simpler terms, an individual is said to be a **resident and ordinarily resident,** if he satisfies both the following conditions:

(i) He is a resident in any 2 out of the last 10 years preceding the relevant previous year, **and**

(ii) His total stay in India in the last 7 years preceding the relevant previous year is 730 days or more.

If the individual satisfies both the conditions mentioned above, he is a resident and ordinarily resident but if only one or none of the conditions are satisfied, the individual is a resident but not ordinarily resident.

How to determine period of stay in India for an Indian citizen, being a crew member?

In case of foreign bound ships where the destination of the voyage is outside India, there was uncertainty regarding the manner and the basis of determining the period of stay in India for an Indian citizen, being a crew member.

To remove this uncertainty, *Explanation 2* has been inserted in section 6(1) to provide that in the case of an Individual, being a citizen of India and a member of the crew of a foreign bound ship leaving India, the period or periods of stay in India shall, in respect of such voyage, be determined in the prescribed manner and subject to the prescribed conditions.

Accordingly, the CBDT has vide, *Notification No. 70/2015 dated 17.8.2015*, inserted Rule 126 in the Income-tax Rules, 1962 to compute the period of stay in such cases.

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[1] A person is said to be of Indian origin if he or either of his parents or either of his grandparents were born in undivided India

[2] If the individual returns to India permanently, then the additional condition of 60 days in PY + 365 in the four immediately preceding PYs would apply for determining his residential status.

According to Rule 126, for the purposes of section 6(1), in case of an individual, being a citizen of India and a member of the crew of a ship, the period or periods of stay in India shall, in respect of an eligible voyage, not include the following period:

Period to be excluded

Period commencing from		Period ending on
the date entered into the Continuous Discharge Certificate in respect of joining the ship by the said individual for the eligible voyage	**and**	the date entered into the Continuous Discharge Certificate in respect of signing off by that individual from the ship in respect of such voyage.

Meaning of certain terms:

	Terms	Meaning
(a)	Continuous Discharge Certificate	This term has the meaning assigned to it in the Merchant Shipping (Continuous Discharge Certificate-cum Seafarer's Identity Document) Rules, 2001 made under the Merchant Shipping Act, 1958.
(b)	Eligible voyage	A voyage undertaken by a ship engaged in the carriage of passengers or freight in international traffic where – (i) for the voyage having originated from any port in India, has as its destination any port outside India; and (ii) for the voyage having originated from any port outside India, has as its destination any port in India.

Important points:

1. *Residential status is to be determined on year to year basis*
2. *The term "stay in India" includes stay in the territorial waters of India (i.e. 12 nautical miles into the sea from the Indian coastline). Even the stay in a ship or boat moored in the territorial waters of India would be sufficient to make the individual resident in India.*
3. *The residence of an individual for income-tax purpose has nothing to do with citizenship, place of birth or domicile. An individual can, therefore, be resident in more countries than one even though he can have only one domicile.*
4. *For the purpose of counting the number of days stayed in India, both the date of departure as well as the date of arrival are considered to be in India.*
5. *It is not necessary that the period of stay must be continuous or active nor is it essential that the stay should be at the usual place of residence, business or employment of the individual.*

(ii) Residential status of a HUF, firm, AOPs/BOIs, local authorities and artificial juridical persons

Resident: These persons would be resident in India if the control and management of their affairs is situated wholly or partly in India.

Non-resident: If the control and management of the affairs is situated wholly outside India, they would become a non-resident.

Control and Management of HUF: It is with Karta or its Manager.

Control and Management of Firm/AOPs: It is with Partners/Members.

A HUF can be Resident and ordinarily resident (ROR) or Resident but not ordinarily resident (RNOR)

If Karta of resident HUF satisfies both the following additional conditions (as applicable in case of individual) then, resident HUF will be Resident and ordinarily resident, otherwise it will be Resident but not ordinarily resident.

Additional Conditions:

(a) Karta of Resident HUF should be resident in at least 2 previous years out of 10 previous years immediately preceding relevant previous year.

(b) Stay of Karta during 7 previous year immediately preceding relevant previous year should be 730 days or more.

Firms, association of persons, local authorities and other artificial juridical persons can be either resident or non-resident but they cannot be resident but not ordinarily resident in India.

Meaning of the term "control and management":

- *The expression 'control and management' referred to under section 6 refers to the central control and management and not to the carrying on of day-to-day business by servants, employees or agents.*
- *The business may be done from outside India and yet its control and management may be wholly within India. Therefore, control and management of a business is said to be situated at a place where the head and brain of the adventure is situated.*
- *The place of control may be different from the usual place of running the business and sometimes even the registered office of the assessee. This is because the control and management of a business need not necessarily be done from the place of business or from the registered office of the assessee.*
- *But control and management do imply the functioning of the controlling and directing power at a particular place with some degree of permanence.*

(iii) Residential status of a Company

With effect from assessment year 2017-18, a company would be resident in India in any previous year, if-

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India.

"Place of effective management" *means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made [Explanation to section 6(3)].*

Guiding Principles for determination of Place of Effective management ('POEM') of a Company, other than an Indian company – [Circular No. 6/2017, dated 24.01.2017 & Circular No. 8/2017, dated 23-02-2017]:

Place of effective management' (POEM) is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognises the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation.

The CBDT has laid down the following guiding principles to be followed for determination of POEM.

Concept of Substance over form

Any determination of the POEM will depend upon the facts and circumstances of a given case. The POEM concept is one of substance over form. It may be noted that an entity may have more than one place of management, but it can have only one place of effective management at any point of time. Since "residence" is to be determined for each year, POEM will also be required to be determined on year to year basis.

Whether the company is engaged in active business outside India? - An important criterion for determination of POEM

The process of determination of POEM would be primarily based on the fact as to **whether or not the company is engaged in active business outside India.**

A company shall be said to be engaged in 'active business outside India'

- if passive income is not more than 50% of its total income, and
- less than 50% of its total asset are situated in India; and
- less than 50% of total number of employees are situated in India or are resident in India; and
- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Meaning of certain terms:

<table>
<tr><th>Term</th><th colspan="2">Meaning</th></tr>
<tr><td>Income</td><td colspan="2">(a) As computed for tax purpose in accordance with the laws of the country of incorporation; or
(b) As per books of account, where the laws of the country of incorporation does not require such a computation.</td></tr>
<tr><td rowspan="3">Value of assets</td><td>(a) In case of an individually depreciable asset</td><td>The average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the previous year; and</td></tr>
<tr><td>(b) In case of pool of fixed asset, being treated as a block for depreciation</td><td>The average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the year;</td></tr>
<tr><td>(c) In case of any other asset</td><td>Value as per books of account</td></tr>
<tr><td>Number of employees</td><td colspan="2">The average of the number of employees as at the beginning and at the end of the year and shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees.</td></tr>
<tr><td>Pay roll</td><td colspan="2">This term includes the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.</td></tr>
<tr><td>Passive income</td><td colspan="2">It is the aggregate of, -
(i) income from the transactions where both the purchase and sale of goods is from/to its associated enterprises; and
(ii) income by way of royalty, dividend, capital gains, interest or rental income;
However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation.</td></tr>
</table>

Place of Effective Management:

(i) In case of Companies engaged in Active Business outside India

POEM of a company engaged in active business shall be presumed to be outside India if the majority of the board meeting are held outside India.

However, in case the Board is not exercising its powers of management and such powers are being exercised by either the holding company or any other person, resident in India, then POEM shall be considered to be in India.

For this purpose, merely because the Board of Directors (BOD) follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of Pay roll functions, Accounting, Human resource (HR) functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; would not constitute a case of BoD of companies standing aside.

CBDT Circular No. 25/2017, dated 23.10.2017 clarifies that so long as the Regional Headquarter operates for subsidiaries/ group companies in a region within the general and objective principles of global policy of the group laid down by the parent entity in the field of Pay roll functions, Accounting, HR functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; it would, in itself, not constitute a case of BoD of companies standing aside and such activities of Regional Headquarter in India alone will not be a basis for establishment of PoEM for such subsidiaries/ group companies.

It is further mentioned in the said Circular that the provisions of General Anti-Avoidance Rule contained in Chapter X-A of the Income-tax Act, 1961 may get triggered in such cases where the above clarification is found to be used for abusive/ aggressive tax planning.

For the purpose of determining whether the company is engaged in active business outside India, the average of the data of the previous year and two years prior to that shall be taken into account. In case the company has been in existence for a shorter period, then data of such period shall be considered. Where the accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the previous year, then, data of the accounting year that ends during the relevant previous year and two accounting years preceding it shall be considered.

The final guidelines have clarified that mere following of global policies laid down by the Indian holding company would not constitute that Board is standing aside.

(ii) In case Companies not engaged in active business outside India

The guidelines provide a two stage process for determination of POEM in case of companies not engaged in active business.

(a) **First stage**: Identifying the person(s) who actually make the key management and commercial decisions for the conduct of the company as a whole.

(b) **Second stage**: Determine the place where these decisions are, in fact, being made.

The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM, it is the substance which would be conclusive rather than the form.

The conditions specified in the circular are depicted in the flow charts below:

The determination of POEM is based on the following categorization of foreign companies:

Active Business Outside India (Business Test)

Companies fulfilling the test of ABOI

- *POEM outside India, if majority BOD meetings are held outside India*
- *If de facto decision making authority is not BOD but Indian parent or resident, POEM shall be in India*

Companies other than those fulfilling the test of ABOI

Stage 1: *Identification of persons who actually make the key management and commercial decision for conduct of the company's business as a whole*

Stage 2: *Determination of place where these decisions are, in fact, made*

What is ABOI test?

A company is said to be engaged in ABOI, if it fulfills the cumulative conditions of:

- Its passive income* (wherever earned) is 50% or less of its total income
- Less than 50% of its total assets situated in India
- Less than 50% of the total number of employees are situated in India or are residents in India
- Payroll expenses incurred on such employees are less than 50% of its total payroll expenditure

** Passive income of a company shall be aggregate of:*

(i) Income from the transactions where both the purchase and sale of goods is from/ to its associated enterprises; and

(ii) income by way of royalty, dividend, capital gains, interest (except for banking companies and public financial institutions) or rental income whether or not involving associated enterprises

Some of the guiding principles which may be taken into account for determining the POEM are as follows:

(a) **Location where the Board of Directors meet and makes decisions: This location may be** the place of effective management of a company provided, the Board –

(i) retains and exercises its authority to govern the company; and

(ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.

It may be mentioned that mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM.

As an example this may be the case where the board meetings are held in a location distinct from the place where head office of the company is located or such location is unconnected with the place where the predominant activity of the company is being carried out.

If a Board has *de facto* delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder, promoter, strategic or legal or financial advisor etc. and does nothing more than routinely ratifying the decisions that have been made, the company's place of effective management will ordinarily be the place where these senior managers or the other person make those decisions.

"Senior Management" in respect of a company means the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While designation may vary, these persons may include:

(i) Managing Director or Chief Executive Officer;

(ii) Financial Director or Chief Financial Officer;

(iii) Chief Operating Officer; and

(iv) The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

(b) Location of Executive Committee, in case powers are delegated by the Board: A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for mere formal approval by the full board will often be considered to be the company's place of effective management.

The delegation of authority may be either *de jure* (by means of a formal resolution or Shareholder Agreement) or *de facto* (based upon the actual conduct of the board and the executive committee).

(c) Location of Head Office: The location of a company's head office will be a very important factor in the determination of the company's place of effective management because it often represents the place where key company decisions are made. The following points need to be considered for determining the location of the head office of the company:-

If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters then that location is the place where head office is located.

If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers,-

(i) are primarily or predominantly based; or

(ii) normally return to following travel to other locations; or

(iii) meet when formulating or deciding key strategies and policies for the company as a whole.

Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situation the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located.

In situations where the senior management is so decentralised that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's place of effective management.

"Head Office" of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.

(d) **Use of modern technology:** The use of modern technology impacts the place of effective management in many ways. It is no longer necessary for the persons taking decision to be physically present at a particular location. Therefore physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.

(e) **Decision *via* circular resolution or round robin voting:** In case of circular resolution or round robin voting the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered. It cannot be said that proposer of decision alone would be relevant but based on past practices and general conduct; it would be required to determine the person who has the authority and who exercises the authority to take decisions. The place of location of such person would be more important.

(f) **Decisions made by Shareholders are not relevant factor in determination of POEM:** The decisions made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's place of effective management. Such decisions may include sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. These decisions typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company's business from a management or commercial perspective and are therefore, generally not relevant for the determination of a company's place of effective management.

However, the shareholder's involvement can, in certain situations, turn into that of effective management. This may happen through a formal arrangement by way of shareholder agreement etc. or may also happen by way of actual conduct. As an example if the shareholders limit the authority of board and senior managers of a company and thereby remove the company's real authority to make decision then the shareholder guidance transforms into usurpation and such undue influence may result in effective management being exercised by the shareholder.

Therefore, whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only.

(g) **Day to day routine operational decisions are not relevant for determination of POEM:** It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM. The operational decisions relate to the oversight of the day-to-day business operations and activities of a company whereas the key management and commercial decision are concerned with broader strategic and policy decision. For example, a decision to open a major new manufacturing facility or to discontinue a major product line would be examples of key commercial decisions affecting the company's business as a whole. By contrast, decisions by the plant manager appointed by senior management to run that facility, concerning repairs and maintenance, the implementation of company-wide quality controls and human resources policies, would be examples of routine operational decisions. In certain situations it may happen that person responsible for operational decision is the same person who is responsible for the key management and commercial decision. In such cases it will be necessary to distinguish the two type of decisions and thereafter assess the location where the key management and commercial decisions are taken.

If the above factors do not lead to clear identification of POEM then the final guidelines provide that following secondary factors may be considered:

- Place where main and substantial activity of the company is carried out; or
- Place where the accounting records of the company are kept.

It needs to be emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

(i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(ii) The fact that there exists a Permanent Establishment of a foreign entity in India would itself not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iv) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.

(v) The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

It is reiterated that the above principles for determining the POEM are for guidance only. No single principle will be decisive in itself. The above principles are not to be seen with reference to any particular moment in time rather activities performed over a period of time, during the previous year, need to be considered.

In other words, a "snapshot" approach is not to be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly /predominantly in India

The CBDT also clarified that the Assessing Officer (AO) shall, before initiating any proceedings for holding a company incorporated outside India, on the basis of its POEM, as being resident in India, seek prior approval of the Principal Commissioner or the Commissioner, as the case may be.

Further, in case the AO proposes to hold a company incorporated outside India, on the basis of its POEM, as being resident in India then any such finding shall be given by the AO after seeking prior approval of the collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned, in this regard. The collegium so constituted shall provide an opportunity of being heard to the company before issuing any directions in the matter.

Example 1: *Company A Co. is a sourcing entity, for an Indian multinational group, incorporated in country X and is 100% subsidiary of Indian company (B Co.). The warehouses and stock in them are the only assets of the company and are located in country X. All the employees of the company are also in country X. The average income wise breakup of the company's total income for three years is, -*

(i) 30% of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises;

(ii) 30% of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises;

(iii) 30% of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises; and

(iv) 10% of the income is by way of interest.

Interpretation: In this case, passive income is 40% of the total income of the company. The passive income consists of, -

(i) 30% income from the transaction where both purchase and sale is from/to associated enterprises; and

(ii) 10% income from interest.

The A Co. satisfies the first requirement of the test of active business outside India. Since no assets or employees of A Co. are in India the other requirements of the test is also satisfied. Therefore, company is engaged in active business outside India.

Example 2: *The other facts remain same as that in Example 1 with the variation that A Co. has a total of 50 employees. 47 employees, managing the warehouse, storekeeping and accounts of the company, are located in country X. The Managing Director (MD), Chief Executive Officer (CEO) and sales head are resident in India. The total annual payroll expenditure on these 50 employees is of ₹ 5 crore. The annual payroll expenditure in respect of MD, CEO and sales head is of ₹ 3 crore.*

Interpretation: Although the first limb of active business test is satisfied by A Co. as only 40% of its total income is passive in nature. Further, more than 50% of the employees are also situated outside India. All the assets are situated outside India. However, the payroll expenditure in respect of the MD, the CEO and the sales head being employees resident in India exceeds 50% of the total payroll expenditure. Therefore, A Co. is not engaged in active business outside India.

Example 3: *The basic facts are same as in Example 1. Further facts are that all the directors of the A Co. are Indian residents. During the relevant previous year 5 meetings of the Board of Directors is held of which two were held in India and 3 outside India with two in country X and one in country Y.*

Interpretation: The A Co. is engaged in active business outside India as the facts indicated in Example 1 establish. The majority of board meetings have been held outside India. Therefore, the POEM of A Co. shall be presumed to be outside India.

Example 4: *The facts are same as in Example 3 but it is established by the Assessing Officer that although A Co.'s senior management team signs all the contracts, for all the contracts above ₹ 10 lakh the A Co. must submit its recommendation to B Co. and B Co. makes the decision whether or not the contract may be accepted. It is also seen that during the previous year more than 99% of the contracts are above ₹ 10 lakh and over past years also the same trend in respect of value contribution of contracts above ₹ 10 lakh is seen.*

Interpretation: These facts suggest that the effective management of the A Co. may have been usurped by the parent company B Co. Therefore, POEM of A Co. may in such cases be not presumed to be outside India even though A Co. is engaged in active business outside India and majority of board meeting are held outside India.

Example 5: *An Indian multinational group has a local holding company A Co. in country X. The A Co. also has 100% downstream subsidiaries B Co. and C Co. in country X and D Co. in country Y. The A Co. has income only by way of dividend and interest from investments made in its subsidiaries. The Place of Effective Management of A Co. is in India and is exercised by ultimate parent company of the group. The subsidiaries B, C and D are engaged in active business outside India. The meetings of Board of Director of B Co., C Co. and D Co. are held in country X and Y respectively.*

Interpretation: Merely because the POEM of an intermediate holding company is in India, the POEM of its subsidiaries shall not be taken to be in India. Each subsidiary has to be examined separately. As indicated in the facts since B Co., C Co., and D Co. are independently engaged in active business outside India and majority of Board meetings of these companies are also held outside India. The POEM of B Co., C Co., and D Co. shall be presumed to be outside India.

Further, the <u>CBDT vide Circular no. 8/2017 dated 23.02.2017</u> also clarified that POEM guidelines shall not apply to a company having turnover or gross receipts of ₹ 50 crores or less in a financial year.

<u>Transition Mechanism for a company incorporated outside India and has not been assessed to tax earlier [Chapter XII-BC – Section 115JH]</u>

A transition mechanism for a company which is incorporated outside India, which has not been assessed to tax in India earlier and has become resident in India for the first time due to application of POEM, has been provided in Chapter XII-BC comprising of section 115JH.

(a) Accordingly, the Central Government is empowered to notify exception, modification and adaptation subject to which, the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation, set-off or carry forward and set off of losses, special provision relating to avoidance of tax and the collection and recovery of taxes shall apply in a case where a foreign company is said to be resident in India due to its POEM being in India for the first time and the said company has never been resident in India before.

(b) In a case where the determination regarding foreign company to be resident in India has been made in the assessment proceedings relevant to any previous year, then, these transition provisions would also cover any subsequent previous year, if the foreign company is resident in India in that previous year and the previous year ends on or before the date on which such assessment proceeding is completed. In effect, the transition provisions would also cover any subsequent amendment upto the date of determination of POEM in an assessment proceeding. However, once the transition is complete, then, normal provisions of the Act would apply.

(c) In the notification issued by the Central Government, certain conditions including procedural conditions subject to which these adaptations shall apply can be provided for and in case of failure to comply with the conditions, the benefit of such notification would not be available to the foreign company.

Accordingly, where in a previous year, any benefit, exemption or relief has been claimed and granted to the foreign company in accordance with the notification, and subsequently, there is failure to comply with any of the conditions specified therein, then –

(i) the benefit, exemption or relief shall be deemed to have been wrongly allowed;

(ii) the Assessing Officer may re-compute the total income of the assessee for the said previous year and make the necessary amendment as if the exceptions, modifications and adaptations as per the notification does not apply; and

(iii) the provisions of section 154 shall, so far as may be, apply thereto and the period of four years for rectification of mistake apparent from the record has to be reckoned from the end of the previous year in which the failure to comply with the condition stipulated in the notification takes place.

(d) Every notification issued in exercise of this power by the Central Government shall be laid before each house of the Parliament.

(e) Accordingly, in exercise of the power under section 115JH(1) of the Income-tax Act, 1961,the Central Government has, vide notification No. 29/2018, dated 22nd June, 2018, specified the exceptions, modifications and adaptions subject to which, the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation, set-off or carry forward and set off of losses, special provision relating to avoidance of tax and the collection and recovery of taxes shall apply in a case where a foreign company is said to be resident in India in any previous year on account of its POEM being in India and the such foreign company has not been resident in India before the said previous year.

Particulars	Provisions
Determination of opening WDV	<u>**If the foreign company is assessed to tax in the foreign jurisdiction**</u> **Where depreciation is required to be taken into account for the purpose of computation of its taxable income**, the WDV of the depreciable asset as per the tax record in the foreign country on the 1st day of the previous year shall be adopted as the opening WDV for the said previous year. **Where WDV is not available as per tax records,** the WDV shall be calculated assuming that the asset was installed, utilised and the depreciation was actually allowed as per the provisions of the laws of that foreign jurisdiction. The WDV so arrived at as on the 1st day of the previous year shall be adopted to be the opening WDV for the said previous year.

	<u>If the foreign company is not assessed to tax in the foreign jurisdiction</u> WDV of the depreciable asset as appearing in the books of account as on the 1st day of the previous year maintained in accordance with the laws of that foreign jurisdiction shall be adopted as the opening WDV for the said previous year.
Brought forward loss and unabsorbed depreciation	**<u>If the foreign company is assessed to tax in the foreign jurisdiction</u>** Brought forward loss and unabsorbed depreciation as per the tax record shall be determined year wise on the 1st day of the said previous year. **<u>If the foreign company is not assessed to tax in the foreign jurisdiction</u>** Brought forward loss and unabsorbed depreciation as per the books of account prepared in accordance with the laws of that country shall be determined year wise on the 1st day of the said previous year. **<u>Other provisions</u>** Such brought forward loss and unabsorbed depreciation shall be deemed as loss and unabsorbed depreciation brought forward as on the 1st day of the said previous year and shall be allowed to be set off and carried forward in accordance with the provisions of the Act for the remaining period calculated from the year in which they occurred for the first time taking that year as the first year. However, the losses and unabsorbed depreciation of the foreign company shall be allowed to be set off only against such income of the foreign company which has become chargeable to tax in India on account of it becoming resident in India due to application of POEM. In cases where the brought forward loss and unabsorbed depreciation originally adopted in India are revised or modified in the foreign jurisdiction due to any action of the tax or legal authority, the amount of the loss and unabsorbed depreciation shall be revised or modified for the purposes of set off and carry forward in India.
Period of profit and loss account and balance sheet in cases	The foreign company is required to prepare profit and loss account and balance sheet for the period starting from the date on which the accounting year immediately following said accounting year begins, upto 31st March of the year immediately preceding the period

where accounting year of foreign company does not end on 31st March	beginning with 1st April and ending on 31st March during which the foreign company has become resident. The foreign company is also required to prepare profit and loss account and balance sheet for succeeding periods of twelve months, beginning from 1st April and ending on 31st March, till the year the foreign company remains resident in India on account of its POEM. **Examples:** **Example 1:** If the accounting year of the foreign company is a calendar year and the company becomes resident in India during P.Y. 2019-20 for the first time due to its POEM being in India, then, the company is required to prepare profit and loss account and balance sheet for the period 1st January, 2019 to 31st March, 2019. It is also required to prepare profit and loss account and balance sheet for the period 1st April, 2019 to 31st March, 2020. For the purpose of carry forward of loss and unabsorbed depreciation in this case, since the period 1st January, 2019 to 31st March, 2019 is less than 6 months, it is to be included in the accounting year immediately preceding the accounting year in which the foreign company is held to be resident in India for the first time. Accordingly, the profit and loss and balance sheet of the 15 month period from 1 January, 2018 to 31st March, 2019 is to be prepared. **Example 2:** If the accounting year of the foreign company is from 1st July to 30th June and the company becomes resident in India during P.Y. 2019-20 for the first time due to its POEM being in India, then, the company is required to prepare profit and loss account and balance sheet for the period 1st July, 2018 to 31st March, 2019. It is also required to prepare profit and loss account and balance sheet for the period 1st April, 2019 to 31st March, 2020. For the purpose of carry forward of loss and unabsorbed depreciation in this case, since the period is more than 6 months, it is to be treated as a separate accounting year. The loss and unabsorbed depreciation as per tax record or books of account, as the case may be, of the foreign company shall, be allocated on proportionate basis.
Applicability of provisions of Chapter XVII-B	Where more than one provision of Chapter XVII-B of the Act applies to the foreign company as resident as well as foreign company, the provision applicable to the foreign company alone shall apply.

(TDS provisions)	Compliance to those provisions of Chapter XVII-B of the Act as are applicable to the foreign company prior to its becoming Indian resident shall be considered sufficient compliance to the provisions of said Chapter. The provisions of section 195(2) relating to application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax shall apply in such manner so as to include payment to the foreign company.
Availability of deduction under section 90 or 91 (Foreign tax credit)	The foreign company shall be entitled to relief or deduction of taxes paid in accordance with the provisions of section 90 or section 91 of the Act. Where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India in respect of the income to which it relates and shall be in accordance with the provisions of rule 128 of the Income-tax Rules, 1962 [Given as Annexure 4 at the end of this material].
Non applicability of the notification	The above exceptions, modifications and adaptations shall not apply in respect of such income of the foreign company which otherwise would have been chargeable to tax in India, even if the foreign company had not become Indian resident.
Applicability of the notification where foreign company becomes resident in the subsequent previous year also	In a case where the foreign company is said to be resident in India during a previous year, immediately succeeding a previous year during which it is said to be resident in India; the exceptions, modifications and adaptations shall apply to the said previous year subject to the condition that the WDV, the brought forward loss and the unabsorbed depreciation to be adopted on the 1st day of the previous year shall be those which have been arrived at on the last day of the preceding previous year in accordance with the provisions of this notification.
No effect on other transactions	Any transaction of the foreign company with any other person or entity under the Act shall not be altered only on the ground that the foreign company has become Indian resident.
Applicability of other provisions relating to foreign company	Subject to the above exceptions, modifications and adaptions specifically provided vide this notification, the foreign company shall continue to be treated as a foreign company even if it is said to be resident in India and all the provisions of the Act shall apply accordingly. Consequently, the provisions specifically applicable to,—

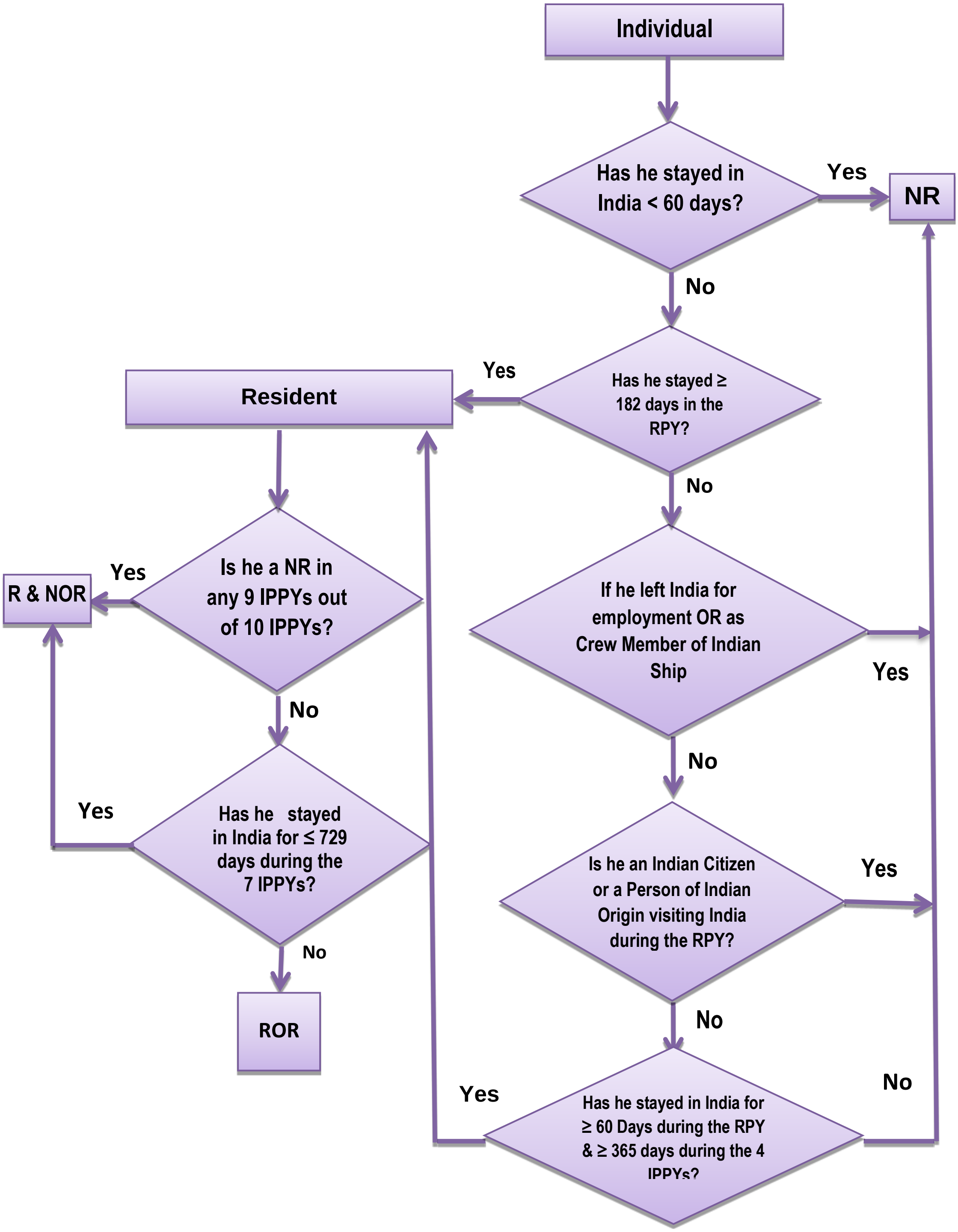
	(i) a foreign company, shall continue to apply to it; (ii) non-resident persons, shall not apply to it; and (iii) the provisions specifically applicable to resident, shall apply to it.
Applicability of tax rate on foreign company	In case of conflict between the provision applicable to the foreign company as resident and the provision applicable to it as foreign company, the later shall generally prevail. Therefore, the rate of tax in case of foreign company i.e., 40% shall remain the same, i.e., rate of income-tax applicable to the foreign company even though residency status of the foreign company changes from non-resident to resident on the basis of POEM.
Applicability of notification	This notification shall be deemed to have come into force from 1st April, 2017.
Meaning of foreign jurisdiction	The place of incorporation of the foreign company.
Applicability of rule 115 of the Income-tax Rules, 1962.	The rate of exchange for conversion into rupees of value expressed in foreign currency, wherever applicable, shall be in accordance with provision of rule 115 of the Income-tax Rules, 1962. [Given as Annexure 2 at the end of this material]

Determination of Residential Status: A summary

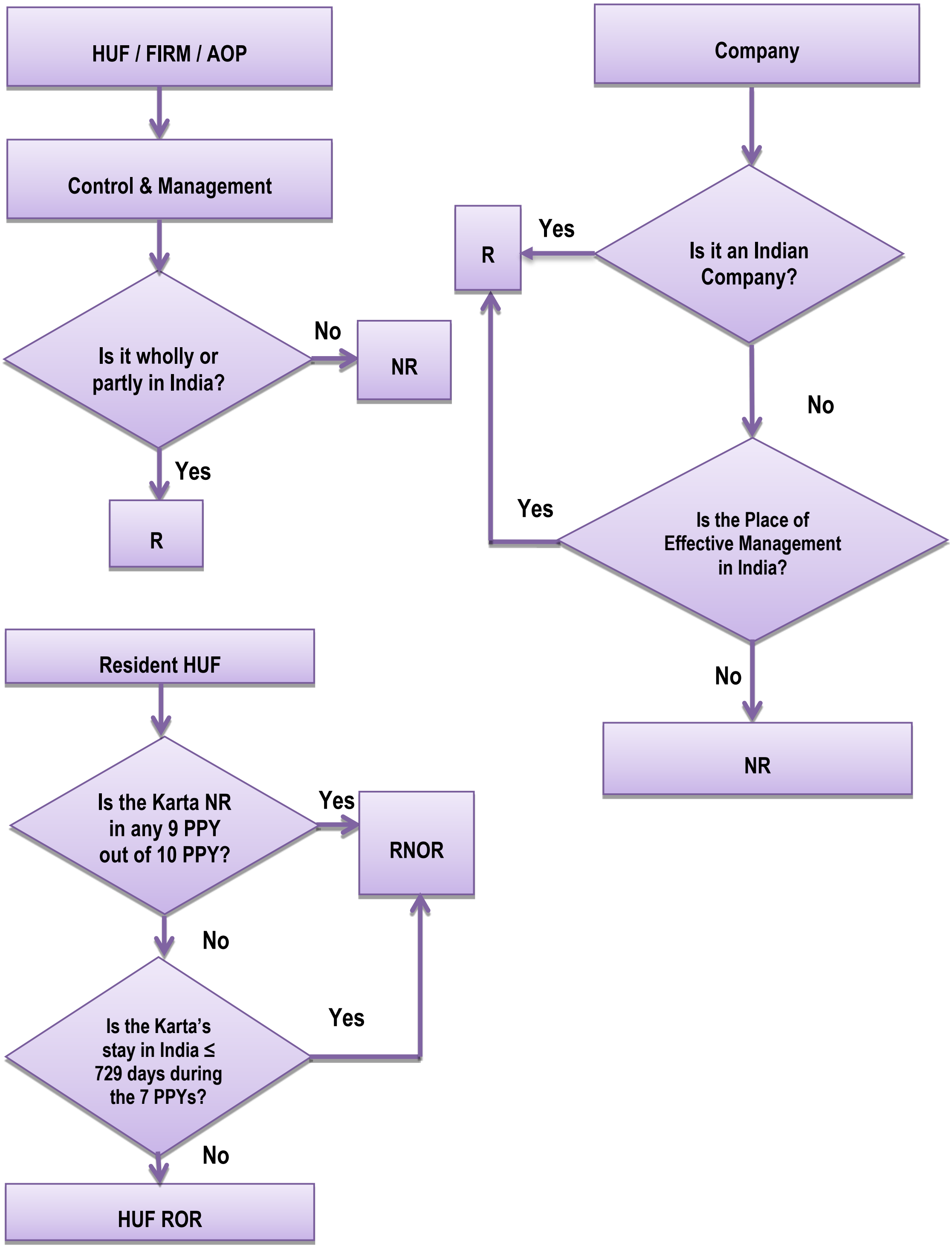
Abbreviations used in the Flow Charts in pages 2.27 & 2.28

IC	=	**Indian Citizen**	**RPY**	=	**Relevant Previous Year**
R	=	**Resident**	**NR**	=	**Non-resident**
IPPYs	=	**Immediately Preceding Previous Years**	**AOP**	=	**Association of Persons**
N & OR	=	**Resident but Not Ordinarily Resident**	**HUF**	=	**Hindu Undivided Family**
ROR	=	**Resident and Ordinarily Resident**			

Determination of Residential Status of Individual



Determination of Residential Status of HUF/ Firm/ AOP/ Company



(2) Scope of Total Income [Section 5]

Section 5 provides the scope of total income in terms of the residential status of the assessee because the incidence of tax on any person depends upon his residential status. The scope of total income of an assessee depends upon the following three important considerations:

(i) the residential status of the assessee;

(ii) the place of accrual or receipt of income, whether actual or deemed; and

(iii) the point of time at which the income had accrued to or was received by or on behalf of the assessee.

A non-resident's total income under section 5(2) includes:

(i) income received or deemed to be received in India in the previous year; and

(ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year.

Clarification regarding liability to income-tax in India of a non-resident seafarer receiving remuneration in NRE (non-resident external) account maintained with an Indian Bank [Circular No.13/2017, dated 11.04.2017 and Circular no.17/2017, dated 26.04.2017]

Income by way of salary, received by non-resident seafarers, for services rendered outside India on-board foreign ships, is being subjected to tax in India for the reason that the salary has been received by the seafarer into the NRE bank account maintained in India by the seafarer. On receiving representations in this regard, the CBDT examined the matter and noted that section 5(2)(a) of the income-tax act, 1961 provides that only such income of a non-resident shall be subjected to tax in India that is either received or is deemed to be received in India.

Accordingly, the CBDT has, vide this circular, clarified that that salary accrued to a non-resident seafarer for services rendered outside India on a foreign going ship (with Indian flag or foreign flag) shall not be included in the total income merely because the said salary has been credited in the NRE account maintained with an Indian bank by the seafarer.

Note: All assessees, whether resident or not, are chargeable to tax in respect of their income accrued, arisen, received or deemed to accrue, arise or to be received in India.

(i) Meaning of "Income received or deemed to be received"

All assessees are liable to tax in respect of the income received or deemed to be received by them in India during the previous year irrespective of -

(i) their residential status, and

(ii) the place of its accrual.

Income is to be included in the total income of the assessee immediately on its actual or deemed receipt. The receipt of income refers to only the first occasion when the recipient gets the money under his control. Therefore, when once an amount is received as income, remittance or transmission of that amount from one place or person to another does not constitute receipt of income in the hands of the subsequent recipient or at the place of subsequent receipt.

Income deemed to be received in India [Section 7]

- Contribution in excess of 12% of salary to Recognised provident fund or interest credited in excess of 9.5% p.a (Annual accretion to the credit of RPF)
- Contribution by the Central Government or other employer under a pension scheme referred u/s 80CCD
- Amount transferred from unrecognised provident fund to recognised provident fund (being the employer's contribution and interest thereon)

(ii) Meaning of income 'accruing' and 'arising'

Accrue refers to the right to receive income, whereas due refers to the right to enforce payment of the same. For e.g. salary for work done in December will accrue throughout the month, day to day, but will become due on the salary bill being passed on 31st December or 1st January.

Similarly, on Government securities, interest payable on specified dates arise during the period of holding, day to day, but will become due for payment on the specified dates.

Example: *Interest on Government securities is usually payable on specified dates, say on 1st January and 1st July. In all such cases, the interest would be said to accrue from 1st July to 31st December on 1st January, it will fall due for payment.*

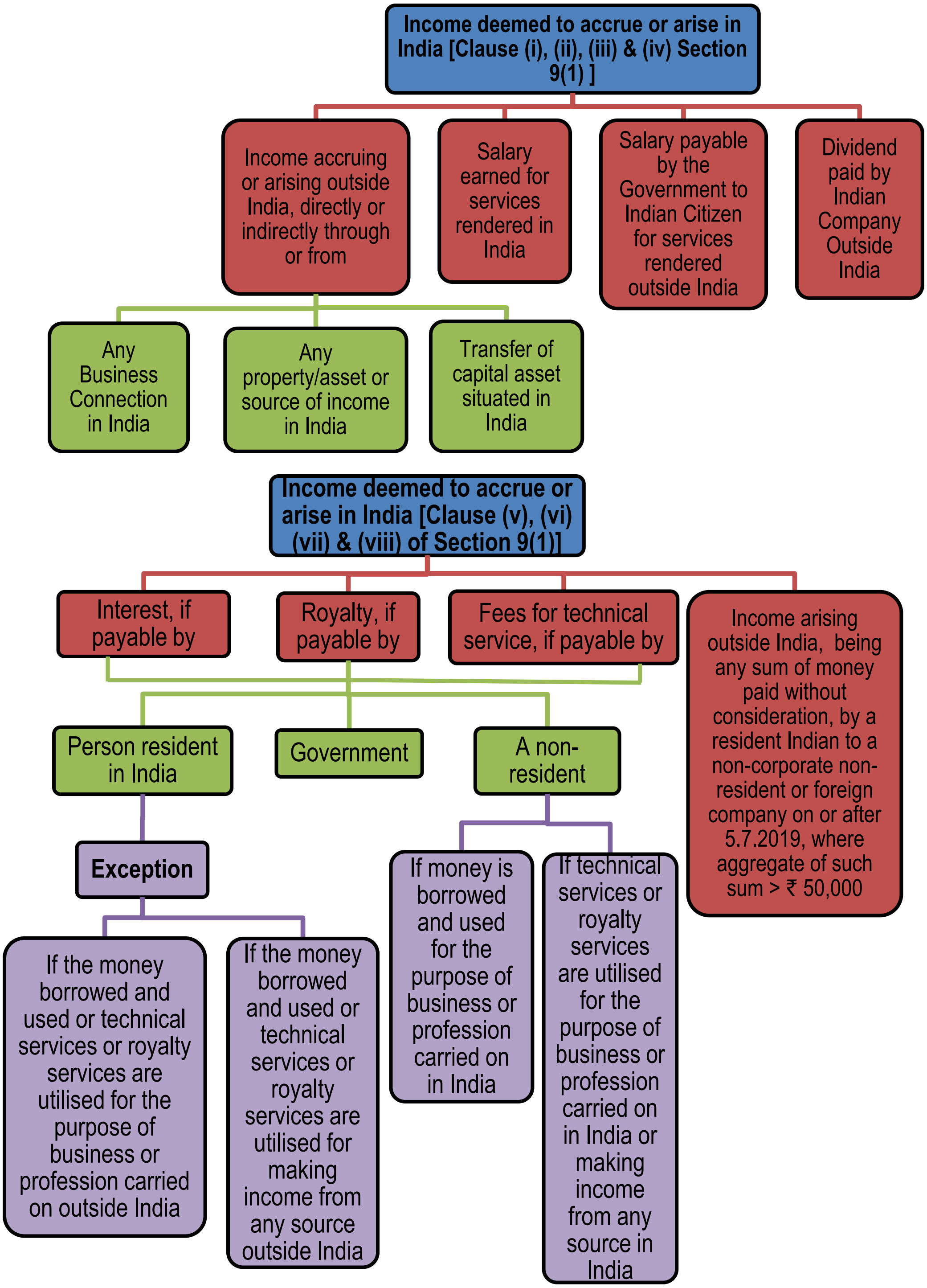
It must be noted that income which has been taxed on accrual basis cannot be assessed again on receipt basis, as it will amount to double taxation.

With a view to removing difficulties and clarifying doubts in the taxation of income, *Explanation 1* to section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

Further, *Explanation 2* to section 5 makes it clear that once an item of income is included in the assessee's total income and subjected to tax on the ground of its accrual/deemed accrual, it cannot again be included in the person's total income and subjected to tax either in the same or in a subsequent year on the ground of its receipt - whether actual or deemed.

(iii) Income deemed to accrue or arise in India [Section 9]

Under section 9, certain types of income are deemed to accrue or arise in India even though they may actually accrue or arise outside India.


Income deemed to accrue or arise in India [Clause (i), (ii), (iii) & (iv) Section 9(1)]
Income accruing or arising outside India, directly or indirectly through or from
Salary earned for services rendered in India
Salary payable by the Government to Indian Citizen for services rendered outside India
Dividend paid by Indian Company Outside India
Any Business Connection in India
Any property/asset or source of income in India
Transfer of capital asset situated in India
Income deemed to accrue or arise in India [Clause (v), (vi) (vii) & (viii) of Section 9(1)]
Interest, if payable by
Royalty, if payable by
Fees for technical service, if payable by
Income arising outside India, being any sum of money paid without consideration, by a resident Indian to a non-corporate non-resident or foreign company on or after 5.7.2019, where aggregate of such sum > ₹ 50,000
Person resident in India
Government
A non-resident
Exception
If the money borrowed and used or technical services or royalty services are utilised for the purpose of business or profession carried on outside India
If the money borrowed and used or technical services or royalty services are utilised for making income from any source outside India
If money is borrowed and used for the purpose of business or profession carried on in India
If technical services or royalty services are utilised for the purpose of business or profession carried on in India or making income from any source in India

The categories of income which are deemed to accrue or arise in India are:

(1) Any income accruing or arising to an assessee in any place outside India whether directly or indirectly

(i) through or from any business connection in India,

(ii) through or from any property in India,

(iii) through or from any asset or source of income in India or

(iv) through the transfer of a capital asset situated in India

would be deemed to accrue or arise in India.**[Section 9(1)(i)]**

(i) What is Business Connection?

'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident [*Explanation 2* to section 9(1)(i)]

For a business connection to be established, the person acting on behalf of the non-resident –

(a) must have an authority, which is habitually exercised in India, to conclude contracts on behalf of the non-resident or

habitually concludes contracts or plays the principal role leading to conclusion of contracts by that non-resident and such contracts are

- in the name of the non-resident; or
- for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
- for the provision of services by that non-resident.

Note - This amendment in the definition of "business connection" is for the purpose of alignment with the provisions of the Double Taxation Avoidance Agreement (DTAA) as modified by Multilateral Instrument (MLI) so as to make the provisions in the treaty effective.

(b) in a case, where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or

(c) habitually secures orders in India, mainly or wholly for the non-resident.

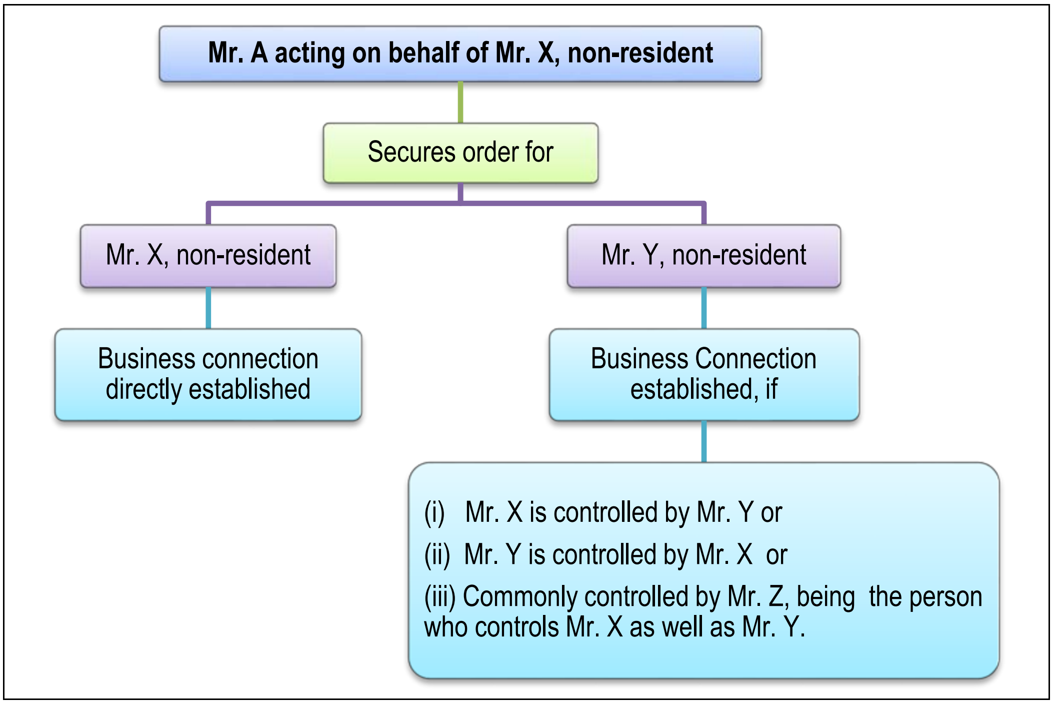
Further, there may be situations when the person acting on behalf of the non-resident secure order for other non-residents. In such situation, business connection for other non-residents is established if,

i. such other non-resident controls the non-resident or

ii. such other non-resident is controlled by the non-resident or

iii. such other non-resident is subject to same control as that of non-resident.

In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.



Agents having independent status are not included in Business Connection: Business connection, however, shall not be established, where the non-resident carries on business through a broker, general commission agent or any other agent having an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident.

He will, however, not be considered to have an independent status in the three situations explained above, where he is employed by such a non-resident.

Where a business is carried on in India through a person referred to in (a), (b) or (c) of (i) above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India *[Explanation 3* to section 9(1)(i)].

Significant economic presence [*Explanation 2A* to section 9(1)(i)]

Significant economic presence of a non-resident in India shall also constitute business connection in India.

Significant economic presence means-

	Nature of transaction	Condition
(a)	transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India,	Aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed
(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India through digital means	The users should be of such number as may be prescribed

The threshold of "aggregate of payments" in (a) and "users" in India in (b) would be prescribed by Rules. Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;

(ii) the non-resident has a residence or place of business in India; or

(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

In the case of a non-resident the following shall not, however, be treated as business connection in India *[Explanation 1* to section 9(1)(i)*]:*

(a) In the case of a business, in respect of which all the operations are not carried out in India [*Explanation 1(a)* to section 9(1)(i)]: In the case of a business of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.

(b) Purchase of goods in India for export [*Explanation 1(b)* to section 9(1)(i)]: In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

(c) Collection of news and views in India for transmission out of India [*Explanation 1(c)* to section 9(1)(i)]: In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

(d) **Shooting of cinematograph films in India [*Explanation 1(d)* to section 9(1)(i)]:** In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, if such non-resident is :

- an individual, who is not a citizen of India or
- a firm which does not have any partner who is a citizen of India or who is resident in India; or
- a company which does not have any shareholder who is a citizen of India or who is resident in India.

(e) **Activities confined to display of rough diamonds in SNZs [*Explanation 1(e)* to section 9(1)(i)]**: In case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any special zone notified by the Central Government in the Official Gazette in this behalf.

(ii) & (iii) Income from property, asset or source of income in India

Any income which arises from any property in India (movable, immovable, tangible and intangible property) would be deemed to accrue or arise in India.

Examples:

- *Hire charges or rent paid outside India for the use of the machinery or buildings situated in India,*
- *deposits with an Indian company for which interest is received outside India etc.*

(iv) Income through transfer of a capital asset situated in India

Capital gains arising through or from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether

- The capital asset is movable or immovable, tangible or intangible;
- The place of registration of the document of transfer etc., is in India or outside; and
- The place of payment of the consideration for the transfer is within India or outside.

Accordingly, the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of". ***[Explanation 4* to section 9(1)(i)*]***

Further, an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. ***[Explanation 5* to section 9(1)(i)*]***

However, an asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly, in Category-I or Category-II foreign portfolio investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, made under the Securities and Exchange Board of India Act, 1992, shall not deemed to be or deemed to have been situated in India [Proviso to *Explanation 5* to section 9(1)(i)]

The CBDT has, vide Circular No. 28/2017, dated 07.11.2017, clarified that the provisions of section 9(1)(i) read with Explanation 5, shall not apply in respect of income accruing or arising to a non-resident on account of redemption or buyback of its share or interest held indirectly (i.e. through upstream entities registered or incorporated outside India) in the specified funds (namely, investment funds, venture capital company and venture capital funds) if such income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds and such income is chargeable to tax in India.

However, the above benefit shall be applicable only in those cases where the proceeds of redemption or buyback arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realized by the specified funds from the said transfer of shares or securities in India. It is further clarified that a non-resident investing directly in the specified funds shall continue to be taxed as per the extant provisions of the Act.

Declaration of dividend by a foreign company outside India does not have the effect of transfer of any underlying assets located in India. *Circular No. 4/2015, dated 26-03-2015*, therefore, clarifies that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would **NOT** be deemed to be income accruing or arising in India by virtue of the provisions of section 9(1)(i).

***Explanation 6* to section 9(1)(i)** provides that the share or interest in a company or entity registered or incorporated outside India, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets, -

- exceeds the amount of ₹ 10 crore; and
- represents at least 50% of the value of all the assets owned by the company or entity, as the case may be;

Meaning of certain terms:

Term	Meaning
Value of an asset	The **fair market value as on the specified date**, of such asset **without reduction of liabilities**, if any, in respect of the asset, determined in prescribed manner**.**

Specified date	The date on which the **accounting period** of the company or, as the case may be, the entity **ends** preceding the date of transfer of a share or an interest. However, the date of transfer shall be the specified date of valuation, in a case where the book value of the assets of the company or entity on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer.
Accounting period	Each period of 12 months ending with 31st March. However, where a company or an entity, referred to in *Explanation 5*, regularly adopts a period of 12 months ending on a day other than 31st March for the purpose of— (a) complying with the provisions of the tax laws of the territory, of which it is a resident, for tax purposes; or (b) reporting to persons holding the share or interest, then, the period of twelve months ending with the other day shall be the accounting period of the company or, as the case may be, the entity:
First Accounting Period	First accounting period of the company or, as the case may be, the entity shall **begin from the date of its registration or incorporation** and **end with the 31st March** or such other day, as the case may be, following the date of such registration or incorporation.
Later accounting period	Later accounting period shall be the **successive periods of twelve months**
Accounting period of an entity which ceases to exist	If the company or the entity ceases to exist before the end of accounting period, as aforesaid, then, the accounting period shall end immediately before the company or, as the case may be, the entity, ceases to exist.

Note - The manner of determination of fair market value of the assets of the foreign company is given in Rule 11UB. Determination of income attributable to assets in India is given in Rule 11UC.

Students may note that the Rule 11UB and Rule 11UC have been given as Annexure – 1 at the end of this Study Material.

***Explanation 7* to section 9(1)(i)** provides that **no income shall be deemed** to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, in the following cases;

(1)	Foreign company or entity **directly** owns the assets situated in India	**AND**	**the transferor** (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, **does not hold** • the right of management or control in relation to foreign company or entity; or

			• the voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the foreign company or entity; or
(2)	Foreign company or entity **indirectly** owns the assets situated in India	**AND**	**the transferor** (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, **does not hold** • the right of management or control in relation to foreign company or entity; or • any right in, or in relation to, such foreign company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India; or • such percentage of voting power or share capital or interest in foreign company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;

In effect, the exemption shall be available to the transferor of a share of, or interest in, a foreign entity if he along with its associated enterprises, -

- neither holds the right of control or management,
- nor holds voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest,

in the foreign company or entity directly holding the Indian assets (direct holding company).

In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly then the exemption shall be available to the transferor if he along with its associated enterprises,-

- neither holds the right of management or control in relation to such company or the entity,
- nor holds any rights in such company which would entitle it to either exercise control or management of the direct holding company or entity or entitle it to voting power or share capital or total interest exceeding 5% in the direct holding company or entity.

Further, where all the assets owned, directly or indirectly, by a company or, as the case may be, an entity registered or incorporated outside India, are not located in India, the income of the non-resident transferor, from transfer outside India of a share of, or interest in the foreign company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in the prescribed manner.

"Associated enterprise", in relation to another enterprise, means an enterprise—

- which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

(2) Income from salaries earned in India [Section 9(1)(ii)]

Income, which falls under the head "Salaries", deemed to accrue or arise in India, if it is earned in India. Salary payable for service rendered in India would be treated as earned in India.

Further, any income under the head "Salaries" payable for rest period or leave period which is preceded and succeeded by services rendered in India, and forms part of the service contract of employment, shall be regarded as income earned in India.

(3) Income from salaries payable by the Government for services rendered outside India [Section 9(1)(iii)].

Income from 'Salaries' which is payable by the Government to a citizen of India for services rendered outside India would be deemed to accrue or arise in India.

However, allowances and perquisites paid or allowed outside India by the Government to an Indian citizen for services rendered outside India is exempt, by virtue of section 10(7).

(4) Dividend paid by a Indian company outside India [Section 9(1)(iv)]

All dividends paid by an Indian company would be deemed to accrue or arise in India. Under section 10(34), income from dividends referred to in section 115-O i.e., dividend distributed by a domestic company on which DDT is leviable in the hands of the company, is exempt from tax in the hands of the shareholder. However, it will not be exempt if such dividend is chargeable to tax under section 115BBDA. Section 115BBDA, which brings to tax dividend in excess of ₹ 10 lakh in the hands of the shareholder @10%, does not apply to the non-residents.

(5) Interest [Section 9(1)(v)]

Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by -

(i) the Government;

(ii) a person resident in India;

Exception: Where it is payable in respect of any debt incurred or money borrowed and used, for the purposes of a business or profession carried on by him outside India or for the purposes of making or earning any income from any source outside India, it will not be deemed to accrue or arise in India.

(iii) a non-resident, when it is payable in respect of any debt incurred or moneys borrowed and used, for the purpose of a business or profession carried on in India by him.

Exception: Interest on money borrowed by the non-resident for any purpose other than a business or profession, will not be deemed to accrue or arise in India.

> ***Example:*** *If a non-resident 'A' borrows money from a non-resident 'B' and invests the same in shares of an Indian company, interest payable by 'A' to 'B' will not be deemed to accrue or arise in India.*

Meaning of interest: Interest means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.

> **Taxability of interest payable by the Permanent Establishment of a non-resident engaged in banking business to the head office**
>
> In order to provide clarity and certainty, on the issue of taxability of interest payable by the PE of a non-resident engaged in banking business to the head office, an Explanation has been inserted in section 9(1)(v). Accordingly, in the case of a **non-resident, being a person engaged in the business of banking,** any interest payable by the **PE in India of such non-resident to the head office** or any PE or any other part of such non-resident outside India, shall be deemed to accrue or arise in India.
>
> Such interest shall be chargeable to tax in addition to any income attributable to the PE in India.
>
> Further, the PE in India shall be deemed to be a person separate and independent of the non-resident person of which it is a PE and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery would apply accordingly.
>
> Also, the PE in India has to deduct tax at source on any interest payable to either the head office or any other branch or PE, etc. of the non-resident outside India. Non-deduction would result in disallowance of interest claimed as expenditure by the PE and may also attract levy of interest and penalty in accordance with relevant provisions of the Act.
>
> **Permanent establishment** includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

(6) Royalty [Section 9(1)(vi)]

Royalty will be deemed to accrue or arise in India when it is payable by -

(i) the Government;

(ii) a person who is a resident in India

Exception: Where it is payable for the transfer of any right or the use of any property or information or for the utilization of services 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

(iii) a non-resident only when the royalty is payable in respect of any right, property or information used or services utilised for purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Important points:

1. **Lumpsum royalty not deemed to accrue arise in India:** Lumpsum royalty payments made by a resident for the transfer of all or any rights (including the granting of a licence) in respect of **computer software** supplied by a non-resident manufacturer along with computer hardware under any scheme approved by the government under the policy on computer software export, software development and training, 1986 shall not be deemed to accrue or arise in India.

2. **Meaning of Computer software:** "Computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customised electronic data.

3. **Meaning of Royalty:** The term 'royalty' means consideration (including any lumpsum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'capital gains') for:

   (i) the transfer of all or any rights (including the granting of licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

   (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

   (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

   (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

   (v) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

   (vi) the transfer of all or any rights (including the granting of licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films;

(vii) the rendering of any service in connection with the activities listed above.

The definition of 'royalty' for this purpose is wide enough to cover both industrial royalties as well as copyright royalties. The deduction specially excludes income which should be chargeable to tax under the head 'capital gains'.

4. Consideration for use or right to use of computer software is royalty within the meaning of section 9(1)(vi)

The consideration for use or right to use of computer software is royalty by clarifying that, transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred *[Explanation 4]*

Consequently, the provisions of tax deduction at source under section 194J and section 195 would be attracted in respect of consideration for use or right to use computer software since the same falls within the definition of royalty.

Note - The Central Government has, vide *Notification No. 21/2012 dated 13.6.2012* to be effective from 1st July, 2012, exempted certain software payments from the applicability of tax deduction under section 194J. Accordingly, where payment is made by the transferee for acquisition of software from a resident-transferor, the provisions of section 194J would not be attracted if –

(1) the software is acquired in a subsequent transfer without any modification by the transferor;

(2) tax has been deducted either under section 194J or under section 195 on payment for any previous transfer of such software; and

(3) the transferee obtains a declaration from the transferor that tax has been so deducted along with the PAN of the transferor.

5. Consideration in respect of any right, property or information – Is it royalty?

Royalty includes and has always included consideration in respect of any right, property or information, whether or not,

(a) the possession or control of such right, property or information is with the payer;

(b) such right, property or information is used directly by the payer;

(c) the location of such right, property or information is in India *[Explanation 5]*

6. Meaning of Process

The term "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret *[Explanation 6]*

(7) Fees for technical services [Section 9(1)(vii)]

Any fees for technical services will be deemed to accrue or arise in India if they are payable by -

(i) the Government.

(ii) a person who is resident in India

Exception: Where the fees is payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India.

(iii) a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India.

Fees for technical services mean any consideration (including any lumpsum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

Income deemed to accrue or arise in India to a non-resident by way of interest, royalty and fee for technical services to be taxed irrespective of territorial nexus [*Explanation* to section 9]

Income by way of interest, royalty or fee for technical services which is deemed to accrue or arise in India by virtue of clauses (v), (vi) and (vii) of section 9(1), shall be included in the total income of the non-resident, whether or not –

(i) the non-resident has a residence or place of business or business connection in India; or

(ii) the non-resident has rendered services in India.

In effect, the income by way of fee for technical services, interest or royalty, from services utilized in India would be deemed to accrue or arise in India in case of a non-resident and be included in his total income, whether or not such services were rendered in India.

(8) Any sum of money paid by a resident Indian to a non-corporate non-resident or foreign company [Section 9(1)(viii)]

Income arising outside India, being any sum of money paid without consideration, by a Indian resident person to a non-corporate non-resident or foreign company on or after 5.7.2019 would be deemed to accrue or arise in India if the same is chargeable to tax under section 56(2)(x) i.e., if the aggregate of such sum received by a non-corporate non-resident or foreign company exceeds ₹ 50,000.

(3) Presence of Eligible Fund Manager in India not to constitute Business Connection in India of such Eligible Investment Fund on behalf of which he undertakes Fund Management Activity [Section 9A]

(i) **Fund Management Activity through an eligible fund manager not to constitute business connection:** In the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund, subject to fulfillment of certain conditions.

(ii) **Location of Fund Manager in India not to affect residential status of an eligible investment fund:** An eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf, is located in India.

(iii) **Conditions to be fulfilled by an Eligible Investment Fund:** The eligible investment fund means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit. Further, it should fulfill the following conditions:

(a) the fund should not be a person resident in India;

(b) the fund should be a resident of a country or a specified territory with which an agreement referred to in section 90(1) or section 90A(1) has been entered into or should be established or incorporated or registered outside India in a country or a specified territory notified by the Central Government in this behalf;

(c) the aggregate participation or investment in the fund, directly or indirectly, by persons being resident in India should not exceed 5% of the corpus of the fund;

(d) the fund and its activities should be subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;

(e) the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;

(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50%;

(h) the investment by the fund in any entity shall not exceed 20% of the corpus of the fund;

(i) no investment shall be made by the fund in its associate entity;

(j) the monthly average of the corpus of the fund shall not be less than ₹ 100 crore. If the fund has been established or incorporated in the previous year, the corpus of fund should not be less than ₹ 100 crore rupees ***at the end of a period of six months from the last day of the month of its establishment or incorporation, or the end of such previous year, whichever is later***;

However, this condition shall not be applicable to a fund which has been wound up in the previous year.

(k) the fund shall not carry on or control and manage, directly or indirectly, any business in India;

(l) the fund should neither be engaged in any activity which constitutes a business connection in India nor should have any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf.

(m) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken on its behalf should not be less than ***the amount calculated in the prescribed manner***.

(iv) **Certain conditions not to apply to investment fund set up by the Government or the Central Bank of a foreign State or a Sovereign Fund or other notified fund [Proviso to Section 9A(3)]:** The following conditions would, however, not be applicable in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund or such other fund notified by the Central Government (i.e., an investment fund set up by a Category-I or Category-II Foreign Portfolio Investor registered under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, made under the Securities and Exchange Board of India Act, 1992:

(e) the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;

(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50%.

(v) **Eligible Fund Manager [Section 9A(4)]:** The eligible fund manager, in respect of an eligible investment fund, means any person who is engaged in the activity of fund management and fulfills the following conditions:

(a) the person should not be an employee of the eligible investment fund or a connected person of the fund;

(b) the person should be registered as a fund manager or investment advisor in accordance with the specified regulations;

> *The CBDT has, vide* ***Circular No.8/2019 dated 10.5.2019****, clarified that a fund manager includes an Asset Management Company (AMC) approved by SEBI under the SEBI (Mutual Funds) Regulations, 1996. This is because AMCs are engaged in the activity of fund management of Mutual Funds and hence are, in substance, Fund Managers.*

(c) the person should be acting in the ordinary course of his business as a fund manager;

(d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than 20% of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through such fund manager.

(vi) **Furnishing of Statement in prescribed form [Section 9A(5)]:** Every eligible investment fund shall, in respect of its activities in a financial year, furnish within 90 days from the end of the financial year, a statement in the prescribed form to the prescribed income-tax authority. The statement should contain information relating to –

(a) the fulfillment of the above conditions; and

(b) such other relevant information or document which may be prescribed.

If any eligible investment fund fails to furnish such statement or information or document within 90 days from the end of the financial year, the income-tax authority prescribed under the said sub-section may direct that such fund shall pay, by way of penalty, a sum of ₹ 5,00,000. [Section 271FAB]

(vii) **Non-applicability of special taxation regime under section 9A [Section 9A(6)]:** This special taxation regime would not have any impact on taxability of any income of the eligible investment fund which would have been chargeable to tax irrespective of whether the activity of the eligible fund manager constituted business connection in India of such fund or not.

Further, the said regime shall not have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

(viii) CBDT to prescribe guidelines for the manner of application of the provisions of this section.

(ix) **Meaning of certain terms:**

Term	Meaning
Associate	An entity in which a director or a trustee or a partner or a member or a fund manager of the investment fund or a director or a trustee or a partner or a member of the fund manager of such fund, holds, either individually or collectively, share or interest, being more than 15% of its share capital or interest, as the case may be.
Corpus	The total amount of funds raised for the purpose of investment by the eligible investment fund as on a particular date.
Connected person	Any person who is connected directly or indirectly to another person and includes,— (a) any relative of the person, if such person is an individual; (b) any director of the company or any relative of such director, if the person is a company; (c) any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member, if the person is a firm or association of persons or body of individuals; (d) any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family; (e) any individual who has a substantial interest in the business of the person or any relative of such individual; (f) a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member; (g) a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member has a substantial interest in the business of the person, or family or any relative of such director, partner or member; (h) any other person who carries on a business, if - (i) the person being an individual, or any relative of such person, has a substantial interest in the business of that other person; or (ii) the person being a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such

		company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person;

2.5 EXEMPT INCOME OF NON RESIDENTS

Section 10 of the Income-tax Act, 1961 exempts from tax various incomes including the following in the hands of a non-resident:

(1) Interest on moneys standing to the credit of individual in his NRE A/c [Section 10(4)(ii)]

As per section 10(4)(ii), in the case of an individual, any income by way of interest on moneys standing to his credit in a **Non-resident (External) Account (NRE A/c)** in any bank in India in accordance with the Foreign Exchange Management Act, 1999 (FEMA, 1999), and the rules made thereunder, would be exempt, provided such individual;

- is a person resident outside India, as defined in FEMA, 1999, or
- is a person who has been permitted by the Reserve Bank of India to maintain such account.

In this context, it may be noted that the joint holders of the NRE Accounts do not constitute an AOP by merely having these accounts in joint names. The benefit of exemption under section 10(4)(ii) will be available to such joint account holders, subject to fulfillment of other conditions contained in that section by each of the individual joint account holders.

Example: *Mrs. Neena Kansal, is resident of Singapore since year 2000. She holds an NRE account with Bank of Baroda, New Delhi Branch. Interest of ₹ 10,000 was credited to such account during financial year 2019-20. Such interest income earned by her shall be exempt from income-tax while she files her tax return for A.Y 2020-21.*

(2) Interest income of a non-corporate non-resident or foreign company on specified off-shore Rupee Denominated Bonds issued by an Indian company or business trust [Section 10(4C)]

Interest payable by an Indian company or business trust to a non-corporate non-resident or a foreign company in respect of money borrowed from a source outside India by way of issue of rupee denominated bond during the period from 17.9.2018 to 31.3.2019 would be exempt.

(3) Income of a specified fund on transfer of certain specified asset on recognized stock exchange, to the extent such income accrues or arises to, or is received in respect of units held by a non-resident [Section 10(4D)]

Income accrued or arising to or received by specified fund on transfer of a capital asset, being a bond of an Indian Company or a public sector company (sold by the Government and purchased *by the specified fund in foreign currency), GDR or rupee denominated bond or derivative or any other notified security, on a recognized stock exchange located in any IFSC would be exempt –*

(i) where the consideration is paid or payable in convertible foreign exchange,

(j) to the extent such income accrues or arises to, or is received in respect of units held by a non-resident.

Meaning of certain terms:

S. No.	***Term***	***Meaning***
1	*Specified fund*	*A fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate, –* *(i) which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Fund) Regulation, 2012, made under the SEBI Act, 1992* *(ii) which is located in any IFSC* *(iii) of which all the units are held by non-residents other than units held by a sponsor or manager*
2	*Trust*	*A trust established under the Indian Trust Act, 1882 or under any other law for the time being in force.*
3	*Unit*	*Unit means beneficial interest of an investor in the fund and shall include shares or partnership interests.*
4	*Manager*	*Any person or entity who is appointed by the Alternative Investment Fund to manage its investment by whatever name called. Manager may also be same as the sponsor of the Fund.*
5	*Sponsor*	*Any person or persons who set up the Alternative Investment Fund and includes promoter in case of a company and designated partner in case of LLP.*

(4) Remuneration received by individuals, who are not citizens of India [Section 10(6)]

(i) Remuneration received by officials of Embassies etc. of Foreign States [Section 10(6)(ii)]: The remuneration received by an individual, who is not a citizen of India, for services as an official by whatever name called of an embassy, high commission, legation, commission, consulate or trade representation of foreign state, or a member of staff of any of these official is exempt.

Conditions

(a) The remuneration received by our corresponding Government officials resident in such foreign countries should be exempt.

(b) The above-mentioned member of the staff of such officials should be the subjects of the respective countries and should not be engaged in any other business or profession or employment in India.

Examples:

1. *Mr. A, a citizen of India but resident of USA since year 2012, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2019-20.* ***Being an Individual who is a citizen of India, though fulfilling other conditions of the section, such remuneration shall not be exempt in his hands for A.Y. 2020-21.***

2. *Mr. Vikram Kohli, an Indian born person but currently the resident and Citizen of USA, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2019-20.* ***Being an Individual who is not a citizen of India and also fulfilling other conditions of the section, such remuneration shall be exempt in his hands for A.Y. 2020-21.***

3. *Mr. Frank D'Souza, an Irish Citizen but currently the resident of USA, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2019-20.* ***Being an Individual who is not a citizen of India, such remuneration shall be exempt in his hands for A.Y. 2020-21, subject to fulfilment of the conditions.***

(ii) **Remuneration received for services rendered in India by a Foreign National employed by foreign enterprise [Section 10(6)(vi)]**: The remuneration received by a foreign national as an employee of a foreign enterprises, for services rendered by him during his stay in India is exempt from tax.

Conditions

(a) The foreign enterprise is not engaged in any business or trade in India:

(b) The employee's stay in India does not exceed in the aggregate a period of 90 days in such previous year and

(c) The remuneration is not liable to be deducted from the income of the employer chargeable under the Income-tax Act, 1961.

Examples:

1. *Mr. A, citizen of India but resident of USA since year 2012, was appointed in India in October, 2018 as an employee of a US enterprise. Such US enterprise is not engaged in any business in India. A's job requires him to visit his US office every twenty five (25) days for reporting purposes.*

   During F.Y. 2019-20, Mr. A earned a remuneration of ₹ 10 lakhs for his India related assignment and his stay in India in aggregate was 85 days. Further, such US *enterprise has not claimed any deduction of such remuneration under the Income-tax Act, 1961.*

Being an Individual who is a citizen of India, such remuneration shall not be exempt in his hands for A.Y. 2020-21 under this section i.e., section 10(6)(vi), though he may get exemption under any other provision of the Income-tax Act, 1961, subject to fulfilment of conditions stipulated thereunder.

2. *In the above case, let's consider that Mr. A is a citizen of USA. All other facts remaining same, his* ***remuneration shall be exempt from tax in his hands for A.Y. 2020-21 under this section.***

3. *Let's take another variation, Mr. A is a citizen of USA but the remuneration paid to him is borne by the permanent establishment of such US enterprise in India. ₹ 10 lakhs paid to A is cross charged by the US enterprise to its Indian permanent establishment (PE).*

In this case, the remuneration shall not be exempt from taxation in the hands of Mr. A as the same is getting deducted from the income of the Indian PE of such foreign enterprise.

(iii) **Salary received by a non-citizen for services rendered in connection with employment on foreign ship [Section 10(6)(viii)]:** Any income chargeable under the head "Salaries" received by or due to, non-citizen of India who is also a non-resident as remuneration for services rendered in connection with his employment on a foreign ship is exempt provided his total stay in India does not exceed 90 days during the previous year.

(iv) **Remuneration received by Foreign Government employees during their stay in India for specified training [Section 10(6)(xi)]:** Any remuneration received by employee of the Government of a foreign state from their respective Government during his stay in India, is exempt from tax, if remuneration is received in connection with training in any establishment or office of or in any undertaking owned by,-

(a) the Government, or

(b) any company owned by the Central Government or any State Government or partly by the Central Government and partly by one or more State Government

(c) any company which is subsidiary of a company referred to in (b) above, or

(d) any statutory corporation; or

(e) any society registered under Societies Registration Act, 1860 or under any law and wholly financed by the Central Government or any State Government(s) or partly by the Central Government and partly by one or more State Governments.

It may be carefully noted that exemption is available under section 10(6) only to an individual who is not a citizen of India.

Exempt Income of Non-Residents

Section	Income	Available to
10(4)(ii)	Interest on money standing to the credit in a Non-resident (External) account of an Individual in any bank in India as per the FEMA Act, 1999.	Individual resident outside India (under FEMA Act) or an individual who has been permitted to maintain said account by RBI
10(4C)	***Interest payable by an Indian company or business trust in respect of moneys borrowed from a source outside India by way of issue of rupee denominated bond during the period from 17.9.2018 to 31.3.2019***	***A non-corporate non-resident or foreign company***
10(4D)	***Income on transfer of a capital asset, being a bond of an Indian Company or a public sector company (sold by the Government and purchased by the specified fund in foreign currency), GDR or rupee denominated bond or derivative or any other notified security, on a recognized stock exchange located in any IFSC is exempt –*** ***(i) where the consideration is paid or payable in convertible foreign exchange;*** ***(ii) to the extent such income accrues or arises to, or is received in respect of units held by a non-resident***	***A specified fund***
10(6)(ii)	Remuneration received by Foreign Diplomats/ Consulate and their staff (Subject to conditions)	Individual (not being a citizen of India)
10(6)(vi)	Remuneration received as an employee of a foreign enterprise for services rendered by him during his stay in India, if: a) Foreign enterprise is not engaged in any trade or business in India; b) His stay in India does not exceed the aggregate a period of 90 days in such previous year; and c) Such remuneration is not liable to deducted from the income of employer chargeable under this Act	Individual - Salaried Employee (not being a citizen of India) of a foreign enterprise
10(6)(viii)	Salary received by or due for services rendered in connection with his employment on a foreign ship if	Individual Salaried Employee (Non-resident who is not a

	his total stay in India does not exceed 90 days in the previous year.	citizen of India) of a foreign enterprise
10(6)(xi)	Remuneration received as an employee of the Government of a foreign state during his stay in India in connection with his training in any Government Office/ Statutory Undertaking/ corporation/ registered society etc.	Individual - Salaried Employee (not being a citizen of India) of Government of foreign state
10(6A)	Tax paid by Government or Indian concern (under terms of agreement entered into after 31-3-1976 but before 1-6-2002 by the Government or Indian concern with the foreign company) on income derived by way of royalty or fees for technical services by the foreign company from Government or Indian concern.	Foreign Company
10(6B)	Tax paid by Government or Indian concern under terms of agreement entered into before 1-6-2002 by Central Government with Government of foreign State or international organization on income derived by a non-corporate non-resident or foreign company from the Government or Indian concern, other than income by way of salary, royalty or fees for technical services	Non-corporate non-resident or foreign company
10(6BB)	Tax paid by Indian company, engaged in the business of operation of aircraft, which has acquired an aircraft or an aircraft engine on lease, under an approved (by Central Government) agreement entered into between 1-4-1997 and 31-3-1999, or after 31-3-2007, on lease rental/income derived (other than payment for providing spares or services in connection with the operation of leased aircraft) by the Government of a Foreign State or foreign enterprise.	Government of foreign State or foreign enterprise (i.e., a person who is a non-resident)
10(6C)	Royalty income or fees for technical services under an agreement with the Central Government for providing services in or outside India in projects connected with security of India	Foreign company (notified by the Central Government)
10(6D)	Royalty income from or fees from technical services rendered in or outside India to, the National Technical Research Organisation (NTRO)	Non-corporate non-resident or foreign company
10(8)	Foreign income; and Remuneration received by an individual from the Government of a foreign State, in connection with	Individual who is assigned to duties in India

	any co-operative technical assistance programme and project under agreement between Central Government and the Government of a foreign State.	
10(8A)	Foreign income; and Any remuneration or fee received by such person (agreement relating to his engagement must be approved) out of funds made available to an international organization (agency like World Bank or any other multi-lateral agency) under a technical assistance grant agreement between that agency and the Government of a foreign State (such technical assistant should be in accordance with an agreement between the Central Government and the agency).	Consultant, being (i) An individual: a) not being an Indian citizen; or b) being an Indian citizen who is not ordinarily resident in India, or (ii) any other person, being a non- resident engaged by the agency for rendering technical services in India in connection with any technical assistance programme or project in accordance with the approved agreement.
10(8B)	Foreign income; and Remuneration received, directly or indirectly, by an individual who is assigned to duties in India in connection with any technical assistance programme and project in accordance with an agreement entered into by the Central Government and the agency from a consultant referred to in section 10(8A)	Employee of a consultant, being an individual: a) not being an Indian citizen; or b) being an Indian citizen who is not ordinarily resident in India Contract of service must be approved by the prescribed authority before commencement of service.
10(9)	Foreign income	Any family member of individual as referred to in section 10(8)/(8A)/(8B), accompanying him to India.

Foreign income referred in section 10(8)/(8A)/(8B)/(9) above refers to the other income accruing or arising outside India. Such income would be exempt provided:

(i) it is not deemed to accrue or arise in India; and

(ii) the individual is required to pay any income tax or social security tax of such income to the Government of that Foreign State or Country of origin of such member.

10(15)(iiia)	Interest on deposits made by a foreign bank with scheduled bank with approval of RBI.	Bank incorporated outside India and authorised to perform Central Banking functions in that country.
10(15)(iv)(fa)	Interest payable by scheduled bank on deposits in foreign currency where acceptance of such deposits is duly approved by RBI. [Scheduled bank does not include co-operative bank]	a) Non-resident b) Individual or HUF being a resident but not ordinary resident
10(15)(viii)	Interest on deposit on or after 01.04.2005 in an Offshore Banking Unit	
10(15)(ix)	***Interest payable by a unit located in an IFSC in respect of monies borrowed by it on or after 1.9.2019***	***Non-resident***
10(15A)	Lease rental paid by Indian company, engaged in the business of operation of aircraft, to acquire an aircraft or an aircraft engine on lease (other than payment for providing spares or services in connection with the operation of leased aircraft) under an approved (by Central Government) agreement not entered into between 1-4-1997 and 31-3-1999, or after 31-3-2007.	Government of foreign State or foreign enterprise (i.e., a person who is a non-resident)
10(23BBB)	Income of European Economic Community derived in India from interest, dividends or capital gains from investment out of its funds under notified scheme of Central Government.	European Economic Community
10(23BBC)	Income of SAARC Fund for Regional Projects set up by Colombo Declaration.	SAARC Fund for Regional Projects.
10(48)	Income received in India in Indian currency on account of sale of Crude oil or any other goods or rendering of services as may be notified by the Central Government in this behalf. Foreign company and agreement should be notified by the Central Government in national interest.	Foreign company on account of sale of crude oil, any other goods or rendering of services. It should not be engaged in any other activity in India.
10(48A)	Income accruing or arsing on account of storage of crude oil in a facility in India and sale of crude oil therefrom to any person resident in India. Foreign company and agreement should be notified by the Central Government in national interest.	Foreign company on account of storage of crude oil in a facility in India and sale of crude oil therefrom.

10(48B)	Income from sale of leftover stock of crude oil from facility in India after the expiry of agreement or arrangement referred to in section 10(48A) or on termination of the said agreement or arrangement, in accordance with the terms mentioned therein, as the case may be, subject to such conditions, as may be notified by the Central Government.	Foreign company from sale of leftover stock of crude oil from the facility in India.

2.6 PRESUMPTIVE TAXATION FOR NON RESIDENTS

Section 28 details the income chargeable to tax under the head "Profits and Gains of Business or Profession". Certain provisions have been incorporated in the Income-tax Act, 1961, whereby the "Profits and gains of business or profession" of certain non-resident assessee is computed on the basis of certain percentage of the amount accrued or arisen and received in India.

(1) Special provision for computing the profits and gains of shipping business in the case of non-residents [Section 44B]

Section 44B is a non-obstante clause. Accordingly, sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of ships.

Section 44B provides that profits and gains of a non-resident engaged in the business of operation of ships are to be taken @ 7.5% of the aggregate of the following amounts:

(i) paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods shipped at any port in India; and

(ii) received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock mail or goods shipped at any port outside India.

The amounts referred to in (i) and (ii) shall include demurrage charges or handling charges or any other amount of similar nature.

> The amounts paid or payable or the amounts received or deemed to be received will also include the amount paid or payable or received or deemed to be received by way of demurrage charges or handling charges or any other amount of similar nature [*CIT v. Japan Lines Ltd. 260 ITR 656 (Mad)*]. Thus 7.5% of the gross amounts mentioned above would be liable to tax and no deduction would be allowed for any expenditure, (i.e. the provisions of section 28 to 43A are not to be taken into account) however carried forward losses would be allowed to be set off from such income.

Analysis of section 44B and section 172:

Section 44B	Section 172
Presumptive tax provisions for non-residents engaged in shipping business. It does not, however, contain any procedure for assessment and collection of tax.	Complete code for taxation of occasional shipping business of non-residents, including assessment and collection of tax.
Manner of computation of presumptive Income:	
Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the - - amount paid or payable (whether in or outside India) to the non-resident or to any other person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any Indian port and - the amount received or deemed to be received in India on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India. **shall be deemed to be the profits and gains of such business** chargeable to tax under the head "Profits and gains of business or profession".	Where a ship carries passengers, livestock, mail or goods shipped at a port in India, a sum equal to **7.5%** of - the amount paid or payable on account of such carriage to the owner or the charterer or to any person on his behalf, whether that amount is paid or payable in or out of India, **shall be deemed to be income accruing in India** to the owner or charterer on account of such carriage.

Other provisions of section 172

(i) **Furnish a return of the amount paid to the owner:** Section 172(3) imposes an obligation on the master of the ship to prepare and furnish to the Assessing Officer a return of the full amount paid or payable to the owner or charterer or any person on this behalf, on account of the carriage of all passengers, livestock, mail or goods shipped at any port in India since the last arrival of the ship thereat. Such return is, ordinarily, to be furnished by the master of the ship before the departure, from that port in India, of the ship.

A return may, however, be filed by the person authorized by the master of the ship within 30 days of the departure of the ship from the port, if:

(a) the Assessing Officer is satisfied that it is not possible for the master of the ship to furnish the return required by section 172(3) before the departure of the ship from the port and

(b) the master of the ship has made satisfactory arrangement for the filing of the return and payment of tax by any other person on this behalf.

(ii) **Assessment [Section 172(4)]:** This section provides for a summary procedure of assessment. On receipt of the return filed by the master of the ship or by any person on this behalf, the Assessing Officer has to determine the tax payable on the taxable income. By virtue of the provisions of section 172(2), the taxable income is a sum equal to 7.5% of the amount paid or payable on account of carriage of passengers etc. to the owner or charterer or to any person on his behalf, whether that amount is paid or payable in or out of India. The tax payable on such taxable income is to be calculated at the **rate or rates in force applicable to the total income of a foreign company**. The master of the ship is liable for payment of such tax.

(iii) **Time limit for passing the assessment order [Section 172(4A)/(5)]:** It is incumbent on the Assessing Officer to pass the order of assessment within 9 months from the end of the financial year in which the return of income under section 172(3) is filed.

For the purpose of determining the tax payable, Assessing Officer is empowered to call for such accounts and documents as he may require.

(iv) **Grant of port of clearance to the ship [Section 172(6)]:** A port clearance shall not be granted to the ship until the Collector of customs or other authorized officer, is satisfied that the tax assessable under section 172 has been duly paid or that satisfactory arrangements have been made for the payment thereof.

(v) **Option to pay tax as per normal provisions of the Income-tax Act, 1961 on the income chargeable to tax under section 172 [Section 172(7)]:** The owner or charterer has the option to claim before the expiry of the assessment year relevant to the previous year in which the date of departure of the ship from the Indian port falls, that an assessment in respect of his total income for the previous year and the tax payable on the basis thereof be determined in accordance with the other provisions of this Act. In such a case, any payment made under section 172 is to be treated as a payment in advance of the tax leviable for that assessment year and the difference between the sum so paid and the amount of tax found payable by him on such assessment is to be paid by him or refunded to him, as the case may be.

The sum chargeable to tax under this section shall include amounts payable by way of **demurrage charge or handling charge** or any other amount of similar nature [Section 172(8)].

Section 172 *vis-à-vis* section 44B

In case the assessee is covered under section 172, 7.5 per cent of the amount paid or payable on account of the carriage of the passengers, livestock, mail or goods to the owner or the chartered or to any person on his behalf is deemed as his income and tax is levied on such income at a rate applicable to a foreign company i.e., 40% *plus* surcharge, if any, and *plus* health and education cess @4%.

Under the provisions of section 172(7), the non-resident owner or charterer is allowed an option to be assessed on his total income of the previous year in accordance with other provisions of the Act i.e., as per section 44B.

When such option is exercised, a regular assessment is made. In such a case, the tax already paid under the provisions of section 172(4) by the non-resident owner or charterer would be treated as tax paid in advance for that assessment year before determining the amount of tax finally due**.** The difference between the sum so paid and the amount of tax payable by him on such assessment shall be paid by the assessee or refunded to him (See Note below).

In that case, the non-resident assessee is liable to pay interest under sections 234B and 234C and also entitled to receive interest under section 244A of the Income-tax Act, 1961 as the case may be. [**Circular No. 9/2001, dated 9-7-2001]**

Note *–Refund may arise in case of non-corporate non-residents, since they are liable to pay tax at a rate lower than the rate of 40% (plus surcharge, if any, and cess@4%) applicable to a foreign company.*

The Supreme Court, in *A.S. Glittre v CIT (1997) 225 ITR 739 (SC)*, held that the assessment made under section 172(4) shall be an 'adhoc' assessment and it will be superceded if a regular assessment is opted as per the provisions of the Act.

ILLUSTRATION 1

Sea Port Shipping Line, a non-resident foreign company ships is engaged in the business of carriage of goods shipped at Mumbai port. During the previous year ended on 31.3.2020, it had collected freight of 100 lakhs, demurrages of ₹ 20 lakhs and handling charges of ₹ 10 lakhs. The expenses of operating its fleet during the year for the Indian Ports were ₹ 110 lakhs. Compute its income applying the presumptive provisions under section 44B.

SOLUTION

Section 44B provides that in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the following amounts would be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(i) The amount paid or payable, whether within India or outside, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India; and

(ii) The amount received or deemed to be received in India by the assessee himself or by any other person on behalf of or on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The above amounts will include demurrage charges and handling charges.

These provisions for computation of income from the shipping business in case of non-residents would apply notwithstanding anything to the contrary contained in the provisions of sections 28 to 43A of the Income-tax Act, 1961.

Therefore, in this case, M/s. Sea Port Shipping Line is required to pay tax in India on the basis of presumptive scheme as per the provisions of section 44B. The assessee shall not be entitled to set off any of the expenses incurred for earning of such income. Therefore, the Shipping Line is required to pay tax on deemed profit of ₹ 9.75 lacs (7.50% on the total receipts of ₹ 130 lacs). The tax payable would be reduced by the amount of tax paid under section 172(4).

(2) Special provision for computing profits and gains in connection with the business of exploration etc. of mineral oils [Section 44BB]

Section 44BB is a non-obstante clause. Accordingly, sections 28 to 41 and section 43 and 43A are not applicable in the case of a non-resident engaged in the business of providing services of facilities in connection with, or supplying plant and machinery on hire used, or to be used in the prospecting for, or extraction or production of, mineral oils.

(i) Eligible assessee: Section 44BB provides for determination of income of taxpayer being a non-resident engaged in the business of providing services and facilities in connection with, or supplying plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils.

(ii) Presumptive rate: In such case, the profits and gains shall be deemed to be equal to 10% of the following amounts:

- paid or payable to the taxpayer or to any person on his behalf whether in or out of India, on account of the provision of such services or facilities or supply of plant & machinery for the aforesaid purposes in India; and
- received or deemed to be received in India by or on behalf of the assesse on account of such service or facilities or supply of plant and machinery used or to be used in prospecting for, or extraction or production of mineral oils outside India.

(iii) Non-applicability of presumptive taxation under section 44BB: The provisions of section 44BB shall not apply to any income to which the provisions of section 42 or section 44DA, 115A or 293A apply for the purpose of computing profit or gains or any other income referred to in these sections.

Section	Provision
42	Special provision for deductions in the case of business for prospecting, etc., for mineral oil

44DA	Special provisions for computing income by way of royalties, etc., in case of non-residents.
115A	Tax on dividends, royalty and fees for technical services in the case of foreign companies
293A	Power to make exemption, etc., in relation to participation in the business of prospecting for, extraction, etc., of mineral oils.

(iv) **Option to claim lower profits:** An assessee may claim lower income than the presumptive rate of 10%, if he keeps and maintains books of account under section 44AA(2) and get them audited and furnish a report of such audit under section 44AB. The assessment in all such cases shall be done by the Assessing Officer under section 143(3).

(v) **Meaning of certain terms:** For the purposes of this section,-

(a) "Plant" includes ships, aircraft, vehicles, drilling units, scientific apparatus and equipment, used for the purposes of the said business;

(b) "Mineral oil" includes petroleum and natural gas.

Note - *If the income of a non-resident is in the nature of fees for technical services, it shall be taxable under the provisions of either section 44DA or section 115A irrespective of the business to which it relates. Section 44BB would apply only in a case where consideration is for services and other facilities relating to exploration activity which are not in the nature of technical services.*

(3) Special provision for computing profits and gains of the business of operation of aircraft in the case of non-residents [Section 44BBA]

Section 44BBA is a non-obstante clause. Accordingly, sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of aircraft.

(i) **Eligible assessee:** Section 44BBA provides presumptive rate in case of a non-resident engaged in the business of operation of aircraft.

(ii) **Presumptive rate:** Income from such business is calculated at a flat rate of **5%** of the following:

(a) amount paid or payable, in or out of India, to the tax payer or to any person on his behalf on account or carriage of passenger, livestock, mail or goods from any place in India and

(b) amount received or deemed to be received in India by or on behalf of the taxpayer on account of carriage of passenger, livestock, mail or goods from any place outside India.

ILLUSTRATION 2

Mr. Q, a non-resident, operates an aircraft between Singapore and Chennai. He received the following amounts while carrying on the business of operation of aircrafts for the year ended 31.3.2020:

(i) ₹ 2 crores in India on account of carriage of passengers from Chennai.

(ii) ₹ 1 crore in India on account of carriage of goods from Chennai.

(iii) ₹ 3 crores in India on account of carriage of passengers from Singapore.

(iv) ₹ 1 crore in Singapore on account of carriage of passengers from Chennai.

The total expenditure incurred by Mr. Q for the purposes of the business during the year ending 31.3.2020 was ₹ 6.75 crores.

Compute the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the assessment year 2020-21.

What would be your answer in case the business was carried on by a foreign company, Q Airlines (P) Ltd?

SOLUTION

Section 44BBA says for computing profits and gains of the business of operation of aircraft in the case of non-residents a sum equal to 5% of the aggregate of the following amounts -

(a) paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Keeping in view the provisions of section 44BBA, the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" is worked out hereunder-

Particulars	₹
Amount received in India on account of carriage of passengers from Chennai	2,00,00,000
Amount received in India on account of carriage of goods from Chennai	1,00,00,000
Amount received in India on account of carriage of passengers from Singapore	3,00,00,000
Amount received in Singapore on account of carriage of passengers from Chennai	1,00,00,000
	7,00,00,000

Income from business under section 44BBA at 5% of ₹ 7,00,00,000 is ₹ 35,00,000, which is the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the A.Y. 2020-21.

In case the assessee is a foreign company, say, Q Airlines (P) Ltd, the answer would be the same since section 44BBA does not distinguish corporate and non-corporate taxpayers who operate aircraft provided their residential status is that of non-resident.

(4) Special provision for computing profits and gains of foreign companies engaged in the business of civil construction etc. in certain turnkey power projects [Section 44BBB]

(i) **Eligible assessee:** A foreign company engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof in connection with a turnkey power project approved by the Central Government in this behalf.

(ii) **Presumptive rate:** A sum equal to 10% of the amount paid or payable (whether in or out of India) to the said assessee or to any person on his behalf on account of such civil construction, erection, testing or commissioning shall be deemed to be the profits and gains of such business chargeable to tax under the head 'profits and gains of business or profession'.

(iii) **Option to claim lower profits:** An assessee may claim lower income than the presumptive rate of 10%, if he keeps and maintains books of account under section 44AA(2) and get them audited and furnish a report of such audit under section 44AB. The assessment in all such cases shall be done by the Assessing Officer under section 143(3).

SUMMARY OF PRESUMPTIVE PROVISIONS APPLICABLE TO NON RESIDENTS

Particulars	44B	44BBA	44BB	44BBB
Nature of business	Shipping business	Operation of aircraft	Business of providing services or facilities in connection with, or supplying P & M on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils	Business of civil construction or the business of erection of P&M or testing or commissioning thereof, in connection with turnkey power projects approved by the Central Government.
Eligible assessee	Non-resident	Non-resident	Non-resident	Only Foreign Co.
Presumptive income	7.5% of specified sum	5% of specified sum	10% of specified sum	10% of specified sum
Specified sum	(i) Amount paid or payable on account of carriage of passengers, livestock, mail or goods shipped at/ from any port/place in India; and (ii) Amount received or deemed to be received in India on account of the carriage of passengers, livestock mail or goods shipped at/ from any port/place outside India		(i) Amount paid or payable on account of the provision of such services or facilities for the aforesaid purposes in India; and (ii) Amount received or deemed to be received in India on account of the provisions of services or facilities for the aforesaid purpose outside India.	Amount paid or payable on a/c of such civil construction, erection, testing or commissioning
Option to declare lower profits	Not available		Lower profits may be claimed u/s 44BB and u/s 44BBB provided the assessee maintains Books of account u/s 44AA and gets them audited u/s 44AB.	

(5) Deduction in respect of head office expenses in case of non-residents [Section 44C]

In case of a non-resident, head office expenditure is allowed in accordance with the provision of section 44C. This section is a non-obstante provision and anything contrary contained in sections 28 to 43A is not applicable.

Deduction in respect of head office expenditure is restricted to the least of the following:

(a) an amount equal to 5% of **"adjusted total income"** or in the case of loss, 5% of the **"average" adjusted total income**; or

(b) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India.

Meaning of certain terms:

Term	Meaning
Adjusted total income	Total income computed in accordance with the provisions of the Act without giving effect to the following :- ▪ Allowance under this section ▪ Unabsorbed depreciation allowance under section 32(2). ▪ Expenditure incurred by a company for the purpose of promoting family planning amongst its employees under first proviso to section 36(1)(ix). ▪ Business loss brought forward under section 72(1). ▪ Speculation loss brought forward under section 73(2). ▪ Loss under the head Capital Gain under section 74(1). ▪ Loss from certain specified source brought forward under Section 74A(3). ▪ Deduction under Chapter VI-A.
Average adjusted total income	(a) The total income of the assessee, assessable for each of the **three assessment years** immediately preceding the relevant assessment year, one third of the aggregate amount of the adjusted total income in respect of previous years relevant to the aforesaid three assessment years is average adjusted total income. (b) When the total income of the assessee is assessable only for **two of the aforesaid three assessment years**, one half of the aggregate amount of the adjusted total income in respect of the previous year's relevant to the aforesaid two assessment years is taken on average adjusted total income. (c) Where the total income of the assessee is assessable only for **one of the aforesaid three assessment years,** the amount of the adjusted total income in respect of the previous year relevant to that assessment year is average adjusted total income.
Head office expenditure	Executive and general administration expenditure incurred by the assessee outside India, including expenditure incurred in respect of: a. rent, rates, taxes, repairs or insurance of any premises outside India

	used for the purpose of the business or profession. b. salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profit in lieu of or in addition to salary, whether paid or allowed to any employee or other person employed in, or managing the affairs of, any office outside India; c. traveling by any employee or other person employed in, or managing the affairs, of any office outside India; and d. such other matters connected with executive and general administrative as may be prescribed.

Deduction of Head Office expenditure in case of Non-residents while computing Profit and gains from business or profession

Lower of

5% of adjusted Total Income	Amount of Head Office expenditure incurred by the Non-resident attributable to the business or profession in India
Meaning of Adjusted Total Income	**Meaning of Head Office expenditure**
Total Income, without giving effect to: (i) Head Office expenditure (ii) Unabsorbed depreciation (iii) Capital expenditure on family planning (iv) Losses carry forward: - Business loss u/s 72(1) - Speculative business Loss u/s 73(2) - LTCL/STCL u/s 74(1) - Loss from owning and maintaining race horses u/s 74A(3) (v) Deductions under Chapter VI-A from GTI	Executive and general administration expenditure incurred by the NR outside India, including: (a) Rent, rates, taxes, repairs or insurance of any premises outside India used for business or profession (b) Salary, wages, perquisites etc. to any employee or other person managing the affairs of any office outside India (c) Travelling expenditure by any employee or other person managing the affairs of any office outside India (d) Such other executive and general administration expenditure prescribed

ILLUSTRATION 3

The net result of the business carried on by a branch of foreign company in India for the year ended 31.03.2020 was a loss of ₹ 100 lakhs after charge of head office expenses of ₹ 200 lakhs allocated to the branch. Explain with reasons the income to be declared by the branch in its return for the assessment year 2020-21.

SOLUTION

Section 44C restricts the allowability of the head office expenses to the extent of lower of an amount equal to 5% of the adjusted total income or the amount actually incurred as is attributable to the business of the assessee in India.

For the purpose of computing the adjusted total income, the head office expenses of ₹ 200 Lakhs charged to the profit and loss account have to be added back.

The amount of income to be declared by the assessee for A.Y. 2020-21 will be as under:

Particulars	₹
Net loss for the year ended on 31.03.2020	(100 lakhs)
Add: Amount of head office expenses to be considered separately as per section 44C	200 lakhs
Adjusted total income	100 lakhs
Less: Head Office expenses allowable under section 44C is the lower of -	
(i) ₹ 5 lakhs, being 5% of ₹ 100 lakhs, or	
(ii) ₹ 200 lakhs.	5 lakhs
Income to be declared in return	**95 lakhs**

(6) Special provision for computing income by way of royalties etc. in case of non-residents [Section 44DA]

(i) Eligible assessee: Section 44DA provides the method of computation of income by way of royalty or fees for technical services arising from the agreement made by the non-resident with the Indian company or Government of India after 31.03.2003 where:

(a) such non-resident carries business/ profession in India through permanent establishment or fixed place of profession; and

(b) the right, property or contract in respect of which the royalty or fees for technical services are paid is effectively connected with such permanent establishment or fixed place of service.

(ii) Expenses not allowed as deduction: While computing the income chargeable to tax under this section, the following expenses are not allowed as deduction:

- expenditure or allowance incurred which is not wholly and exclusively for such permanent establishment or fixed place of service in India
- amount paid (otherwise than Reimbursement of actual expenses) by the permanent establishment to head office or to any of its other offices.

(iii) **Non-applicability of section 44BB:** The provisions of section 44BB do not apply in respect of income covered by this section.

(iv) **Mandatory requirement to maintain books of account and get them audited:** Under this section, the non-resident is mandatorily required to keep and maintain the books of account under section 44AA and get them audited and furnish a report of such audit.

2.7 CAPITAL GAINS TAXATION FOR NON RESIDENTS

Any person including a foreign company or non-corporate non-resident is liable to capital gains tax in India, if there is a transfer of a property (capital asset) in India which results in profit or gain.

Section 45 provides that any profits or gains arising from transfer of a **capital asset** effected in the previous year shall be chargeable to income tax under the head **"Capital gain"** and shall be deemed to be the income of the previous year in which the **transfer** took place.

The requisites of a charge to income-tax, of capital gains under Section 45(1) are:

(i) There must be a capital asset.

(ii) The capital asset must have been transferred.

(iii) The transfer must have been effected in the previous year.

There must be a gain arising on such transfer of a capital asset. Such capital gain should not be exempt under Sections 54, 54B, 54D, 54EC, 54EE, 54F, 54G, 54GA or 54GB.

(1) Meaning of Capital Asset

Definition: According to section 2(14), a capital asset means –

(a) property of any kind held by an assessee, whether or not connected with his business or profession;

(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the SEBI regulations.

However, it does not include—

(i) **Stock-in trade:** Any stock-in-trade [other than securities referred to in (b) above], consumable stores or raw materials held for the purpose of the business or profession of the assessee;

> *The exclusion of stock-in-trade from the definition of capital asset is only in respect of sub-clause (a) above and not sub-clause (b). This implies that even if the nature of such security in the hands of the Foreign Portfolio Investor is stock in trade, the same would be treated as a capital asset and the profit on transfer would be taxable as capital gains.*
>
> *Further, the Explanatory Memorandum to the Finance (No.2) Bill, 2014 clarifies that the income arising from transfer of such security by a Foreign Portfolio Investor (FPI) would be in the nature of capital gain, irrespective of the presence or otherwise in India, of the Fund manager managing the investments of the assessee.*

(ii) **Personal effects:** Personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him.

EXCLUSIONS:

(a) jewellery;

(b) archaeological collections;

(c) drawings;

(d) paintings;

(e) sculptures; or

(f) any work of art.

> **Definition of Jewellery** - Jewellery is a capital asset and the profits or gains arising from the transfer of jewellery held for personal use are chargeable to tax under the head "capital gains". For this purpose, the expression 'jewellery' includes the following:
>
> (i) Ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stones and whether or not worked or sewn into any wearing apparel;
>
> (ii) Precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel.

(iii) **Rural agricultural land** in India i.e., agricultural land in India which is not situated in any specified area.

As per the definition that only rural agricultural lands in India are excluded from the purview of the term 'capital asset'. Hence urban agricultural lands constitute capital assets. Accordingly, the agricultural land described in (a) and (b) below, being land situated within the specified urban limits, would fall within the definition of "capital asset", and transfer of such land would attract capital gains tax -

(a) agricultural land situated in any area within the jurisdiction of a municipality or cantonment board having population of not less than ten thousand, or

(b) agricultural land situated in any area within such distance, measured aerially, in relation to the range of population as shown hereunder –

	Shortest aerial distance from the local limits of a municipality or cantonment board referred to in item (a)	**Population according to the last preceding census of which the relevant figures have been published before the first day of the previous year.**
(i)	≤ 2 kilometers	> 10,000 ≤ 1,00,000
(ii)	≤ 6 kilometers	> 1,00,000 ≤ 10,00,000
(iii)	≤ 8 kilometers	> 10,00,000

***Explanation* regarding gains arising on the transfer of urban agricultural land** - *Explanation* to section 2(1A) clarifies that capital gains arising from transfer of any agricultural land situated in any non-rural area (as explained above) will not constitute agricultural revenue within the meaning of section 2(1A).

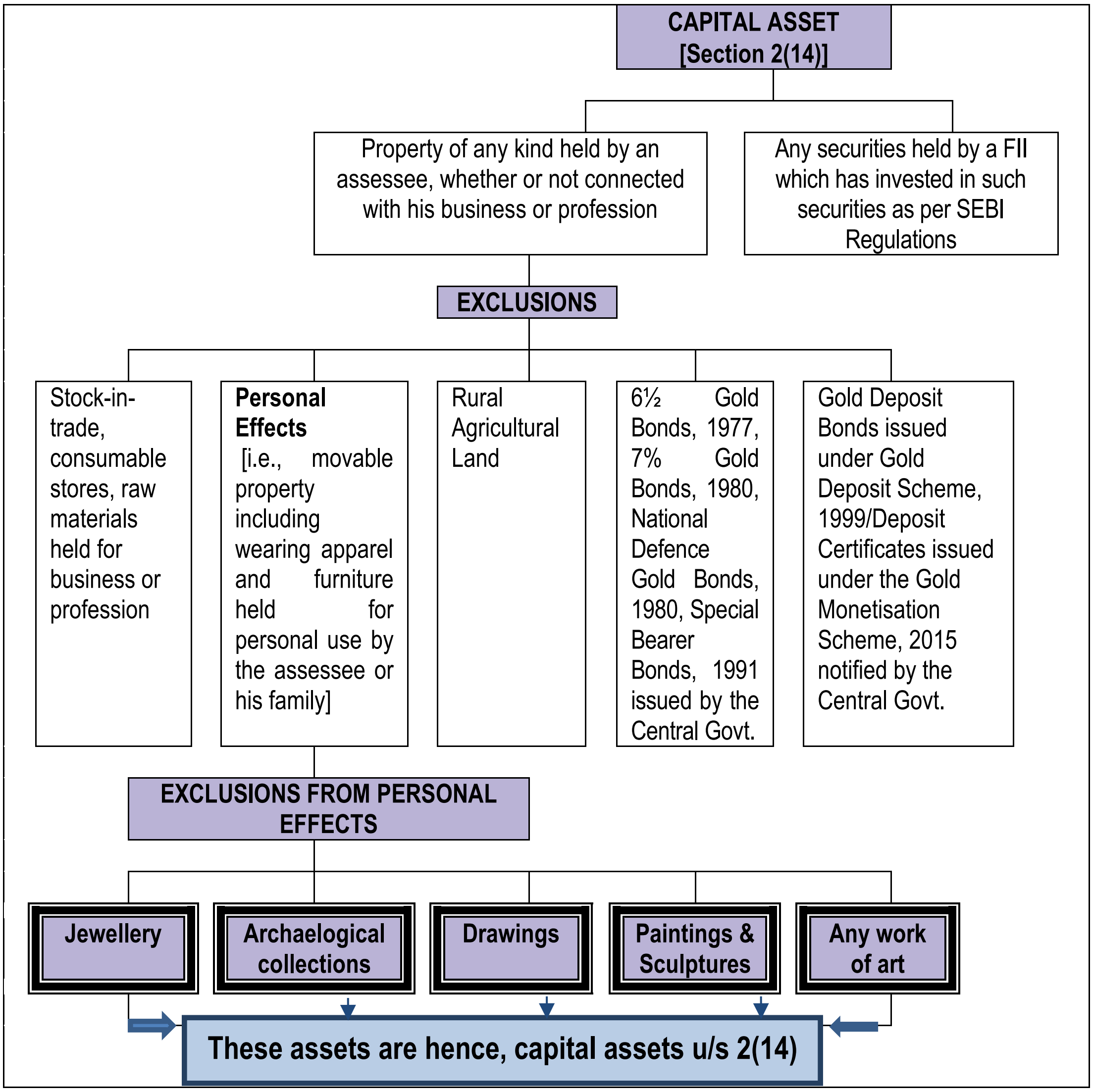
In other words, the capital gains arising from the transfer of such urban agricultural lands would not be treated as agricultural income for the purpose of exemption under section 10(1). Hence, such gains would be exigible to tax under section 45.

(iv) **Specified Gold Bonds:** 6½% Gold Bonds, 1977, or 7% Gold Bonds, 1980, or National Defence Gold Bonds, 1980, issued by the Central Government;

(v) **Special Bearer Bonds, 1991** issued by the Central Government;

(vi) **Gold Deposit Bonds** issued under the Gold Deposit Scheme, 1999 or deposit certificates issued under the Gold Monetisation Scheme, 2015 notified by the Central Government.

Note – 'Property' includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever.



(2) Short term and Long term Capital Asset

(i) Definition – As per section 2(42A), short-term capital asset means a capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer.

As per section 2(29A), long-term capital asset means a capital asset which is not a short-term capital asset.

Thus, a capital asset held by an assessee for more than 36 months immediately preceding the date of its transfer is a long-term capital asset.

(ii) Exceptions - A security (other than a unit) listed in a recognized stock exchange, or a unit of an equity oriented fund or a unit of the Unit Trust of India or a Zero Coupon Bond will be considered as a long-term capital asset if the same is held for more than 12 months immediately preceding the date of its transfer.

Further, a share of a company (not being a share listed in a recognized stock exchange in India) or an immovable property, being land or building or both would be treated as a short-term capital asset if it was held by an assessee for not more than 24 months immediately preceding the date of its transfer.

Thus, the period of holding of unlisted shares or an immovable property, being land or building or both, for being treated as a long-term capital asset would be "more than 24 months" instead of "more than 36 months".

Period of holding: A summary

STCA, if held for ≤ **12 month** LTCA, if held for **> 12 months**	• Security (other than unit) listed in a recognized stock exchange • Unit of equity oriented fund/ unit of UTI • Zero Coupon bond
STCA, if held for ≤ **24 month** LTCA, if held for > **24 months**	• Unlisted shares • Land or building or both
STCA, if held for ≤ **36 month** LTCA, if held for **> 36 months**	• Unit of debt oriented fund • Unlisted securities other than shares • Other capital assets

(iii) Meaning of certain terms:

<table>
<tr><th>Term</th><th>Meaning</th></tr>
<tr><td>Equity oriented fund</td><td>A fund set up under a scheme of a mutual fund specified under section 10(23D).
<table>
<tr><th>Circumstances</th><th>Condition</th></tr>
<tr><td>In a case where the fund invested in the units of another fund which is traded on a recognised stock exchange</td><td>(k) a minimum of 90% of the total proceeds of such fund is invested in the units of such other fund; and
(l) such other fund also invests a minimum of 90% of its total proceeds in the equity shares of domestic companies listed on a recognised stock exchange; and</td></tr>
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<tr><td>In any other case</td><td>a minimum of 65% of the total proceeds of such fund is invested in the equity shares of domestic companies listed on a recognised stock exchange</td></tr>
</table>
However, the percentage of equity shareholding or unit held in respect of the fund, as the case may be, shall be computed with reference to the annual average of the monthly averages of the opening and closing figures.
</td>
</tr>
<tr>
<td>Zero Coupon Bond [Section 2(48)]</td>
<td>A bond
- issued by any infrastructure capital company or infrastructure capital fund or a public sector company or a scheduled bank on or after 1st June, 2005,
- in respect of which no payment and benefit is received or receivable before maturity or redemption from such issuing entity and
- which the Central Government may notify in this behalf.</td>
</tr>
</table>

Note: The income from transfer of a Zero coupon bond (not being held as stock-in-trade) is to be treated as capital gains. Section 2(47)(iva) provides that maturity or redemption of a Zero coupon bond shall be treated as a transfer for the purposes of capital gains tax.

(iv) Period of holding of shares acquired on redemption of GDRs - Where share(s) of a company is acquired by the non-resident assessee on redemption of Global Depository Receipts referred to in clause (b) of section 115AC(1) held by such assesse, the period shall be reckoned from the date on which a request for such redemption was made. *[Refer sub para 3 of para 2.9 on page 2.101 for discussion on section 115AC]*

(v) Period of holding of capital asset acquired by Indian subsidiary company in consequence to conversion of a branch of a foreign company into a subsidiary company – *In the case of a capital asset which became the property of the Indian subsidiary company in consequence to conversion of a branch of a foreign company referred to in section 115JG(1), the period for which the asset was held by the said branch of the foreign company and by the previous owner, if any, who has acquired the capital asset by a mode of acquisition referred to in clause (i)/(ii)/(iii)/(iv) of section 49(1) or section 115JG(1) shall be included [Notification No.86/2018 – Rule 8AA(4)]. Section 115JG has been discussed at length later on in this Chapter.*

(3) Transactions not regarded as transfer [Section 47]

Section 47 specifies certain transactions which will not be regarded as transfer for the purpose of capital gains tax in respect of non-residents and foreign companies.

(1)	(2)	(3)	(4)
Clause of section 47	**Particulars of transfer of capital asset referred to in column (3)**	**Capital Asset transferred**	**Conditions to be fulfilled**
47(via)	Any transfer in a scheme of amalgamation of two foreign companies. Capital asset is transferred by the amalgamating foreign company to the amalgamated foreign company.	Shares held in an Indian company	(a) At least 25% of the shareholders of the amalgamating foreign company must continue to remain shareholders of the amalgamated foreign company; (b) Such transfer should not attract capital gains in the country in which the amalgamating company is incorporated.
47(viab)	Any transfer in a scheme of amalgamation of two foreign companies. Capital asset is transferred by the amalgamating foreign company to the amalgamated foreign company.	Share of a foreign company, referred to in *Explanation 5* to section 9(1)(i), which derives, directly or indirectly, its value substantially from the share or shares of an Indian company	(a) At least 25% of the shareholders of the amalgamating foreign company must continue to remain shareholders of the amalgamated foreign company; (b) Such transfer should not attract capital gains in the country in which the amalgamating company is incorporated.
47(vic)	Any transfer in a scheme of demerger of a foreign company. Capital asset is transferred by the demerged foreign company to the resulting foreign company.	A share or shares held in an Indian company	(a) The shareholders holding at least three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; (b) Such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

			However, the provisions of sections 391 to 394 of the Companies Act, 1956[3], should not apply in case of demergers referred to in this clause.
47(vicc)	Any transfer, in a scheme of demerger of a foreign company Capital asset is transferred by the demerged foreign company to the resulting foreign company.	A share of a foreign company referred to in *Explanation 5* to section 9(1)(i), which derives, directly or indirectly, its value substantially from the share or shares of an Indian company	(a) The shareholders holding at least three-fourths in value of the shares of the demerged foreign company continue to remain shareholders of the resulting foreign company; (b) Such transfer should not attract capital gains in the country in which the demerged foreign company is incorporated. However, the provisions of sections 391 to 394 of the Companies Act, 1956[3], shall not apply in case of demergers referred to in this clause.
47(viia)	Any transfer by a non-resident to another non-resident outside India.	Bonds or Global Depository Receipts (GDRs) referred to in section 115AC(1)	Conditions laid down in section 115AC(1) should be fulfilled: (a) Bonds should be of: (i) an Indian company (issued in accordance with Notified scheme of Central Government) (ii) a public sector company sold by the Government and purchased by the non-resident in foreign currency (c) GDRs should be issued: (i) in accordance with notified scheme of

[3] Sections 230 to 232 of the Companies Act, 2013

			Central Government against initial issue of shares of an Indian company and purchased by the non-resident in foreign currency; or (ii) against the shares of a public sector company sold by the Government and purchased by him in foreign currency through an approved intermediary; or (iii) or reissued in accordance with Notified Scheme of Central Government against the existing shares of an Indian company purchased by him in foreign currency through an approved intermediary.
47(viiaa)	Any transfer, made outside India, by a non-resident to another non-resident.	Rupee denominated bond of an Indian company issued outside India	
47(viiab)	*Any transfer of a capital asset by a non-resident on a recognised stock exchange located in any International Financial Services Centre (IFSC)*	- *A bond or GDR referred to in section 115AC(1) (or)* - *A rupee deno-minated bond of an Indian company (or)* - *A derivative (or)* - *Any other security*	*The consideration for such transaction is paid or payable in foreign currency.*

		notified by the Central Government	
47(viib)	Any transfer of a capital asset made outside India by a non-resident to another non-resident through an intermediary dealing in settlement of securities	A Government Security carrying a periodic payment of interest.	
47(xa)	Any transfer by way of conversion of bonds into shares or debentures of any company	Bonds referred to in section 115AC(1)(a)	Conditions laid down in section 115AC(1) should be fulfilled i.e., Bonds should be of: (i) an Indian company (issued in accordance with Notified scheme of Central Government) (ii) a public sector company sold by the Government and purchased by the non-resident in foreign currency

(4) Mode of computation of capital gains [Section 48]

(i) **Amounts deductible while computing capital gains:** The income chargeable under the head 'Capital gains' shall be computed by deducting from the full value of consideration received or accruing as a result of the transfer of the capital asset the following amounts viz:

i) expenditure incurred wholly and exclusively in connection with such transfer; and

ii) the cost of acquisition of the asset and the cost of any improvement thereto.

(ii) **No deduction in respect of STT paid:** No deduction shall, however, be allowed in computing the income chargeable under the head "Capital Gains" in respect of any amount paid on account of securities transaction tax (STT) under Chapter VII of the Finance (No.2) Act, 2004.

(iii) **Cost inflation index:** Under section 48, for computation of long term capital gains, the cost of acquisition and cost of improvement increased by applying the cost inflation index

(CII). Once the cost inflation index is applied to the cost of acquisition and cost of improvement, it becomes indexed cost of acquisition and indexed cost of improvement.

This means an amount which bears to the cost of acquisition, the same proportion as CII for the year in which the asset is transferred bears to the CII for the first year in which the asset was held by the assessee or for the year beginning on 1st April, 2001, whichever is later.

Similarly, indexed cost of any improvement means an amount which bears to the cost of improvement, the same proportion as CII for the year in which the asset is transferred bears to the CII for the year in which the improvement to the asset took place.

The cost inflation indices for the financial years so far have been notified as under:

Financial Year	Cost Inflation Index
2001-02	100
2002-03	105
2003-04	109
2004-05	113
2005-06	117
2006-07	122
2007-08	129
2008-09	137
2009-10	148
2010-11	167
2011-12	184
2012-13	200
2013-14	220
2014-15	240
2015-16	254
2016-17	264
2017-18	272
2018-19	280
2019-20	**289**

(5) Special provisions of computation in case of non-residents

(i) **First Proviso to Section 48 read with Rule 115A**:-

In order to give protection to non-residents who invest foreign exchange to acquire capital assets, the first proviso to section 48 provides that capital gains arising from the transfer of shares or debentures of an Indian company is to be computed as follows:

- The cost of acquisition, the expenditure incurred wholly and exclusively in connection with the transfer and the full value of the consideration are to be converted into the same foreign currency with which such shares or debentures were acquired.
- The resulting capital gains shall be reconverted into Indian currency.

The aforesaid manner of computation of capital gains shall be applied for every purchase and sale of shares or debentures in an Indian company.

Benefit of indexation will not be applied in this case.

Rule 115A of the Income-tax Rules, 1962 provides that the average of the telegraphic transfer buying rate and telegraphic transfer selling rate of the foreign currency initially utilized in purchase of the capital asset as on the date specified in column (3) in the table below, shall be used to convert rupees into foreign currency for the purpose of computation of capital gains.

(1)	(2)	(3)
S. No.	**Item**	**Date**
(a)	Cost of acquisition of capital asset	Date of acquisition of capital asset
(b)	Expenditure incurred wholly and exclusively in connection with transfer of capital asset	Date of transfer of capital asset
(c)	Full value of consideration received or accruing as a result of transfer of a capital asset	Date of transfer of capital asset

For reconverting capital gains computed in the foreign currency initially utilized in the purchase of the capital asset into rupees, the telegraphic transfer buying rate of such currency, as on the date of transfer of the capital asset, is to be considered.

Meaning of certain terms

Term	Meaning
Telegraphic transfer buying rate	The rate or rates of exchange adopted by the State Bank of India for buying foreign currency having regard to the guidelines specified from time to time by the RBI for buying foreign currency where such currency, made available to that bank through a telegraphic transfer.

Telegraphic transfer selling rate	The rate of exchange adopted by the State Bank of India for selling foreign currency where such currency is made available by that bank through telegraphic transfer.

However, the benefit of indexation and currency fluctuation would not be available in respect of capital gains arising from the transfer of the following long term capital assets referred to in section 112A –

(i) equity share in a company on which STT is paid both at the time of acquisition and transfer

(ii) unit of equity oriented fund or unit of business trust on which STT is paid at the time of transfer.

Other Important Points:

a. It is also provided that the aforesaid manner of computation of capital gains shall be applicable in respect of capital gains accruing or arising from every re-investment thereafter in and sale of shares in or debentures of an Indian company.

b. If the total income of an assessee includes any income chargeable under the head 'Capital Gains' arising from transfer of a capital asset being an equity share in a company or unit of an equity oriented fund or unit of a business trust, then, tax on short term capital gains shall be payable at the rates specified in section 111A if transaction of sale of such security has been entered on or after October 1, 2004 on which STT is chargeable; and tax on long-term capital gains shall be payable on such securities as per section 112A, if STT has been paid both at the time of acquisition and transfer of equity share or at the time of transfer of unit of equity oriented fund or unit of business trust.

c. Section 50CA provides that where the consideration received or accruing as a result of transfer of a capital asset, being share of a company other than a quoted share, is less than the fair market value of such share determined in such manner as may be prescribed, such fair market value shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

   This provision would, however, not be applicable to any consideration received or accruing as a result of transfer by such class of persons and subject to such conditions as may be prescribed.

d. Section 50D provides that, in case where the consideration received or accruing as a result of the transfer of a capital asset by an assessee is not ascertainable or cannot be determined, then, for the purpose of computing income chargeable to tax as capital gains, the fair market value of the said asset on the date of transfer shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

e. The shares and debentures (whether listed or non-listed) of Indian companies only are covered under this proviso. Indian company shall include Government company. However, bonds of Central Government/State Government and RBI are not covered for this purpose.

ILLUSTRATION 4

Mr. A, a non-resident Indian remits US $ 40,000 to India on 16.09.2005. The amount is partly utilised on 3.10.2005 for purchasing 10,000 equity shares in A Ltd, an Indian Company, at the rate of ₹ 12 per share. These shares are sold for ₹ 48 per share on 30.03.2020. Fair Market value of these shares on 31.01.2018 was ₹ 35 per share.

The telegraphic transfer buying and selling rate of US dollars adopted by the State Bank of India is as follows :-

Date	*Buying Rate (1 US$)*	*Selling Rate (1 US $)*
16.09.2005	*18*	*20*
3.10.2005	*19*	*21*
30.3.2020	*59*	*61*

Compute Capital gain chargeable to tax for the A.Y. 2020-21 on the assumption that –

(a) These shares have not been sold through a recognised stock exchange

(b) These shares have been purchased and sold through a recognised stock exchange.

SOLUTION

(a) Where the shares are not sold through recognised stock exchange

Particulars	US $
Sale consideration (₹ 4,80,000/60)	8000
Less: Cost of Acquisition (1,20,000/20)	6000
Long term capital gain	**2000**

Long-term capital gain converted into $ 2000 x ₹ 59 = ₹ 1,18,000

(b) **Where the shares are purchased and sold through a recognised stock exchange**

Particulars		₹
Sale consideration		4,80,000
Less: Cost of Acquisition		
Higher of the following		
Cost of acquisition	1,20,000	
Lower of Fair market value as on 31.1.2018 and Full		

value of consideration (i.e., lower of ₹ 3,50,000 and ₹ 4,80,000)	3,50,000	3,50,000
Long term capital gain		**1,30,000**

Long term capital gains upto ₹ 1,00,000 would be exempt. Long term capital gains exceeding ₹ 1,00,000, i.e., ₹ 30,000 is taxable @10% under section 112A.

(ii) **Fourth Proviso to Section 48**

As a measure to enable Indian companies to raise funds from outside India, the RBI has permitted them to issue rupee denominated bonds outside India. Accordingly, in case of non-resident assessees, any gains arising on account of appreciation of rupee between the date of purchase and the date of redemption of rupee denominated bond of an Indian company held by him against foreign currency in which investment is made shall not be included in computation of full value of consideration. This would provide relief to the non-resident investor who bears the risk of currency fluctuation.

***Note** - Non-corporate non-residents and foreign companies to be subject to tax at a concessional rate of 10% (without indexation benefit or currency fluctuation) on long-term capital gains arising from transfer of unlisted securities or shares of a company in which public are not substantially interested [Section 112]*

(6) Ascertainment of cost in specified circumstances [Section 49]

Section 49 provides for the guidelines for computing the cost of under different circumstances.

(i) **Cost of previous owner deemed as cost of acquisition of asset [Section 49(1)]:** In the following cases, the cost of acquisition of the asset shall be deemed to be cost for which the previous owner of the property acquired it. To this cost, the cost of improvement to the asset incurred by the previous owner or the assessee must be added:

Where capital asset became the property of the assessee:

Capital asset	Transfer ref. to in section	Details of transfer
Share(s) held in an Indian company	47(via)	In a scheme of amalgamation, by the amalgamating foreign company to the amalgamated foreign company
	47(vic)	In a scheme of demerger, by the demerged foreign company to the resulting foreign company
A share in a foreign company, which derives, directly or indirectly, its	47(viab)	In a scheme of amalgamation, by the amalgamating foreign company to the amalgamated foreign company

value substantially from the share(s) of an Indian company	47(vicc)	In a scheme of demerger, by the demerged foreign company to the resulting foreign company

Accordingly, section 2(42A) provides that in all such cases, for determining the period for which the capital asset is held by the transferee, the period of holding of the asset by the previous owner shall also be considered.

Note: The issue as to whether indexation benefit in respect of a gifted asset shall apply from the year in which the asset was first held by the assessee or from the year in which the same was first acquired by the previous owner was taken up by the Bombay High Court in CIT v. Manjula J. Shah (2013) 355 ITR 474 (Bom.).

As per *Explanation 1* to section 2(42A), in case the capital asset becomes the property of the assessee in the circumstances mentioned in section 49(1), *inter alia,* by way of gift by the previous owner, then for determining the nature of the capital asset, the aggregate period for which the capital asset is held by the assessee and the previous owner shall be considered.

As per the provisions of section 48, the profit and gains arising on transfer of a long-term capital asset shall be computed by reducing the indexed cost of acquisition from the net sale consideration.

The indexed cost of acquisition means the amount which bears to the cost of acquisition the same proportion as Cost Inflation Index (CII) for the year in which the asset is transferred bears to the CII for the year in which the asset was first held by the assessee transferring it i.e., the year in which the asset was gifted to the assessee in case of transfer by the previous owner by way of gift.

The issue under consideration was whether, in a case where the assessee had acquired a capital asset by way of gift from the previous owner, the said asset can be treated as a long-term capital asset considering the period of holding by the assessee as well as the previous owner.

The Bombay High Court held that the indexed cost of acquisition in case of gifted asset has to be computed with reference to the year in which the previous owner first held the asset and not the year in which the assessee became the owner of the asset.

As per the plain reading of the provisions of section 48, however, the indexed cost of acquisition would be determined by taking CII for the year in which in which asset is first held by the assessee.

(ii) **Cost of acquisition of shares or debentures acquired on conversion of bonds [Section 49(2ABB)]:** The cost of acquisition of the capital asset, being share or debenture of a company acquired by the assessee consequent to conversion of bonds [referred to in section 115AC(1)(a)] would be that part of the cost of bond in relation to which such asset is acquired by that person.

(iii) **Cost of acquisition of shares acquired on redemption of Global Depository Receipts [Section 49(2ABB)]:** The cost of acquisition of the capital asset, being share or shares of a company acquired by a non-resident assessee, consequent to redemption of GDRs [referred to in section 115AC(1)(b)] held by him would be the price of such share or shares prevailing on any recognized stock exchange on the date on which a request for such redemption was made.

(7) Tax on Short term capital gains in respect of equity shares/ units of an equity oriented fund/ units of a business trust [Section 111A]

(i) **Concessional rate of tax in respect of STCG on transfer of certain assets:** This section provides for a concessional rate of tax (i.e. 15%) on the short-term capital gains on transfer of –

- an equity share in a company or
- a unit of an equity oriented fund or
- a unit of a business trust.

(ii) **Conditions:** The conditions for availing the benefit of this concessional rate are-

a) the transaction of sale of such equity share or unit should be entered into on or after 1.10.2004, being the date on which Chapter VII of the Finance (No. 2) Act, 2004 came into force; and

b) such transaction should be chargeable to securities transaction tax under the said chapter.

However, short-term capital gains arising from transactions undertaken in foreign currency on a recognized stock exchange located in an International Financial Services Centre (IFSC) would be taxable at a concessional rate of 15% even though STT is not leviable in respect of such transaction.

(iii) **Adjustment of unexhausted basic exemption limit:** The benefit of adjusting the unexhausted basic exemption limit is **not** available in the case of non-residents.

(iv) **No deduction under Chapter VI-A against STCG taxable under section 111A:** Deductions under Chapter VI-A cannot be availed in respect of such short-term capital gains on equity shares of a company or units of an equity oriented fund or units of a business trust included in the gross total income of the assessee.

Note *- The Finance (No. 2) Act, 2019 has levied an enhanced surcharge of 25% and 37%, where the total income of an individual/HUF/AOP/BOI exceeds ₹ 2 crores and ₹ 5 crores, respectively. However, the enhanced surcharge has been withdrawn on tax payable at special rates under section 111A and*

112A by both resident and non-resident assessees on short-term and long-term capital gains arising from the transfer of equity share in a company or unit of an equity-oriented fund/ business trust, which has been subject to securities transaction tax ***[Press Release dated 24-8-2019]***

(8) Tax on long term capital gains [Section 112]

(i) Where the **total income of a non-corporate non-resident or a foreign company** includes any income, arising from the transfer of a long-term capital asset, which is chargeable under the head "Capital gains", the tax payable by the non-resident or foreign company on the total income shall be the aggregate of —

(a) Long-term capital gains arising from the transfer of a capital asset, being **unlisted securities, or shares of a company not being a company in which the public are substantially interested would be calculated at the rate of 10%** on the capital gains in respect of such asset without giving effect to the indexation benefit provided under second proviso to section 48 and currency fluctuation under first proviso to section 48.

(b) In respect of other long-term capital gains, the applicable rate of tax would be 20%.

(ii) **Lower rate of tax for transfer of listed securities and zero coupon bonds:** Where the tax payable in respect of any income arising from the transfer of a listed security (other than a unit) or a zero coupon bond, being a long-term capital asset, exceeds 10% of the amount of capital gains before indexation, then such excess shall be ignored while computing the tax payable by the assessee.

(iii) **No deduction under Chapter VI-A against LTCG:** The provisions of section 112 make it clear that the deductions under Chapter VIA cannot be availed in respect of the long-term capital gains included in the gross total income of the assessee.

(iv) **Rate of tax on long-term capital gains for non-corporate non-residents or foreign companies [Section 112]:**

Capital Asset	Period of holding to qualify as a long-term capital asset	Rate of tax on long-term capital gains
Listed securities (other than unit) or Zero coupon bond	> 12 months	10% (without indexation benefit) **or** 20% (with indexation benefit) whichever is more beneficial to the assessee
Unlisted securities or shares of closely held companies	> 24 months	10% (without benefit of indexation or foreign currency fluctuation)
Other capital assets	> 36 months	20% (with indexation)

(9) Tax on long term capital gains on certain assets [Section 112A]

(i) **Concessional rate of tax in respect of LTCG on transfer of certain assets:** In order to minimize economic distortions and curb erosion of tax base, section 112A provides that notwithstanding anything contained in section 112, a concessional rate of tax @10% will be leviable on the long-term capital gains exceeding ₹ 1,00,000 on transfer of –

(a) an equity share in a company or

(b) a unit of an equity oriented fund or

(c) a unit of a business trust.

> ***Note*** - *The Finance (No. 2) Act, 2019 has levied an enhanced surcharge of 25% and 37%, where the total income of an individual/HUF/AOP/BOI exceeds ₹ 2 crores and ₹ 5 crores, respectively. However, the enhanced surcharge has been withdrawn on tax payable at special rates under section 111A and 112A by both resident and non-resident assessees on short-term and long-term capital gains arising from the transfer of equity share in a company or unit of an equity-oriented fund/ business trust, which has been subject to securities transaction tax* ***[Press Release dated 24-8-2019]***

(ii) **Conditions:** The conditions for availing the benefit of this concessional rate are–

(a) In case of equity share in a company, STT has been paid on acquisition and transfer of such capital asset

(b) In case of unit of an equity oriented fund or unit of business trust, STT has been paid on transfer of such capital asset.

However, the Central Government may, by notification in the Official Gazette, specify the nature of acquisition of equity share in a company on which the condition of payment of STT on acquisition would not be applicable.

In view of the above, the Central Government has, vide notification No. 60/2018, dated 1st October, 2018, notified that the condition of chargeability of STT shall not apply to the acquisition of equity shares entered into

- before 1st October, 2004 or
- on or after 1st October, 2004 which are not chargeable to STT, other than the following transactions.

In effect, only in respect of the following transactions mentioned in column (2), the requirement of paying STT at the time of acquisition for availing the benefit of concessional rate of tax under section 112A would apply. In may be noted that the exceptions are listed in column (3) against the transaction. The requirement of payment of STT at the time of acquisition for availing benefit of concessional tax rate under section 112A will not apply to acquisition transactions mentioned in column (3).

(1)	(2)	(3)	
	Transaction	**Non-applicability of condition of chargeability of STT**	
(a)	Where acquisition of existing listed equity share in a company whose equity shares are not frequently traded in a recognised stock exchange of India is made through a preferential issue	Where acquisition of listed equity share in a company –	
		(i)	has been approved by the Supreme Court, High Court, National Company Law Tribunal, Securities and Exchange Board of India or Reserve Bank of India in this behalf;
		(ii)	is by any non-resident in accordance with foreign direct investment guidelines issued by the Government of India;
		(iii)	is by an investment fund referred to in clause (a) of *Explanation 1* to section 115UB or a venture capital fund referred to in section 10(23FB) or a Qualified Institutional Buyer;
		(iv)	is through preferential issue to which the provisions of chapter VII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 does not apply.
(b)	Where transaction for acquisition of existing listed equity share in a company is not entered through a recognised stock exchange in India	Following acquisitions of listed equity share in a company made in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956:	
		(i)	acquisition through an issue of share by a company other than through preferential the issue referred to in (a);
		(ii)	acquisition by scheduled banks, reconstruction or securitisation companies or public financial institutions during their ordinary course of business;
		(iii)	acquisition by the Supreme Court, High Courts, National Company Law Tribunal, Securities and Exchange Board of India or Reserve Bank of India in this behalf;
		(iv)	acquisition under employee stock option scheme or employee stock purchase scheme framed under the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines,1999;

		(v)	acquisition by any non-resident in accordance with foreign direct investment guidelines of the Government of India;
		(vi)	acquisition in accordance with Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulation, 2011;
		(vii)	acquisition from the Government;
		(viii)	acquisition by an investment fund referred to in clause (a) to Explanation 1 to section 115UB or a venture capital fund referred to in section 10(23FB) or a Qualified Institutional Buyer;
		(ix)	acquisition by mode of transfer referred to in section 47 (e.g., transfer of capital asset under a gift, an irrevocable trust, transfer of capital asset between holding company and its subsidiary, transfer pursuant to amalgamation, demerger, etc.) or section 50B (slump sale) or section 45(3) (Introduction of capital asset as capital contribution in firm/ AOPs/ BOIs) or section 45(4) (Distribution of capital assets on dissolution of firm/ AOPs/ BOIs) of the Income-tax Act, if the previous owner or the transferor, as the case may be, of such shares has not acquired them by any mode referred to in (a), (b) or (c) listed in column (2) [other than the exceptions listed in column (3)]
(c)	acquisition of equity share of a company during the period beginning from the date on which the company is delisted from a recognised stock exchange and ending on the date immediately preceding the date on which the company is again listed on a recognised stock exchange in accordance with the Securities Contracts (Regulation) Act, 1956 read		

	with Securities and Exchange Board of India Act,1992 and the rules made thereunder;	

Meaning of certain terms:

S.No.	Term	Particulars
1	Frequently traded shares	Shares of a company, in which the traded turnover on a recognised stock exchange during the twelve calendar months preceding the calendar month in which the acquisition and transfer is made, is at least 10 percent of the total number of shares of such class of the company. However, where the share capital of a particular class of shares of the company is not identical throughout such period, the weighted average number of total shares of such class of the company would represent the total number of shares
2	"Preferential issue" and "Qualified Institutional Buyer	"Preferential issue" and "Qualified Institutional Buyer" would have the meanings respectively assigned to them in sub-regulation (1) of regulation (2) of the SEBI (ICDR) Regulations, 2009. "**Preferential issue**" means an issue of specified securities by a listed issuer to any select person or group of persons on a private placement basis and does not include an offer of specified securities made through a public issue, rights issue, bonus issue, employee stock option scheme, employee stock purchase scheme or an issue of sweat equity shares or depository receipts issued in a country outside India or foreign securities. "**Qualified Institutional Buyer**" means (i) a mutual fund, venture capital fund, alternative investment fund and foreign venture capital investor registered with the SEBI; (ii) a foreign portfolio investor other than Category III foreign portfolio investor, registered with the SEBI; (iii) a public financial institution; (iv) a scheduled commercial bank; (v) a multilateral and bilateral development financial institution;

		(vi) a state industrial development corporation; (vii) an insurance company registered with the Insurance Regulatory and Development Authority of India; (viii) a provident fund with minimum corpus of ₹ 25 crore; (ix) a pension fund with minimum corpus of ₹ 25 crore; (x) National Investment Fund set up by resolution no. F. No. 2/3/2005-DDII dated November 23, 2005 of the Government of India published in the Gazette of India; (xi) insurance funds set up and managed by army, navy or air force of the Union of India; and (xii) insurance funds set up and managed by the Department of Posts, India; and (xiii) systemically important non-banking financial companies.

Further, long-term capital gains arising from transaction undertaken on a recognized stock exchange located in an International Financial Service Centre (IFSC) would be taxable at a concessional rate of 10%, where the consideration for transfer is received or receivable in foreign currency, even though STT is not leviable in respect of such transaction.

(iii) **Adjustment of Unexhausted Basic Exemption Limit:** The benefit of adjustment of unexhausted basic exemption limit is **not** available in the case of non-residents.

(iv) **No deduction under Chapter VI-A against LTCG taxable under section 112A:** Deductions under Chapter VI-A cannot be availed in respect of such long-term capital gains on equity shares of a company or units of an equity oriented fund or unit of a business trust included in the gross total income of the assessee.

Subsequent to insertion of section 112A, the CBDT has issued clarification F. No. 370149/20/2018-TPL dated 04.02.2018 in the form of a Question and Answer format to clarify certain issues raised in different fora on various issues relating to the new tax regime for taxation of long-term capital gains. The relevant questions raised and answers to such questions as per the said Circular are given hereunder:

Q 1. What is the meaning of long term capital gains under the new tax regime for long term capital gains?

Ans. Long term capital gains mean gains arising from the transfer of long-term capital asset.

It provides for a new long-term capital gains tax regime for the following assets–

i. Equity Shares in a company listed on a recognised stock exchange;

ii. Unit of an equity oriented fund; and

iii. Unit of a business trust.

The new tax regime applies to the above assets, if–

a. the assets are held for a minimum period of twelve months from the date of acquisition; and

b. the Securities Transaction Tax (STT) is paid at the time of transfer. However, in the case of equity shares acquired after 1.10.2004, STT is required to be paid even at the time of acquisition (subject to notified exemptions).

Q 2. What is the point of chargeability of the tax?

Ans. The tax will be levied only upon transfer of the long-term capital asset on or after 1st April, 2018, as defined in clause (47) of section 2 of the Act.

Q 3. What is the method for calculation of long-term capital gains?

Ans. The long-term capital gains will be computed by deducting the cost of acquisition from the full value of consideration on transfer of the long-term capital asset.

Q 4. How do we determine the cost of acquisition for assets acquired on or before 31st January, 2018?

Ans. The cost of acquisition for the long-term capital asset acquired on or before 31st of January, 2018 will be the actual cost.

However, if the actual cost is less than the fair market value of such asset as on 31st of January, 2018, the fair market value will be deemed to be the cost of acquisition.

Further, if the full value of consideration on transfer is less than the fair market value, then such full value of consideration or the actual cost, whichever is higher, will be deemed to be the cost of acquisition.

Q 5. Please provide illustrations for computing long-term capital gains in different scenarios, in the light of answers to questions 4.

Ans. The computation of long-term capital gains in different scenarios is illustrated as under

Scenario 1 – An equity share is acquired on 1st of January, 2017 at ₹100, its fair market value is ₹200 on 31st of January, 2018 and it is sold on 1st of April, 2019 at ₹250. As the actual cost of acquisition is less than the fair market value as on 31st of January, 2018, the fair market value of ₹200 will be taken as the cost of acquisition and the long-term capital gain will be ₹50 (₹250 – ₹200).

Scenario 2 – An equity share is acquired on 1st of January, 2017 at ₹100, its fair market value is ₹200 on 31st of January, 2018 and it is sold on 1st of April, 2019 at ₹150. In this case, the actual cost of acquisition is less than the fair market value as on 31st of January, 2018. However, the sale value is also less than the fair market value as on 31st of January, 2018. Accordingly, the sale value of ₹150 will be taken as the cost of acquisition and the long-term capital gain will be NIL (₹150 – ₹150).

Scenario 3 – An equity share is acquired on 1st of January, 2017 at ₹100, its fair market value is ₹50 on 31st of January, 2018 and it is sold on 1st of April, 2019 at ₹150. In this case, the fair market value as on 31st of January, 2018 is less than the actual cost of acquisition, and therefore, the actual cost of ₹100 will be taken as actual cost of acquisition and the long-term capital gain will be ₹50 (₹150 – ₹100).

Scenario 4 – An equity share is acquired on 1st of January, 2017 at ₹100, its fair market value is ₹200 on 31st of January, 2018 and it is sold on 1st of April, 2019 at ₹50. In this case, the actual cost of acquisition is less than the fair market value as on 31st January, 2018. The sale value is less than the fair market value as on 31st of January, 2018 and also the actual cost of acquisition. Therefore, the actual cost of ₹100 will be taken as the cost of acquisition in this case. Hence, the long-term capital loss will be ₹50 (₹50 – ₹100) in this case.

Q 6. Whether the cost of acquisition will be inflation indexed?

Ans. Third proviso to section 48, provides that the long-term capital gain will be computed without giving effect to the provisions of the second provisos of section 48. Accordingly, it is clarified that the benefit of inflation indexation of the cost of acquisition would not be available for computing long-term capital gains under the new tax regime.

Q 7. What will be the tax treatment of transfer made on or after 1st April 2018?

Ans. The long-term capital gains exceeding ₹1 Lakh arising from transfer of these assets made on after 1st April, 2018 will be taxed at 10 per cent. However, there will be no tax on gains accrued upto 31st January, 2018.

Q 8. What is the date from which the holding period will be counted?

Ans. The holding period will be counted from the date of acquisition.

Q 9. Whether tax will be deducted at source in case of gains by resident tax payer?

Ans. No. There will be no deduction of tax at source from the payment of long-term capital gains to a resident tax payer.

Q 10. What will be the cost of acquisition in the case of bonus shares acquired before 1st February 2018?

Ans. The cost of acquisition of bonus shares acquired before 31st January, 2018 will be determined as per section 55(2)(ac). Therefore, the fair market value of the bonus shares as on 31st January, 2018 will be taken as cost of acquisition (except in some typical situations explained in Ans 5), and hence, the gains accrued upto 31st January, 2018 will continue to be exempt[4].

Q 11. What will be the cost of acquisition in the case of right share acquired before 1st February 2018?

Ans. The cost of acquisition of right share acquired before 31st January, 2018 will be determined as per section 55(2)(ac). Therefore, the fair market value of right share as on 31st January, 2018 will be taken as cost of acquisition (except in some typical situations explained in Ans 5), and hence, the gains accrued upto 31st January, 2018 will continue to be exempt[4].

Q 12. What will be the treatment of long-term capital loss arising from transfer made on or after 1st April, 2018?

Ans. Long-term capital loss arising from transfer made on or after 1st April, 2018 will be allowed to be set-off and carried forward in accordance with existing provisions of the Act. Therefore, it can be set-off against any other long-term capital gains and unabsorbed loss can be carried forward to subsequent eight years for set-off against long-term capital gains

2.8 SPECIAL PROVISIONS PRESCRIBED UNDER CHAPTER XII-A

Chapter XII-A, introduced in the Income-tax Act 1961 with effect from June 01, 1983, contains seven sections viz. 115C, 115D, 115E ,115F,115G,115H and115-I. The provisions of this Chapter are applicable to a non-resident Indian who derives investment income from a foreign exchange asset and/ or long term capital gains in respect thereof.

(1) Definitions [Section 115C]

	Terms	Meaning
(a)	Convertible foreign exchange	Foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Management Act, 1999, and any rules made thereunder.
(b)	Foreign exchange asset	Any specified asset which the assessee has acquired or purchased with, or subscribed to in, convertible foreign exchange
(c)	Investment income	Any income derived (other than dividends referred to in section 115-O) from a foreign exchange asset.

[4] *Subject to the notification issued by the Central Government to specify the nature of acquisition of equity share in a company on which the condition of payment of STT on acquisition would not be applicable.*

(d)	Long-term capital gains	Income chargeable under the head "Capital gains" relating to a capital asset, being a foreign exchange asset which is not a short-term capital asset.
(e)	Non-resident Indian	An individual, being a citizen of India or a person of Indian origin who is not a "resident. A person shall be deemed to be of Indian origin if he, or either of his parents or any of his grand-parents, was born in undivided India
(f)	Specified asset	Any of the following assets, namely: (i) Shares in an Indian company; (ii) Debentures issued by an Indian company which is not a private company (iii) Deposits in an Indian Company which is not a private company (iv) Any security of the Central Government (v) Any other asset which the Central Government may notify

(2) Special provisions relating to taxation of investment income and on long term capital gains of a non-resident [Sections 115D to 115F]

(i) **On gross basis [Section 115D(1)]:** Section 115D deals with the computation of total income of non-residents. In computing the investment income of non-resident Indian, no deduction is to be allowed under any provision of the Act in respect of any expenditure or allowance thereabout.

(ii) **No deduction allowed [Section 115D(2)]:** No deduction under Chapter VI-A shall be allowed and indexation benefit will **not** be available, where the gross total income of a non-resident Indian consists only of investment income or/and long term capital gain.

However, where the gross total income includes investment incomes or/and long term capital gain, the deduction under Chapter VI-A shall be allowed only on that portion of gross total income which does not include the investment income and long term capital gain.

(iii) **Tax rate on investment income and long term capital gains [Section 115E]:** Under section 115E, the investment income and long-term capital gains of non-resident Indians are to be treated as a separate block and charged to tax at flat rates.

Tax payable by shall be aggregate of –

(a) income-tax on Investment income at 20%;

(b) income-tax on long term capital gains from transfer of specified assets (i.e., purchased in foreign currency) at 10%; and

(c) income-tax on his other total income

Investment Income ↓ 20% + Surcharge (if applicable) + Health and Education Cess@4%
Long-term Capital Gain on Foreign Exchange Assets ↓ 10% + Surcharge (if applicable) + Health and Education Cess@4%

(iv) **Exemption for long-term capital gains [Section 115F]**

Where a non-resident Indian has transferred a long-term foreign exchange asset and has within a period of six months after the date of such transfer, invested the whole or part of the net consideration in any specified asset then

(a) If the cost of the new asset is not less than the net consideration in respect of the original asset , the whole of the capital gains shall not be charged to tax under section 45

(b) If the cost of the new asset is less than the net consideration in respect of the original asset, the amount as calculated below shall not be charged to tax under section 45

$$\text{Capital Gains x } \frac{\text{Cost of acquisition of new asset}}{\text{Net Consideration}}$$

Important points:

1. Net consideration means the full value of consideration from transfer less expenditure incurred wholly and exclusively in connection with transfer.

2. Where the new asset is transferred or converted into money within a period of 3 years from the date of its acquisition, the amount of capital gains arising from the transfer of original asset not charged to tax earlier shall be deemed to be the income under the head “Capital Gains ‘’ relating to long term capital assets. The same shall be charged to tax in the previous year in which new asset is transferred or converted into money.

ILLUSTRATION 5

A non-resident Indian acquired shares in an Indian company, A Ltd., on 1.1.2009 for ₹ 1,00,000 in foreign currency. These shares are sold by him on 1.1.2019 for ₹ 3,00,000. He invests ₹ 3,00,000 in shares on 31.03.2019 and these shares are sold by him on 30.06.2019 for ₹ 3,50,000. Discuss the tax implications. Ignore the effect of first proviso to section 48.

SOLUTION

Computation of Long term Capital Gain for Assessment Year 2019-20

Particulars	Amount (₹)
Sale consideration	3,00,000
Less: Cost of Acquisition	1,00,000
Long term capital gain	2,00,000
Less: Exemption under section 115F	2,00,000
Exempt long-term capital gain	**NIL**

Capital Gain for Assessment year 2020-21:

1. LTCG of ₹ 2,00,000 which was exempt in A.Y.2019-20 becomes taxable this year.
2. STCG of ₹ 50,000 is also taxable this year.

ILLUSTRATION 6

Mr. John, a non-resident Indian, purchased unlisted shares of an Indian Company at a cost of ₹ 70,000 on 01.07.20010 in foreign currency. Mr. John sold the said shares for a consideration of ₹ 2,50,000 on 01.08.2019 and the expenditure incurred wholly or exclusively in connection with the transfer is ₹ 10,000. Compute the taxable capital gain if he deposited in specified assets ₹ 1,50,000 out of sale consideration. Ignore the effect of first proviso to section 48.

SOLUTION

Particulars	Amount (₹)
Sale Consideration	2,50,000
Less: Transfer Expenses	10,000
Net Consideration	2,40,000
Less: Cost of Acquisition	70,000
Long-term capital gain	1,70,000
Less: Exemption u/s 115F	1,06,250*
Taxable long-term capital gain	**63,750**

$$\frac{*\ 1,70,000 \times 1,50,000}{2,40,000} = ₹\ 1,06,250$$

(v) Option not to file income-tax return [Section 115G]

A non-resident Indian need not furnish a return of income under section 139(1) if he satisfies the following two conditions:-

(a) His total income consists only of investment income or income by way of long-term capital gains or both; and

(b) Tax deductible at source has been deducted from such income.

(vi) **Continuance of benefits after the non-resident becomes a resident [Section 115H]**

(a) Where a person who is NRI in any previous year becomes assessable as a resident in any subsequent year, then he may furnish a declaration in writing along with the return of income under section 139 for the year in which he is so assessable.

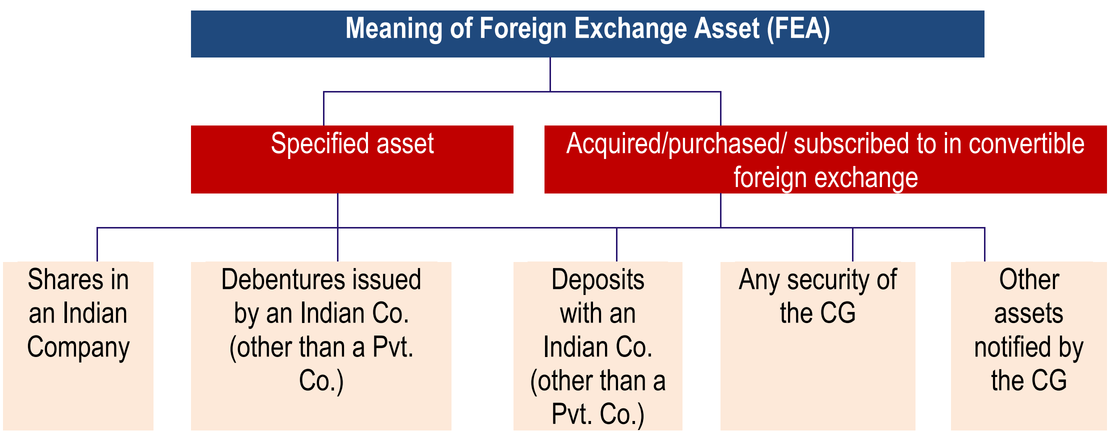
(b) The declaration shall be to the effect that the provisions of this chapter shall continue to apply to him in respect of the investment income derived from foreign exchange assets being debentures, deposits, securities of Central Government and such other notified assets as specified under section 115C.

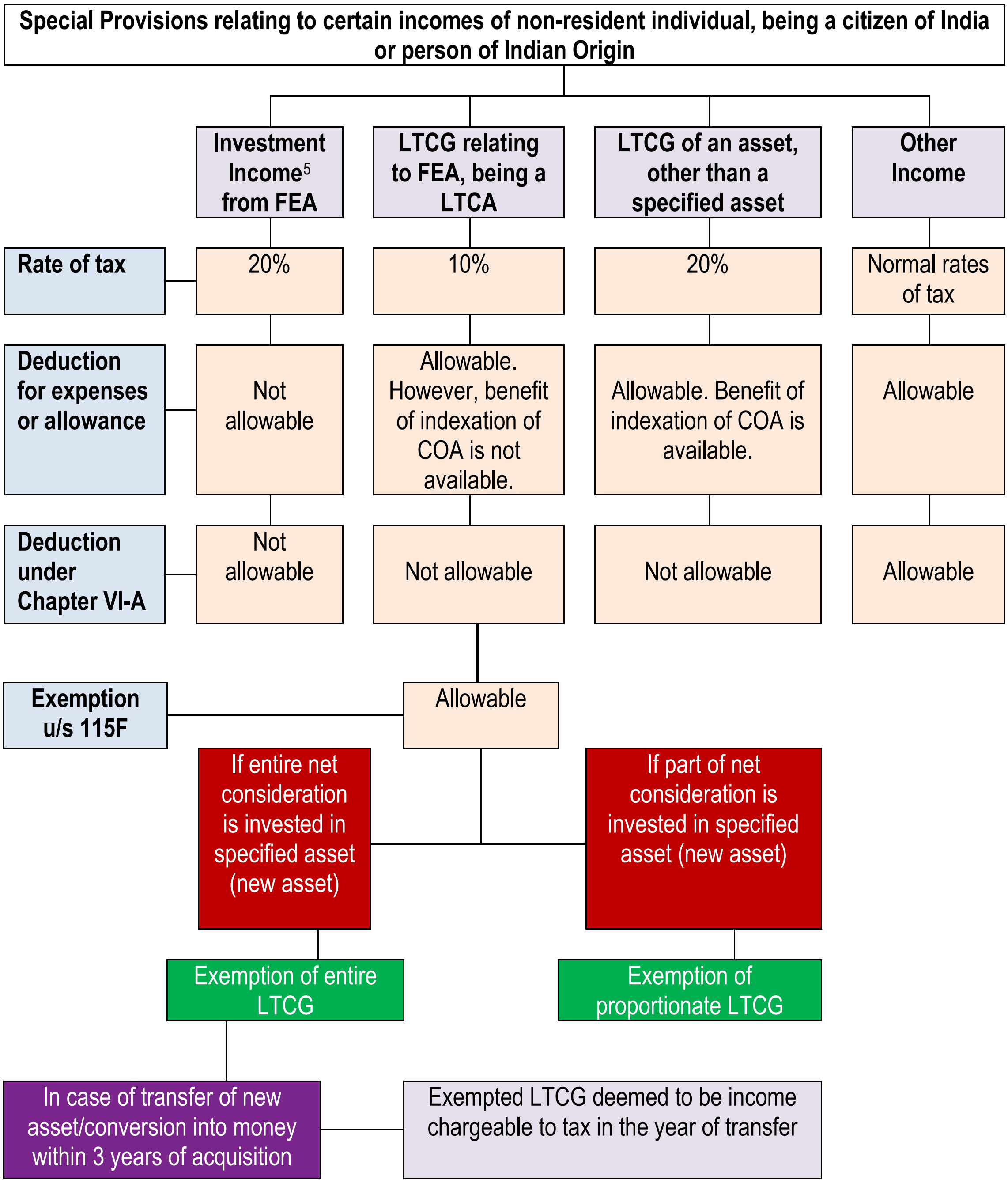
(c) If he does so, the provisions of this chapter shall continue to apply to him in relation to such income for that assessment year and every subsequent year until the transfer or conversion into money of such assets.

(vii) **Option to opt out of Chapter XII-A [Section 115-I]**

This section gives an option to a non-resident Indian to elect that he should not be governed by the special provisions of Chapter XII-A for any particular assessment year by furnishing his return of income for that assessment year under section 139 declaring therein that the provisions of Chapter XII-A shall not apply to him for that assessment year. In case where such an option is exercised by a non-resident Indian, his total income for that assessment year would be charged to tax under the general provisions of the Act.

Summary





[5] Other than dividend referred to in section 115-O

2.9 DETERMINATION OF TAX IN CERTAIN SPECIAL CASES [CHAPTER XII]

Sections 111A, 112 and 112A have already been discussed under para 2.7 Capital gains taxation for non-residents. The special provisions contained in other sections under Chapter XII are discussed hereunder -

(1) Special provisions for computing tax on income by way of royalty, fees for technical service, interest etc. [Section 115A]

(i) **Tax on dividend and interest in case of non-corporate non-residents and foreign companies:**

Where the total income of a foreign company or a non-corporate non- resident includes any income by way of	Rate of Tax
(1) Dividends [other than dividend referred to in section 115-O]	20%
(2) Interest received from the Government or an Indian concern on moneys borrowed or debt incurred by the Government /Indian concern in foreign currency, other than 3 and 4 mentioned below	20%
(3) Interest received from an infrastructure debt fund referred to in section 10(47)	5%
(4) Interest referred to in section 194LC received from an Indian company or business trust – - in respect of monies borrowed by an Indian company or business trust in foreign currency from sources outside India • Under a loan agreement between 1.7.2012 and 30.6.2020 or • by way of issue of long-term infrastructure bonds between 1.7.2012 and 30.9.2014 or • by way of issue of long-term bonds including long term infrastructure bond between 1.10.2014 and 30.6.2020 as approved by the Central Government - in respect of monies borrowed from sources outside India by way of rupee denominated bond before 1.7.2020	5%
(5) Interest referred to in section 194LD payable between 1.6.2013 and 30.6.2020 to a Foreign Institutional Investor or Qualified Foreign Investor on investment made in – - Rupee denominated bond of an Indian company - Government security	5%

(6)	Interest referred to in section 194LBA(2), being interest income of a business trust from a SPV, distributed by business trust to non-resident unit holders of a business trust	5%
(7)	Income received in respect of units purchased in foreign currency of a mutual fund specified under section 10(23D) or of the Unit Trust of India	20%

(ii) **Tax on royalty or fees for technical services in case of non-residents**

Where the total income of a foreign company or a non-corporate non-resident includes any income by way of royalty or fees for technical services (FTS) other than the income referred to in section 44DA		Applicable Rate of Tax
(1)	Received from the Government in pursuance of an agreement made by the non-resident/ foreign company with the Government	10% of such royalty or FTS. However, if DTAA provides for a rate lower than 10%, then, the provisions of DTAA would apply.
(2)	Received from the Indian concern in pursuance of an agreement made by the non-resident/ foreign company with the Indian concern and the agreement is approved by the Central Government or where it relates to industrial policy of Government of India, the agreement in accordance with that policy.	

Important Points:

1. Special rate of tax is applicable on the above mentioned incomes. The remaining income of the assessee will be chargeable to tax at normal rates applicable to assessee.

2. No deduction in respect of any expenditure or allowance shall be allowed to the assessee under sections 28 to 44C and section 57 in computing the above income.

3. Deduction under Chapter VI-A is not available in respect of dividend and interest referred to in (i) above. ***However, this condition would not be applicable to deduction allowed to a unit of an International Financial Services Centre (IFSC) under section 80LA i.e., a unit of an IFSC can claim deduction under section 80LA against dividend and interest referred to in (i) above.***

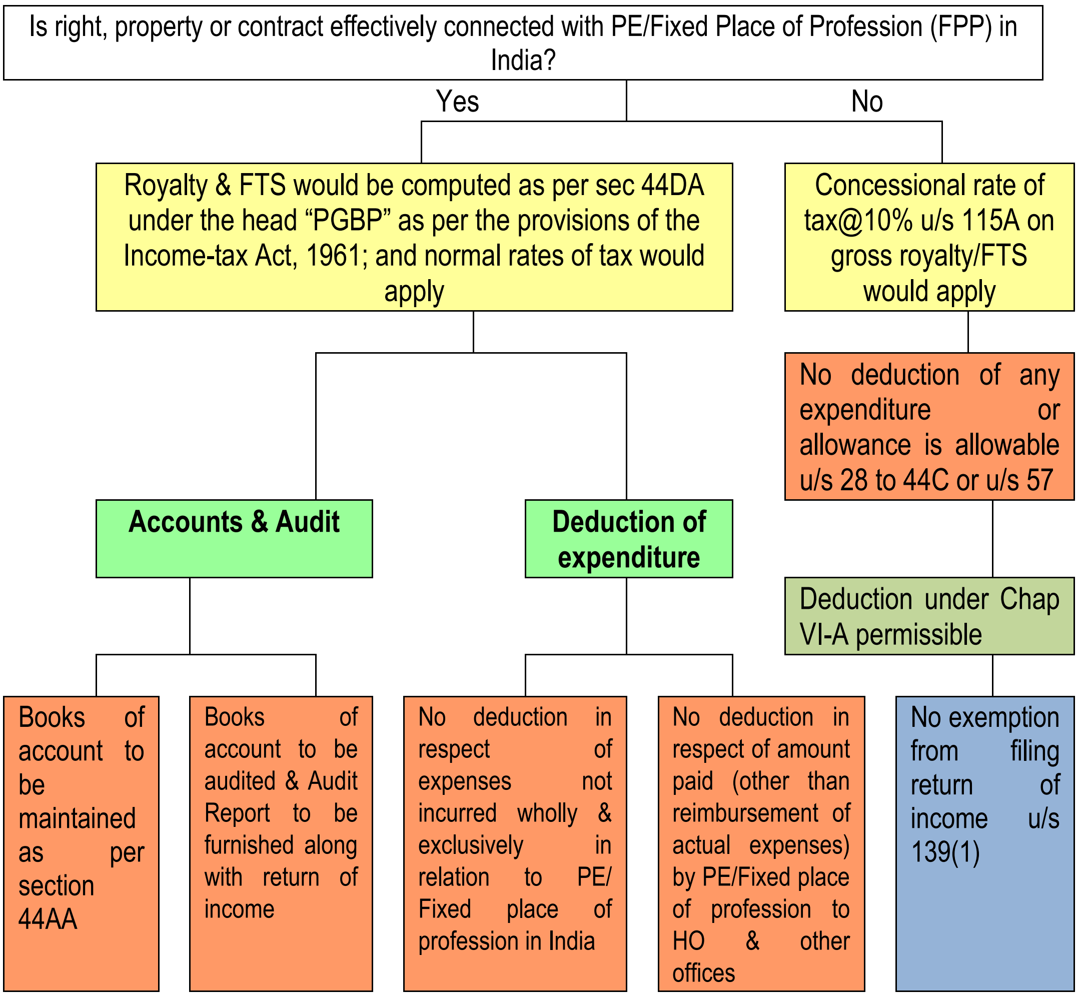
4. It shall not be necessary for the assessee to furnish a return of income if the following conditions are satisfied :

   (a) The total income consists of only the interest or dividend income referred to in (i) above

   (b) Tax deductible at source has been deducted from such income.

Summary

Tax treatment of Royalty & Fees for technical service received from Government / Indian concern in pursuance of approved agreement



(2) Special provision for computing tax on income from units purchased in foreign currency or capital gains arising from their transfer in case of offshore fund [Section 115AB]

Where the total income of an overseas financial organisation (Offshore Fund) includes the following incomes namely-

(i) Income received in respect of units purchased in foreign currency or

(ii) by way of long term capital gains arising from the **transfer of units** of a mutual fund specified under section 10(23D) or units of UTI purchased in **foreign currency**,

Then, the income tax payable shall be the aggregate of the following:

(a) **10%** on income referred to above

(b) the amount of income-tax with which the Offshore Fund would have been chargeable had its total income been reduced by the amount of Long term Capital Gains and income received referred to above.

Important Points:

(i) The benefit of indexation shall **not** be available in the computation of long term capital gains.

(ii) No deduction shall be allowed to the assessee under sections 28 to 44C or section 57(i)/(iii) or under Chapter VI-A in computing the above income.

(iii) Where the gross total income of the Overseas Financial Organisation consists of other incomes, then, the deduction under Chapter VI- A will be available in respect of other incomes. The normal provisions of the Income-tax Act,1961 will apply for computation of other income.

(iv) **"Overseas Financial Organisation''** means any fund, institution, association 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 any public sector bank or public financial institution or a mutual fund specified under section 10(23D). Such arrangement should be approved by the Securities and Exchange Board of India.

(v) It may be noted that long term capital gains upto ₹ 1,00,000 on units of equity oriented fund would be exempt and long term capital gains exceeding ₹ 1,00,000 shall be taxable @10% under section 112A provided securities transaction tax has been paid on the sale of such units.

(vi) It may be noted that short term capital gains on units of equity oriented fund are taxable @15% under section 111A provided securities transaction tax has been paid on the sale of such units.

(3) Special provision for computing tax on income from bonds or Global Depository Receipts purchased in foreign currency or capital gains arising from their transfer [Section 115AC]

(i) **Eligible assessee and special rate of tax:** According to section 115AC(1), where the total income of an assessee, being a non-resident includes:

(a) income by way of interest on bonds of an Indian company issued in accordance with such scheme as the Central Government may notify or on bonds of a public sector company sold by the Government, and purchased by him in foreign currency; or

(b) income by way of dividends, other than dividends referred to in section 115-O, on Global Depository Receipts-

(1) issued in accordance with such scheme as the Central Government may specify against the initial issue of shares of an Indian company and purchased by him in foreign currency through an approved intermediary; or

(2) issued against the shares of a public sector company sold by the Government and purchased by him in foreign currency through an approved intermediary; or

(3) issued or re-issued in accordance with such scheme as the Central Government may specify against the existing shares of an Indian company purchased by him in foreign currency through an approved intermediary; or

(c) income by way of long-term capital gains arising from the transfer of above bonds or GDRs,

then, income-tax will be charged at the rate of 10% on the above income.

(ii) **Deductions not allowable [Section 115AC(2)]:** Where the gross total income of the non-resident consists only the aforesaid interest or dividend income referred to in (a) and (b) of (i) above, no deduction shall be allowed to him under section 28 to 44C or section 57(i) or 57(iii) or under Chapter VIA.

Deduction under Chapter VI-A is also **not** allowable against long term capital gains arising from transfer of bonds or GD₹

Where the gross total income of the non-resident consists of incomes other than interest, dividend and long term capital gains referred to in (a), (b) and (c) of (i) above, then, the deduction under Chapter VI-A will be available in respect of other incomes

(iii) **Non-availability of indexation benefit and computation of capital gains in foreign currency [Section 115AC(3)]:** The indexation benefit and benefit of computation of capital gains in foreign currency, shall not be available for the computation of long-term capital gains arising out of the transfer of long term asset, being bonds or GD₹

(iv) **Filing of Return of Income not required [Section 115AC(4)]:** It shall not be necessary for a non-resident to furnish under section 139(1), a return of income if his total income in respect of which he is assessable under the Act during the previous year consisted only of aforesaid interest or dividend income, and the tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income.

(v) **Concessional tax treatment for GDR/Bonds acquired in course of Amalgamation [Section 115AC(5)]:** Where the assessee acquired GDR or bonds in an amalgamated or resulting company by virtue of his holding GDR or bonds in the amalgamating or demerged company, in accordance with the provisions of 115AC(1) the concessional tax treatment would apply to such GDR or bonds.

(vi) **Meaning of Global Depository Receipts:** "Global Depository Receipts" means any instrument in the form of a depository receipt or certificate (by whatever name called) created by the Overseas Depository Bank outside India and issued to investors against the issue of —

(a) ordinary shares of issuing company, being a company listed on a recognised stock exchange in India; or

(b) foreign currency convertible bonds of issuing company;

(4) Special provisions for computing tax on income of Foreign Institutional Investors from securities or capital gains arising from their transfer [Section 115AD]

(i) **Special rate of tax:** Where the total income of a Foreign Institutional Investor includes the income referred to in column (2), the same would be subject to tax at the rate mentioned in column (3):

(1) S. No.	(2) Income	(3) Rate of Tax
(a)	Income received in respect of securities **other than** • income by way of dividends ref u/s 115-O • income on units ref u/s 115AB i.e., units of Mutual Fund specified u/s 10(23D) or UTI • Interest referred u/s 194LD	20%
(b)	Interest referred u/s 194LD	5%
(c)	Income by way of Short term capital gains arising from the transfer of securities (other than Short term capital gains u/s 111A)	30%
(d)	Income by way of Short term capital gains u/s 111A	15%
(e)	Income by way of Long term capital gains arising from the transfer of securities (other than Long term capital gains u/s 112A)	10%
(f)	Income by way of Long term capital gains u/s 112A exceeding ₹ 1 lakh	10%
(g)	Other income of FII	At normal rates of tax

> ***Note** - The Finance (No. 2) Act, 2019 has levied an enhanced surcharge of 25% and 37%, where the total income of an individual/HUF/AOP/BOI exceeds ₹ 2 crores and ₹ 5 crores, respectively. However, the enhanced surcharge of 25% and 37% has been withdrawn on tax payable at special rate under section 115AD by the FPI on the capital gains arising from the transfer of derivatives (Future & Options).*
>
> *In case of assessee other than FPI, derivatives are not treated as capital asset and the income arising from the transfer of the derivatives is treated as business income. Further, it has been clarified that the business income arising from the transfer of derivatives to a person other than FPI would be liable to enhanced surcharge* ***[Press Release dated 24-8-2019]***

(ii) **No deduction is allowed [Section 115AD(2)]:** Where the gross total income of the Foreign Institutional Investor comprises only of the aforesaid interest or dividend income from securities, no deduction shall be allowed to it under sections 28 to 44C or section 57(i) or 57(iii) or under Chapter VI-A.

Deduction under Chapter VI-A is also not allowable in case of short term capital gain or long term capital gain arising from transfer of securities.

Where the gross total income of the Foreign Institutional Investor consists of incomes other than income referred to in (a), (b) and (c) of table in (i) above, then, the deduction under Chapter VI-A will be available in respect of other incomes.

(iii) **First and second provisos to section 48 shall not apply [Section 115AD(3)]:** The benefit of computation of capital gains in foreign currency and the benefit of indexation would not be available for the computation of capital gains arising on transfer of securities.

(5) Special provision for computing tax on non-resident sportsmen or sports associations [Section 115BBA]

(i) **Eligible assessee and special rate of tax:** Where the total income of an assessee, referred to in column (2) includes income referred to in column (3) of the table below, such income would be chargeable to tax@20%.

	Assessee	**Income**
(1)	**(2)**	**(3)**
(a)	A sportsman (including an athlete), who is not a citizen of India and is a non-resident	Any income received or receivable by way of— (i) participation in India in any game (other than a game the winnings wherefrom are taxable under section 115BB, being winning from crossword puzzles, races including horse races, card games and other games of any sort of gambling or betting) or sport; or (ii) advertisement; or

		(iii) contribution of articles relating to any game or sport in India in newspapers, magazines or journals;
(b)	A non-resident sports association or institution	Any amount guaranteed to be paid or payable to such association or institution in relation to any game (other than a game the winnings wherefrom are taxable under section 115BB) or sport played in India
(c)	An entertainer who is not a citizen of India and is a non-resident	Any income received or receivable from his performance in India

(ii) **Deduction of expenditure not permissible:** No deduction in respect of any expenditure or allowance shall be allowed under any provision of this Act in computing the income referred to in (*a*) or (b) or (c) in the table given above.

(iii) **Filing of return of income not required:** The assessee is **not** required to furnish under section 139(1) a return of his income if—

(a) his total income in respect of which he is assessable under this Act during the previous year consisted **only** of income referred to in (a) or (b) or (c) above; and

(b) the tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income.

Note: The issue as to whether the non-resident match referees and umpires in the games played in India fall within the meaning of "sportsmen" to attract taxability under the provisions of section 115BBA, and consequently attract the TDS provisions under section 194E in the hands of the payer was taken up by the Calcutta High Court in *Indcom v. CIT (TDS) (2011) 335 ITR 485*.

In order to attract the provisions of the section 194E, the person should be a non-resident sportsperson or non-resident sports association or institution whose income is taxable as per the provisions of section 115BBA.

Umpires and match referees can be described as professionals or technical persons who render professional or technical services, but they cannot be said to be either non-resident sportsmen (including an athlete) or non-resident sports association or institution so as to attract the provisions of section 115BBA and consequently, the provisions of tax deduction at source under section 194E are can not be attracted.

The Calcutta High Court held that although the payments made to non-resident umpires and the match referees are "income" which has accrued and arisen in India, the same are not taxable under the provisions of section 115BBA and thus, the assessee is not liable to deduct tax under section 194E.

It may be noted that since income has accrued and arisen in India to the non-resident umpires and match referees, the TDS provisions under section 195 would be attracted and tax would be deductible at the rates in force.

ILLUSTRATION 7

During the financial year 2019-20, Nadal, a tennis professional and a non-Indian citizen participated in India in a Tennis Tournament and won prize money of ₹ 15 lakhs. He contributed articles on the tournament in a local newspaper for which he was paid ₹ 1 lakh. He was also paid ₹ 5 lakhs by a Soft Drink company for appearance in a T.V. advertisement. Although his expenses in India were met by the sponsors, he had to incur ₹ 3 lakhs towards his travel costs to India. He was a non-resident for tax purposes in India.

What would be his tax liability in India for A.Y. 2020-21? Is he required to file his return of income?

SOLUTION

Under section 115BBA, all the three items of receipts in India viz. prize money of ₹ 15 lakhs, amount received from newspaper of ₹ 1 lakh and amount received towards TV advertisement of ₹ 5 lakhs - are chargeable to tax. No expenditure is allowable as deduction against such receipts. The rate of tax chargeable under section 115BBA is 20%, *plus* health and education cess @4%. The total tax liability works out to ₹ 4,36,800 being 20.8% of ₹ 21 lakhs. Thus, Nadal will be liable to tax on the income earned in India

He is not required to file his return of income if -

(a) his total income during the previous year consists only of income arising under section 115BBA; **and**

(b) the tax deductible at source under the provisions of Chapter XVII-B have been deducted from such incomes.

ILLUSTRATION 8

Smith, a foreign national and a cricketer came to India as a member of Australian cricket team in the year ended 31st March, 2020. He received ₹ 5 lakhs for participation in matches in India. He also received ₹ 1 lakh for an advertisement of a product on TV. He contributed articles in a newspaper for which he received ₹ 10,000. When he stayed in India, he also won a prize of ₹ 20,000 from horse racing in Mumbai. He has no other income in India during the year.

(i) Compute tax liability of Smith for Assessment Year 2020-21.

(ii) Are the income specified above subject to deduction of tax at source?

(iii) Is he liable to file his return of income for Assessment Year 2020-21?

(iv) What would have been his tax liability, had he been a match referee instead of a cricketer?

SOLUTION

(i) Computation of tax liability of Smith for the A.Y.2020-21

Particulars	₹	₹
Income taxable under section 115BBA		
Income from participation in matches in India	5,00,000	
Advertisement of product on TV	1,00,000	
Contribution of articles in newspaper	10,000	
Income taxable under section 115BB		
Income from horse races	20,000	
Total income	**6,30,000**	
Tax@ 20% under section 115BBA on ₹ 6,10,000		1,22,000
Tax@ 30% under section 115BB on income of ₹ 20,000 from horse races		6,000
		1,28,000
Add: Health and Education cess@4%		5,120
Total tax liability of Smith for the A.Y.2020-21		**1,33,120**

(ii) Yes, the above income is subject to tax deduction at source.

Income referred to in section 115BBA (i.e., ₹ 6,10,000, in this case) is subject to tax deduction at source@ 20% under section 194E.

Income referred to in section 115BB (i.e., ₹ 20,000, in this case) is subject to tax deduction at source@30% under section 194BB.

Since Smith is a non-resident, the amount of tax to be deducted calculated at the prescribed rates mentioned above, would be increased by health and education cess@4%.

(iii) Section 115BBA provides that if the total income of the non-resident sportsman comprises of only income referred to in that section and tax deductible at source has been fully deducted, it shall not be necessary for him to file his return of income. However, in this case, Mr. Smith has income from horse races as well. Therefore, he cannot avail the benefit of exemption from filing of return of income as contained in section 115BBA. Hence, he would be liable to file his return of income for A.Y.2020-21.

(iv) The Calcutta High Court in *Indcom v. CIT (TDS)(2011) 335 ITR 485* has held that 'match referee' would not fall within the meaning of "sportsmen" to attract the provisions of section 115BBA. Therefore, although the payments made to non-resident 'match referee' are "income" which has accrued and arisen in India, the same are not taxable under the provisions of section 115BBA. They are subject to the normal rates of tax.

Particulars		₹
Tax@30% under section 115BB on winnings of ₹ 20,000 from horse races		6,000
Tax on ₹ 6,10,000 at the rates in force		
Upto ₹ 2,50,000	Nil	
2,50,000 – 5,00,000 @5%	12,500	
5,00,000 – 6,10,000 @ 20%	22,000	34,500
		40,500
Add: Health and Education cess@4%		1,620
Total tax liability		**42,120**

2.10 APPLICABILITY OF MAT ON FOREIGN COMPANIES [SECTION 115JB]

As per section 115JB(1), in case of company (domestic or foreign), if the income-tax payable on the total income computed under the Income-tax Act, 1961 is *less* than 18.5%[6] of its book profit, such book profit shall be deemed to be the total income of the assessee and the tax payable by the assessee on such total income shall be the amount of income-tax at the rate of 18.5%[6] (add surcharge, if applicable, i.e., 7% for domestic companies and 2% for foreign companies, where the total income exceeds ₹ 1 crore but does not exceed ₹ 10 crore, and 12% for domestic companies and 5% for foreign companies where the total income exceeds ₹ 10 crore). Further, health and education cess @4% shall be added on the aggregate of income-tax and surcharge.

In order to address the issue relating to the applicability of section 115JB(1) to Foreign Institutional Investors (FIIs) who do not have a permanent establishment (PE) in India, it has been provided that in case of a foreign company, any income by way of capital gains on transactions in securities or interest, royalty or fees for technical services chargeable to tax at the rates specified in Chapter XII, is credited to statement of profit and loss and income-tax payable thereon is at a rate lower than the rate specified in section 115JB, the same shall be reduced from the book profits; and the corresponding expenditure will be added back, if the same is debited to statement of profit and loss.

However, the above amendment by the Finance Act, 2015 was prospective w.e.f. A.Y.2016-17. Therefore, the issue related to applicability for assessment year prior to A.Y.2016-17 remained to be addressed.

[6] Reduced to 15%. Refer press note at the end of this study material.

The Committee on Direct Tax matters headed by Justice A.P. Shah, set up by the Government to look into the matter, suggested that section 115JB be amended to clarify the applicability of Minimum Alternate Tax (MAT) provisions to Foreign Institutional Investors/ Foreign Portfolio Investors (FIIs/FPIs) in view of the fact that FIIs and FPIs normally do not have a place of business in India.

Keeping in mind the suggestions of the Committee and in order to ensure certainty in taxation of foreign companies, *Explanation 4* was inserted in section 115JB by the Finance Act, 2016 with retrospective effect from 01.04.2001 to provide for non-applicability of levy of MAT under section 115JB in the following cases:

	Existence of DTAA with the country of residence of the foreign company	**Additional condition to be satisfied for non-applicability of MAT**
(i)	The foreign company is a resident of a country or a specified territory with which India has a DTAA under section 90(1) or the Central Government has adopted any agreement between specified associations for double taxation relief under section 90A(1)	It should not have a permanent establishment in India in accordance with the provisions of such Agreement
(ii)	The foreign company is a resident of a country with which India does not have an agreement of the nature referred to in clause (i) above	It is not required to seek registration under any law for the time being in force relating to companies.

Explanation 4A to section 115JB has been inserted with retrospective effect from 01.04.2001 to clarify that MAT provisions shall not be applicable to a foreign company, whose total income comprises solely of profits and gains from business referred to in section 44B or section 44BB or section 44BBA and such income has been offered to tax at the presumptive rates specified thereunder.

Note: *For detailed understanding of the provisions of Minimum Alternate Tax, students may refer to Chapter 12: Assessment of Various Entities in Module 2 of Paper 7: Direct Tax Laws and International Taxation*

2.11 SPECIAL PROVISIONS RELATING TO CONVERSION OF INDIAN BRANCH OF A FOREIGN BANK INTO A SUBSIDIARY COMPANY [CHAPTER XII-BB]

(1) Conversion of an Indian branch of foreign company into subsidiary Indian company [Section 115JG(1)]

(i) The provisions of this section apply to a foreign company engaged in banking business in India through its branch situated in India, which is converted into an Indian subsidiary company in accordance with the scheme framed by RBI.

(ii) If the conditions notified by the Central Government in this behalf are satisfied, then capital gains arising from such conversion would not be chargeable to tax in the assessment year relevant to the previous year in which such conversion takes place.

(iii) Also, the provisions of the Act relating to computation of income of foreign company and Indian subsidiary company would apply with such exceptions, modifications and adaptations as specified in the notification.

(iv) Further, the benefit of set-off of unabsorbed depreciation, set-off or carry forward and set-off of losses, tax credit in respect of tax paid on deemed income relating to certain companies available under the Act shall apply with such exceptions, modifications and adaptations as specified in the notification.

Accordingly, the Central Government has, vide notification no. 85/2018, specified the conditions to be fulfilled –

(1) For Capital Gains exemption:

Where a foreign company is engaged in the business of banking through its Indian branch and converts such Indian branch into its Indian subsidiary company in accordance with the scheme framed by RBI, the capital gains arising from such conversion would not be chargeable to tax, if -

(a) the Indian branch amalgamates with the Indian subsidiary company in accordance with the scheme of amalgamation approved by the shareholders of the foreign company and the Indian subsidiary company and sanctioned by the RBI[7]

(b) all the assets and liabilities of the Indian branch immediately before conversion would become the assets and liabilities of the Indian subsidiary company;

[7] under paragraph 20(h) of the Framework for setting up of wholly owned subsidiaries by foreign banks in India issued by the Reserve Bank of India *vide* Press release number 2013-2014/936 dated 6th day of November, 2013

(c) *the asset and liabilities of the Indian branch are transferred to the Indian subsidiary company at values appearing in the books of account of the Indian branch immediately before its conversion.*

***Note** - Any change in the value of assets consequent to their revaluation would not be considered while determining the value of the assets.*

(d) *the foreign bank or its nominee shall hold the whole of the share capital of the Indian subsidiary company during the period beginning from the date of conversion and ending on the last day of the previous year in which the conversion took place and continue to hold the shares of Indian subsidiary company carrying not less than 51% of the voting power for a period of five years immediately succeeding the said previous year;*

(e) *the foreign company does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the Indian subsidiary company.*

(2) Application of the provisions of the Income-tax Act, 1961 with modifications/exceptions

The provisions of the Income-tax Act, 1961 relating to unabsorbed depreciation, set off or carry forward and set off of losses, tax credit in respect of tax paid on deemed income relating to certain companies and the computation of income in case of foreign company and Indian subsidiary company shall apply with following modifications, exceptions and adaptation –

	Purpose	***Modification/exception/adaptation***
(a)	*Allowance of depreciation under section 32*	*The aggregate deduction, in respect of depreciation on buildings, machinery, plant or furniture, being tangible assets, or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets, allowable to the Indian branch and the Indian subsidiary company shall not exceed in any previous year the deduction calculated at the prescribed rates as if the conversion had not taken place.* *Such deduction would be apportioned between the Indian branch and the Indian subsidiary company in the ratio of the number of days for which the assets were used by them;*
(b)	*Set-off and c/f of loss and depreciation*	*The **accumulated loss** and the **unabsorbed depreciation** of the Indian branch would be deemed to be the loss or allowance for depreciation of the Indian subsidiary company for the previous year in which conversion was effected; and provisions of the Income-tax Act, 1961, relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.*
(c)	*Determination of actual cost u/s 43(1)*	*The actual cost of the block of assets in the case of the Indian subsidiary company shall be the written down value of the block of assets as in the case of the Indian branch on the **date of its***

		conversion *into the Indian subsidiary company* *The actual cost of any capital asset on which deduction has been allowed or is allowable under section 35AD, shall be treated as 'nil' in the case of the Indian subsidiary company if the capital asset became the property of the Indian subsidiary company as a result of conversion of the Indian branch*
(d)	*Cost of acquisition of other capital assets*	*Where the capital asset other than those referred to in (c) above became the property of the Indian subsidiary company as a result of conversion of the Indian branch, the cost of acquisition of the asset for the purposes of computation of capital gains shall be deemed to be the cost for which the Indian branch acquired it or, as the case may be, the cost for which* ***previous owner*** *has acquired it.*
(e)	*Tax credit*	*The* ***tax credit*** *of the Indian branch shall be deemed to be the tax credit of the Indian subsidiary company for the purpose of the previous year in which conversion was effected; and the provisions of section 115JAA of the Income-tax Act, 1961 shall apply accordingly.*
(f)	*Amortisation of VRS Expenditure*	*The provisions of 35DDA of the Act shall be, as far as may be, apply to the Indian subsidiary company, as they would have applied to the Indian branch, if the conversion had not taken place*
(g)	*Deemed credit balance in provision for bad and doubtful debts*	*The credit balance in the provision for bad and doubtful debts account made under section 36(1)(viia) of the Indian branch on the date of conversion shall be deemed to be the credit balance of the Indian subsidiary company and the provisions of section 36 of the Income-tax Act, 1961, shall apply accordingly*
(h)	*Non-applicability of section 56(2)(x)*	*The provisions of section 56(2)(x) shall not apply to the transaction of receipt of shares in the Indian subsidiary company by the foreign company or its nominee in consequence of the conversion of the Indian branch into the Indian subsidiary company.*

Meaning of certain terms (given in bold in the above table):

Term	***Meaning***
Accumulated loss	*So much of the loss of the Indian branch before its conversion into Indian subsidiary company under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such Indian branch would have been entitled to carry forward and set off under the provisions of section 72, if the conversion had not taken place.*
Unabsorbed depreciation	*So much of the allowance for depreciation of the Indian branch before its conversion into Indian subsidiary company, which remains to be allowed and which would have been allowed to the Indian branch under the provisions of the Act, if the conversion had not taken place.*
Previous owner	*In relation to any capital asset owned by the Indian subsidiary company means the last previous owner of the capital asset who acquired it by a mode of*

	acquisition other than those referred in section 49(1)(i)/(ii)/(iii)/(iv) or section 115JG(1).
Tax credit	*So much of the tax credit of the Indian branch before conversion into Indian subsidiary company which such Indian branch would have been entitled to carry forward and set off under the provisions of section 115JAA of the Act, if the conversion had not taken place.*
Date of conversion	*The date, which the Reserve Bank of India appoints for the vesting of undertaking of the Indian branch in Indian subsidiary company*[8]

(2) Consequences of failure to comply with the specified conditions [Section 115JG(2)]

If the conditions specified in the scheme of RBI or notification issued by the Central Government are not complied with, then, all the provisions of the Act would apply to the foreign company and Indian subsidiary company without any benefit, exemption or relief under this section.

(3) Consequences of subsequent failure to comply with the conditions [Section 115JG(3)]

(i) If the benefit, exemption or relief has been granted to the foreign company or Indian subsidiary company in any previous year and thereafter, there is a failure to comply with any of the conditions specified in the scheme or notification, then, such benefit, exemption or relief shall be deemed to have been wrongly allowed.

(ii) In such a case, the Assessing Officer is empowered to re-compute the total income of the assessee for the said previous year and make the necessary amendment. This power is notwithstanding anything contained in the Income-tax Act, 1961.

(iii) The provisions of rectification under section 154, would, accordingly, apply and the four year period within which such rectification should be made has to be reckoned from the end of the previous year in which the failure to comply with such conditions has taken place.

(iv) Every notification under issued under this section shall be laid before each House of Parliament.

2.12 WITHHOLDING TAX PROVISIONS FOR NON-RESIDENTS

(1) Salary payable in foreign currency [Section 192]

By virtue of section 9(1)(ii), salary is deemed to accrue or arise in India, if services are rendered in India. Therefore, if a non-resident renders services in India, the salary income would be

[8] under paragraph 20(i) of the Framework for setting up of wholly owned subsidiaries by foreign banks in India issued by the Reserve Bank of India vide press release number 2013-2014/936 dated 6th day of November, 2013.

chargeable to tax in India and the person responsible for paying the salary income i.e., the employer, has to deduct withholding tax in accordance with the provisions of Section 192.

Such income-tax has to be calculated at the average rate of income-tax computed on the basis of the rates in force for the relevant financial year in which the payment is made, on the estimated total income of the assesse.

Average rate of income-tax means the rate arrived at by dividing the amount of income-tax calculated on the total income, by such total income.

Section 192(6) deals with the provisions of withholding tax in case of salary payable in foreign currency. In case, where salary is payable in foreign currency, the amount of tax deducted is to be calculated after converting the salary payable into Indian currency at the telegraphic transfer buying rate as adopted by State Bank of India on the last day of the month immediately preceding the month in which the salary is due, or is paid in advance or in arrears [Rule 26 read with Rule 115].

Students may note that the Rule 26 and Rule 115 have been given as Annexure – 2 at the end of this material.

(2) Premature withdrawal from employees provident fund [Section 192A]

(i) Applicability and Rate of TDS: Section 192A provides for deduction of tax @10% on premature taxable withdrawal from employees provident fund scheme. Accordingly, in a case where the accumulated balance due to an employee participating in a recognized provident fund is includible in his total income owing to the provisions of Rule 8 of Part A of the Fourth Schedule not being applicable, the trustees of the Employees Provident Fund Scheme, 1952 or any person authorised under the scheme to make payment of accumulated balance due to employees are required to deduct income-tax@ 10%.

(ii) Time of tax deduction at source: Tax should be deducted at the time of payment of accumulated balance due to the employee.

(iii) Non-applicability of TDS under section 192A: No tax deduction is to be made under this section, if the amount of such payment or aggregate amount of such payment to the payee is less than ₹ 50,000.

(iv) Deduction at maximum marginal rate in case of non-submission of PAN: Any person entitled to receive any amount on which tax is deductible under this section has to furnish his PAN to the person responsible for deducting such tax. In case he fails to do so, tax would be deductible at the maximum marginal rate.

(3) Winnings from lotteries, crossword puzzles and horse races [Section 194B and 194BB]

(i) **Rate of tax on casual income:** Any income of a casual and non-recurring nature of the type of winnings from lotteries, crossword puzzles, card game and other game of any sort, races including horse races, etc. will be charged to income-tax at a flat rate of **30%** [Section 115BB].

(ii) **TDS on winning from lotteries, crossword puzzles etc.:** According to the provisions of section 194B, every person responsible for paying to any person, whether resident or non-resident, any income by way of winnings from lottery or crossword puzzle or card game and other game of any sort, is required to deduct income-tax therefrom at the rate of **30%** if the amount of payment exceeds **₹ 10,000.**

If payment is to a non-resident, surcharge, wherever applicable, and health and education cess @4% have to be added to the above rate for deduction of tax at source.

(iii) **Cases where winnings are partly in kind and partly in cash:** In a case where the winnings are wholly in kind or partly in cash and partly in kind but the part in cash is not sufficient to meet the liability of deduction of tax in respect of whole of the winnings, the person responsible for paying shall, before releasing the winnings, ensure that tax has been paid in respect of the winnings.

(iv) **Person responsible for deduction of tax under section 194BB:** Section 194BB casts responsibility on the following persons to deduct tax at source -

(a) a bookmaker; or

(b) a person to whom a license has been granted by the Government under any law for the time being in force -

- for horse racing in any race course; or
- for arranging for wagering or betting in any race course.

(v) **Threshold limit and rate of TDS under section 194BB:** The obligation to deduct tax at source under section 194BB arises when the above-mentioned persons make payment to any person of any income by way of winnings from any horse race in excess of **₹ 10,000**. The rate applicable for deduction of tax at source is **30%**.

Surcharge, wherever applicable, and health and education cess @4% have to be added to the above rate for deduction of tax at source in case of payment to a non-resident.

Tax will have to be deducted at source from winnings from horse races even though the winnings may be paid to the person concerned in instalments of less than **₹ 10,000**. Similarly, in cases where the book-maker or other person responsible for paying the winnings, credits such winnings and debits the losses to the individual account of the punter, tax has to be deducted **@30%** on winnings before set-off of losses. Thereafter, the net amount, after deduction of tax and losses, has to be paid to the winner.

(vi) **Meaning of the expression "horse race":** In the context of the provisions of section 194BB, the expression 'any horse race' used therein must be taken to include, wherever the circumstances so necessitate, more than one horse race. Therefore, winnings by way of jack pot would also fall within the scope of section 194BB.

(4) Payments to non-resident sportsmen or sports association [Section 194E]

(i) **Applicability:** This section provides for deduction of tax at source in respect of any income referred to in section 115BBA payable to a non-resident sportsman (including an athlete) or an entertainer who is not a citizen of India or a non-resident sports association or institution.

(ii) **Rate of TDS:** Deduction of tax at source @20% *plus* surcharge, if applicable, *plus* health and education cess @4% should be made by the person responsible for making the payment.

(iii) **Time of deduction of tax:** Such tax deduction should be at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier.

(iv) **Income referred to in section 115BBA**

(a) income received or receivable by a non-resident sportsman (including an athlete) by way of-

(1) participation in any game or sport in India (However, games like crossword puzzles, horse races etc. taxable under section 115BB are not included herein); or

(2) advertisement; or

(3) contribution of articles relating to any game or sport in India in newspapers, magazines or journals.

(b) Guarantee amount paid or payable to a non-resident sports association or institution in relation to any game or sport played in India. However, games like crossword puzzles, horse races etc. taxable under section 115BB are not included herein.

(c) income received or receivable by a non-resident entertainer (who is not a citizen of India) from his performance in India.

(5) Commission etc. on the sale of lottery tickets [Section 194G]

(i) **Applicability and Rate of TDS:** Under section 194G, the person responsible for paying to any person, who is or has been stocking, distributing, purchasing or selling lottery tickets, any income by way of commission, remuneration or prize (by whatever name called) on lottery tickets in an amount exceeding **₹ 15,000** shall deduct income-tax thereon at the rate of **5%**

Surcharge, wherever applicable, and health and education cess @4% have to be added to the above rate for deduction of tax at source in case of payment to a non-resident.

(ii) **Time of deduction of tax:** Such deduction should be made at the time of credit of such income to the account of the payee or at the time of payment of such income by cash, cheque, draft or any other mode, whichever is earlier.

Where any such income is credited to any account, whether called "Suspense Account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.

(6) Income by way of interest from Infrastructure Debt Fund [Section 194LB]

(i) **Special rate of tax on interest received by non-residents from notified infrastructure debt funds:** Interest income received by a non-corporate non-resident or a foreign company from notified infrastructure debt funds set up in accordance with the prescribed guidelines would be subject to tax at a concessional rate of **5%** under section 115A on the gross amount of such interest income as compared to tax @20% on other interest income of non-resident. The concessional rate of tax is expected to give a fillip to infrastructure and encourage inflow of long-term foreign funds to the infrastructure sector.

(ii) **Rate of TDS:** Accordingly, tax would be deductible @**5%** *plus* surcharge, if applicable, *plus* health and education cess @4% on interest paid/credited by such fund to a non-resident/foreign company.

(iii) **Time of deduction:** The person responsible for making the payment shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct tax at source.

(7) Income from units of a business trust to non-resident [Section 194LBA]

(i) **Applicability and rate of tax:** A business trust shall be liable to deduct the tax at source where any distributed income referred to in section 115UA, being in the nature referred to in section 10(23FC)(a) or section 10(23FCA) is payable by the business trust to its unit holder, being non-resident non-corporate and foreign company [Section 194LBA(2) & (3)].

	Nature of distributed income to its non-resident non-corporate and foreign company unit holders	Rate of tax
(a)	Interest income received by business trust from a SPV referred to in section 10(23FC)(a)	5%
(b)	Rental income arising to business trust, being real estate investment trust from real estate referred to in section 10(23FCA)	At the rates in force

Surcharge, wherever applicable, and health and education cess @4% have to be added to the above rates for deduction of tax at source.

(ii) **Time of deduction:** Tax shall be deducted at the time of credit of such payment to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or any other mode, whichever is earlier.

(iii) **Meaning of Business Trust:** "Business trust" means a trust registered as an Infrastructure Investment Trust (Invit) under SEBI (Infrastructure Investment Trusts) Regulations, 2014 or a Real Estate Investment Trust (REIT) under SEBI (Real Estate Investment Trusts) Regulations, 2014 and the units of which are required to be listed on a recognized stock exchange in accordance with the aforesaid regulations.

(8) Income of units of investment fund to non-resident unit holders [Section 194LBB]

(i) **Applicability and rate of tax:** Investment fund to deduct tax at source on any income (other than the proportion of income which is of the same nature as income chargeable under the head "Profits and gains of business or profession" which is taxable at investment fund level) payable by the investment fund to a unit holder at rates in force in case of payable to a non-resident non corporate or non-corporate unit holder.

Any such income credited to any account, whether called "suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be the credit of such income to the account of the payee, and the provisions of section 194LBB shall apply accordingly.

(ii) **No TDS if income is not chargeable under the Act:** In case of income payable to a non-resident non corporate or non-corporate unit holder, no deduction is to be made in respect of any income that is not chargeable to tax under the Act.

(iii) **Time of deduction:** Such tax has to be deducted at the time of credit of such income to the account of the payee or at the time of payment, whichever is earlier.

(iv) **Meaning of Investment Fund:** Any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992;

(9) Income in respect of investment made in a securitisation trust [Section 194LBC]

(i) **Applicability and rate of tax:** Tax deduction at source under section 194LBC shall be effected by the securitisation at the rates in force trust where income is payable to an investor, being a non-resident non-corporate or a foreign company, in respect of investment in it.

Any such income credited to any account, whether called "suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be the credit of such income to the account of the payee, and the provisions of section 194LBC shall apply accordingly.

(ii) **Time of deduction:** TDS shall be deducted at the time of credit of such payment to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or any other mode, whichever is earlier.

(iii) **Meaning of certain terms:**

	Term	Meaning
(a)	Investor	Means a person who is holder of any securitised debt instrument or securities or security receipt issued by the securitisation trust
(b)	Securities	Means debt securities issued by a Special Purpose Vehicle as referred to in the guidelines on securitisation of standard assets issued by RBI
(c)	Securitisation trust	A trust being a – (i) Special purpose distinct entity as defined in and regulated under SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 (ii) Special Purpose vehicle as defined in and regulated by the guidelines on securitization of standard assets issued by the Reserve Bank of India (iii) Trust set-up by a securitization company or a reconstruction company formed for the purpose of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 or any guidelines or directions issued by the RBI for the same.

(10) Income by way of interest from an Indian company [Section 194LC]

(i) **Concessional rate of tax on interest on foreign currency borrowings by an Indian company or business trust:** Interest paid by an Indian company or business trust to a foreign company or a non-corporate non-resident in respect of borrowing made in foreign currency from sources outside India between 1.7.2012 and 30.6.2020 would be subject to tax at a concessional rate of 5% on gross interest (as against the rate of 20% of gross interest applicable in respect of other interest received by a non-corporate non-resident or foreign company from Government or an Indian concern on money borrowed or debt incurred by it in foreign currency).

To avail this concessional rate, the borrowing should be from a source outside India under a loan agreement at any time between 1.7.2012 and 30.6.2020 or by way of issue of long-term infrastructure bonds during the period between 1.7.2012 and 30.9.2014 or by way of issue of any long-term bond, including long-term infrastructure bonds during the period between 1.10.2014 and 30.6.2020 and approved by the Central Government in this behalf.

The interest to the extent the same does not exceed the interest calculated at the rate approved by the Central Government, taking into consideration the terms of the loan or the bond and its repayment, will be subject to tax at a concessional rate of **5%** *plus* surcharge, wherever applicable, *plus* health and education cess@4%.

> ***Note*** *- Interest payable by an Indian company or a business trust to a non-resident, including a foreign company, in respect of rupee denominated bond issued outside India during the period from 17.9.2018 to 31.3.2019 shall be exempt from tax, and consequently, no tax shall be deducted on the payment of interest in respect of the said bond under section 194LC [**Press Release, dated 17-09-2018]***

(ii) **Rate of TDS:** Such interest paid by an Indian company or business trust to a non-corporate non-resident or a foreign company would be subject to TDS@**5%** plus surcharge, wherever applicable, plus health and education cess@4% under section 194LC.

(iii) **Non-applicability of higher rate of TDS under section 206AA for non-furnishing of PAN:** Levy of higher rate of TDS@20% under section 206AA in the absence of PAN would not be attracted in respect of payment of interest on long-term bonds, as referred to in section 194LC, to a non-corporate non-resident or to a foreign company.

(11) Interest on Government securities or rupee-denominated bonds of an Indian company payable to a Foreign Institutional Investor (FII) or a Qualified Foreign Investor (QFI) [Section 194LD]

(i) **Applicability and Rate of TDS:** Section 194LD provides that any income by way of interest payable during the period between 1.6.2013 and 30.6.2020 in respect of investment made by an FII or QFI in a rupee denominated bond of an Indian company or a Government security, shall be subject to tax deduction at source at a concessional rate of 5% (as against the rate of 20% of interest applicable in respect of other interest received by a QFI or FII).

The interest to the extent the same does not exceed the interest calculated at the rate notified by the Central Government in this behalf will be subject to tax deduction at a concessional rate of **5%** *plus* surcharge, wherever applicable, *plus* health and education cess@4%.

(ii) **Time of deduction:** Any person who is responsible for paying to a person being a FII or a QFI, any such interest shall, at the time of credit of such income to the account of the payee or **at the time of payment** of such income in cash or by the issue of a cheque or draft or by any other mode, **whichever is earlier**, deduct income-tax thereon@**5%** *plus* surcharge, wherever applicable, *plus* health and education cess@4%.

(iii) **Meaning of FII and QFI:**

	Term	Meaning
(i)	**FII**	Foreign Institutional Investors specified by the Central Government by notification in the Official Gazette.
(ii)	**QFI**	Qualified Foreign Investors i.e., Foreign Investors, being non-residents, who meet certain KYC requirements under SEBI laws and are hence permitted to invest in equity and debt schemes of Mutual Funds, thereby enabling Indian Mutual Funds to have direct access to foreign investors and widen the class of foreign investors in Indian equity and debt market. **QFI does not include FII.**

(12) TDS on withdrawal of cash [Section 194N]

(i) ***Applicability and rate of TDS:*** *Section 194N, inserted with effect from 1.9.2019, provides that every person, being*

- *a banking company to which the Banking Regulation Act, 1949 applies (including any bank or banking institution referred under section 51 of that Act)*
- *a co-operative society engaged in carrying on the business of banking or*
- *a post office*

who is responsible for paying, in cash, any sum or aggregate of sums exceeding ₹ 1 crore during the previous year to any person from one or more accounts maintained by such recipient-person with it, shall deduct tax at source ***@2% of sum exceeding ₹ 1 crore.***

If payment is to a non-resident, surcharge, wherever applicable, and health and education cess @4% have to be added to the above rate for deduction of tax at source.

(ii) ***Time of deduction:*** *This deduction is to be made at the time of payment of such sum.*

(iii) ***Non-applicability of TDS under section 194N:*** *Liability to deduct tax at source under section 194N shall not be applicable to any payment made to –*

- *the Government*
- *any banking company or co-operative society engaged in carrying on the business of banking or a post-office*
- *any business correspondent of a banking company or co-operative society engaged in carrying on the business of banking, in accordance with the RBI guidelines*
- *any white label ATM operator of a banking company or co-operative society engaged in carrying on the business of banking, in accordance with the*

authorisation issued by the RBI under the Payment and Settlement Systems Act, 2007

- *such other person or class of persons notified by the Central Government in consultation with the RBI.*

(13) Payment of any other sum to non-resident [Section 195]

(i) **Applicability:** Any person responsible for paying interest (other than interest referred to in section 194LB or section 194LC or section 194LD) or any other sum chargeable to tax (other than salaries) to a non-corporate non-resident or to a foreign company is liable to deduct tax at source at the rates prescribed by the relevant Finance Act.

Payee to be a non-resident - In order to subject an item of income to deduction of tax under this section the payee must be a non-corporate non-resident or a foreign company.

Payer may be a resident or non-resident - Under section 195(1), the obligation to deduct tax at source from interest and other payments to a non-resident, which are chargeable to tax in India, is on "any person responsible for paying to a non-resident or to a foreign company".

The words "any person" used in section 195(1) is intended to include both residents and non-residents. Therefore, a non-resident person is also required to deduct tax at source before making payment to another non-resident, if the payment represents income of the payee non-resident, chargeable to tax in India. Therefore, if the income of the payee non-resident is chargeable to tax, then tax has to be deducted at source, whether the payment is made by a resident or a non-resident.

Explanation 2 clarifies that the obligation to comply with section 195(1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:-

(a) a residence or place of business or business connection in India; or

(b) any other presence in any manner whatsoever in India.

(ii) **Time of deduction:** The tax is to be deducted at source at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

Where any interest or other sum as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee.

However, in the case of interest payable by the Government or a public sector bank within the meaning of section 10(23D) or a public financial institution within the meaning of section 10(23D), deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode.

(iii) **Payments subject to tax deduction:** The statutory obligation imposed under this section would apply for the purpose of deduction of tax at source from any sum being income assessable to tax (other than salary income) in the hands of the non-resident/ foreign company. However, no deduction shall be made in respect of any dividends declared/ distributed/ paid by a domestic company, on which dividend distribution tax has been paid under section 115-O.

Payment to a non-resident by way of royalties and payments for technical services rendered in India are common examples of sums chargeable under the provisions of the Act to which the liability for deduction of tax at source would apply.

(iv) **Certificate of non-deduction of tax at source:**

(a) Any person entitled to receive any interest or other sum on which income-tax has to be deducted under section 195(1) may make an application in the prescribed form to the Assessing Officer for grant of certificate authorizing him to receive such interest or other sum without deduction of tax thereunder.

(b) Where any such certificate is granted, every person responsible for paying such interest or other sum to the person to whom certificate is granted make payment of such interest or other sum without deduction of tax at source under section 195(1), so long as the certificate in force.

(c) Such certificate shall remain in force till the expiry of the period specified therein. However, if it is cancelled by the Assessing Officer before the expiry of such period, the certificate shall remain in force till such cancellation.

(d) The CBDT is empowered to make rules specifying the cases in which, and the circumstances under which, an application may be made for the grant of certificate. While doing so, it should take into account the convenience of the assessees and the interests of the revenue.

(e) Such Rules would provide for the conditions subject to which such certificate may be granted and any other matter connected therewith.

(v) **Person responsible for paying any sum to non-resident to furnish prescribed information:** Section 195(6) provides that the person responsible for paying any sum, whether or not chargeable to tax under the provisions of the Act, to a non-corporate non-resident or to a foreign company, shall be required to furnish the information relating to payment of such sum in the prescribed form and prescribed manner. Such form and manner is prescribed in Rule 37BB.

Students may note that the Rule 37BB has been given as Annexure – 3 at the end of this material.

(vi) **Specified class or classes of persons, making payment to the non-resident, to mandatorily make application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax**

(a) Under section 195(1), any person responsible for paying to a non-corporate non-resident or to a foreign company, any interest or any other sum chargeable under the provisions of the Act (other than salary), has to deduct tax at source at the rates in force.

(b) Under section 195(2), where the person responsible for paying any such sum chargeable to tax under the Act (other than salary) to a non-resident, considers that the whole of such sum would not be income chargeable in the hands of the recipient, he may make an application ***in the prescribed form and manner to the Assessing Officer, to determine in the prescribed manner,*** the appropriate proportion of such sum so chargeable. When the Assessing Officer so determines, the appropriate proportion, tax shall be deducted under section 195(1) only on that proportion of the sum which is so chargeable.

(c) Consequent to the retrospective amendments in section 2(47), section 2(14) and section 9(1) by the Finance Act, 2012, section 195(7) provides that, notwithstanding anything contained in sections 195(1) and 195(2), the CBDT may, by notification in the Official Gazette, specify a class of persons or cases, where the person responsible for paying to a non-corporate non-resident or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall make an application ***in the prescribed form and manner to the Assessing Officer, to determine in the prescribed manner,*** the appropriate proportion of sum chargeable to tax. Where the Assessing Officer determines the appropriate proportion of the sum chargeable, tax shall be deducted under sub-section (1) on that proportion of the sum which is so chargeable.

(d) Consequently, where the CBDT specifies a class of persons or cases, the person responsible for making payment to a non-corporate non-resident or a foreign company in such cases has to mandatorily make an application in the ***prescribed form and manner to the Assessing Officer***, whether or not such payment is chargeable under the provisions of the Act.

(vii) **Procedure for refund of TDS under section 195 to the person deducting tax in cases where tax is deducted at a higher rate prescribed in the DTAA**

(a) The CBDT has, through *Circular No.7/2011 dated 27.9.2011*, modified Circular No.07/2007, dated 23.10.2007 which laid down the procedure for refund of tax deducted at source under section 195 of the Income-tax Act, 1961 to the person deducting tax at source from the payment to a non-resident. The said Circular allowed refund to the person making payment under section 195 in the circumstances indicated therein as the income does not accrue to the non-resident or if the income is accruing, no tax is due or tax is due at a lesser rate. The amount paid to the Government in such cases to that extent does not constitute tax.

(b) The said Circular, however, did not cover a situation where tax is deducted at a rate prescribed in the relevant DTAA which is higher than the rate prescribed in the Income-tax Act, 1961. Since the law requires deduction of tax at a rate prescribed in the relevant DTAA or under the Income-tax Act, 1961, whichever is lower, there is a possibility that in such cases excess tax is deducted relying on the provisions of relevant DTAA.

(c) Accordingly, in order to remove the genuine hardship faced by the resident deductor, the CBDT has modified *Circular No. 07/2007, dated 23-10-2007* to the effect that the beneficial provisions under the said Circular allowing refund of tax deducted at source under section 195 to the person deducting tax at source shall also apply to those cases where deduction of tax at a higher rate under the relevant DTAA has been made while a lower rate is prescribed under the domestic law.

(14) Income payable net of tax [Section 195A]

(i) Where, under an agreement or other arrangement, the tax chargeable on any income referred to in the foregoing provisions of this Chapter is to be borne by the person by whom the income is payable, then, for the purposes of deduction of tax under those provisions such income shall be increased to such amount as would, after deduction of tax thereon, be equal to the net amount payable under such agreement or arrangement.

(ii) However, no grossing up is required in the case of tax paid [under section 192(1A)] by an employer on the non-monetary perquisites provided to the employee.

(15) Income from units [Section 196B]

The person responsible for making the following payment to an Offshore Fund shall deduct tax @ 10% plus surcharge, wherever applicable, *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

- income in respect of units referred to in section 115AB or
- income by way of long-term capital gains arising from the transfer of such units

(16) Income from foreign currency bonds or shares of Indian company [Section 196C]

The person responsible for making the following payment to a non-resident has to deduct tax @ 10% plus surcharge, wherever applicable, *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

- income by way of interest or dividends in respect of bonds or Global Depository Receipts referred to in section 115AC or
- income by way of long-term capital gains arising from the transfer of such bonds or Global Depository Receipts.

However, no deduction shall be made in respect of any dividends referred to in section 115-O.

(17) Income of foreign institutional investors from securities [Section 196D]

(i) The person responsible for making the payment in respect of securities referred to in section 115AD(1)(a) to a Foreign Institutional Investor has to deduct tax @20% *plus* surcharge, wherever applicable**,** *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

(ii) However, no deduction shall be made in respect of the following

- any dividends referred to in section115-O
- income, by way of capital gains arising from the transfer of securities referred to in section 115AD, payable to a Foreign Institutional Investor.

(18) Certificate for deduction of tax at a lower rate [Section 197]

(i) This section applies where, in the case of any income of any person or sum payable to any person, income-tax is required to be deducted at the time of credit or payment, as the case may be at the rates in force as per the provisions of sections 192, 194G, 194LBB, 194LBC and 195.

(ii) In such cases, the assessee can make an application to the Assessing Officer for deduction of tax at a lower rate or for non-deduction of tax.

(iii) If the Assessing Officer is satisfied that the total income of the recipient justifies the deduction of income-tax at lower rates or no deduction of income-tax, as the case may be, he may give to the assessee such certificate, as may be appropriate.

(iv) Where the Assessing Officer issues such a certificate, then the person responsible for paying the income shall deduct income-tax at such lower rates specified in the certificate or deduct no tax, as the case may be, until such certificate is cancelled by the Assessing Officer.

(v) Enabling powers have been conferred upon the CBDT to make rules for prescribing the procedure in this regard.

(19) Tax deducted is income received [Section 198]

(i) All sums deducted in accordance with the foregoing provisions shall, for the purpose of computing the income of an assessee, be deemed to be income received.

(ii) However, the following tax paid or deducted would not be deemed to be income received by the assessee for the purpose of computing the total income–

(a) the tax paid by an employer under section 192(1A) on non-monetary perquisites provided to the employees

(b) ***sum deducted under section 194N***

(20) Credit for tax deducted at source [Section 199]

(i) Tax deducted at source in accordance with the above provisions and paid to the credit of the Central Government shall be treated as payment of tax on behalf of the-

(a) person from whose income the deduction was made; or

(b) owner of the security; or

(c) depositor; or

(d) owner of property; or

(e) unit-holder; or

(f) shareholder.

(ii) Any sum referred to in section 192(1A) and paid to the Central Government, shall be treated as the tax paid on behalf of the person in respect of whose income, such payment of tax has been made.

(iii) The CBDT is empowered to frame rules for the purpose of giving credit in respect of tax deducted or tax paid under Chapter XVII. The CBDT also has the power to make rules for giving credit to a person other than the persons mentioned in (i) and (ii) above. Further, the CBDT can specify the assessment year for which such credit may be given.

(iv) **Rule 37BA – Credit for tax deducted at source for the purposes of section 199**

Rule 37BA(1) provides that credit for tax deducted at source and paid to the Central Government shall be given to the person to whom the payment has been made or credit has been given (i.e., the deductee) on the basis of information relating to deduction of tax furnished by the deductor to the income-tax authority or the person authorized by such authority.

Rule 37BA(2)(i) provides that where under any provisions of the Act, the whole or any part of the income on which tax has been deducted at source is assessable in the hands of a person other than the deductee, credit for the whole or any part of the tax deducted at source, as the case may be, shall be given to the other person and not to the deductee.

However, the deductee should file a declaration with the deductor and the deductor should report the tax deduction in the name of the other person in the information relating to deduction of tax referred to in Rule 37BA(1).

(21) Mandatory requirement of furnishing PAN in all TDS, bills, voucher and correspondence between the deductor and deductee [Section 206AA]

(i) With a view to strengthening the PAN mechanism, section 206AA provides that any person whose receipts are subject to deduction of tax at source i.e. the deductee, shall mandatorily furnish his PAN to the deductor failing which the deductor shall deduct tax at source at higher of the following rates –

(a) the rate prescribed in the Act;

(b) at the rate in force i.e., the rate mentioned in the Finance Act; or

(c) at the rate of 20%.

(ii) No certificate under section 197 will be granted by the Assessing Officer unless the application contains the PAN of the applicant.

(iii) If the PAN provided to the deductor is invalid or it does not belong to the deductee, it shall be deemed that the deductee has not furnished his PAN to the deductor. Accordingly, tax would be deductible at the rate specified in (i) above.

(iv) The provisions of section 206AA shall not apply in respect of payment of interest on long-term bonds, as referred to in section 194LC, to a non-corporate non-resident or to a foreign company.

(v) **Non-applicability of section 206AA to non-residents subject to fulfilment of certain conditions:** For the purpose of reducing the compliance burden, section 206AA provides for non-applicability of the requirements contained in section 206AA to a non-corporate non-resident or a foreign company not having PAN in respect of payment in the nature of interest, royalty, fees for technical services and payments on transfer of any capital asset, subject to the deductee furnishing the following details and documents to the deductor, namely:-

a. name, e-mail id, contact number;

b. address in the country or specified territory outside India of which the deductee is a resident;

c. a certificate of his being resident in any country or specified territory outside India from the Government of that country or specified territory if the law of that country or specified territory provides for issuance of such certificate;

d. Tax Identification Number of the deductee in the country or specified territory of his residence and in case no such number is available, then a unique number on the basis of which the deductee is identified by the Government of that country or the specified territory of which he claims to be a resident *[Notification No. 53/2016 dated 24th June, 2016].*

(vi) Both the deductor and the deductee have to compulsorily quote the PAN of the deductee in all correspondence, bills, vouchers and other documents exchanged between them.

Withholding tax provisions for Non-resident: A Summary

<table>
<tr><th>Section</th><th>Nature of payment</th><th>Rate of TDS</th></tr>
<tr><td>192</td><td>Salary</td><td>Normal Slab rates</td></tr>
<tr><td>192A</td><td>Premature withdrawal from EPF, aggregating to ₹ 50,000 or more</td><td>10%</td></tr>
<tr><td>194B</td><td>Income by way of winnings from lotteries, crossword puzzles, card games and other games of any sort, where payment to a person > ₹ 10,000</td><td>30%</td></tr>
<tr><td>194BB</td><td>Income by way of winnings from horse races, where payment to a person > ₹ 10,000</td><td>30%</td></tr>
<tr><td>194E</td><td>Specified payments referred under section 115BBA to non-resident sportsmen/sports association or an entertainer</td><td>20%</td></tr>
<tr><td>194G</td><td>Commission etc. on the sale of lottery tickets, where payment to a person > ₹ 15,000</td><td>5%</td></tr>
<tr><td>194LB</td><td>Payment of interest on infrastructure debt fund</td><td>5%</td></tr>
<tr><td>194LBA(2)</td><td>Distribution any interest income, received or receivable by a business trust from a SPV, to its unit holders.</td><td>5%</td></tr>
<tr><td>194LBA(3)</td><td>Distribution of any income received from renting or leasing or letting out any real estate asset directly owned by the business trust, to its unit holders.</td><td rowspan="3">At the rates in force</td></tr>
<tr><td>194LBB</td><td>Investment fund paying income to a unit holder [other than income which is exempt under section 10(23FBB)].</td></tr>
<tr><td>194LBC(2)</td><td>Income in respect of investment made in a securitisation trust (specified in Explanation to section 115TCA)</td></tr>
<tr><td rowspan="2">194LC</td><td>Payment of interest by an Indian Company or a business trust to a non-corporate non-resident or foreign company
- in respect of money borrowed in foreign currency from a source outside India
• under a loan agreement between 1.7.2012 and 30.6.2020 or
• by way of issue of long term bonds (including long term infrastructure bond) between 1.10.2004 and 30.6.2020 as approved by Central Government or
- in respect of money borrowed from source outside India by way of rupee denominated bond before 1.7.2020</td><td>5%</td></tr>
<tr><td>Interest payable by an Indian company or a business trust to a non-resident, including a foreign company, in respect of rupee denominated bond issued outside India during the</td><td>Nil
(Since such interest is exempt</td></tr>
</table>

	period from 17.9.2018 to 31.3.2019	u/s 10(4C), no tax is deductible u/s 194LC)
194LD	Payment of interest between 1.6.2013 and 30.6.2020 on rupee denominated bond of an Indian Company or Government securities to a Foreign Institutional Investor or a Qualified Foreign Investor	5%
194N	On withdrawal of cash in excess of ₹ 1 crore	2% on amount exceeding ₹ 1 crore
195	Payment of any other sum to a non-resident	At the rates in force
196B	Income from units of a mutual fund or UTI purchased in foreign currency (including long term capital gain on transfer of such units) payable to an Offshore Fund	10%
196C	Income by way of interest on bonds of an Indian company or public sector company sold by the Government and purchased by a non-resident in foreign currency or GDRs referred to in section 115AC (including long term capital gain on transfer of such bonds or GDRs payable to a non-resident	10%
196D	Income of foreign Institutional Investors from securities (not being income by way of interest referred to in section 194LD, dividend referred under section 115-O or capital gain arising from such securities)	20%

Note: *In all the above cases, the rate of tax would be increased by surcharge, wherever applicable, and health and education cess @4%.*

2.13 MISCELLANEOUS PROVISIONS

(1) Furnishing of Return of Income [Section 139(1)]

Filing an income-tax return in India is mandatory for non-residents except in the cases specified in "Chapter XII: Determination of tax in certain special cases" of the Income-tax Act, *1961 [Refer to para 2.9]* .

Section 139(1) of the Income-tax Act, 1961 requires every person,—

(a) being a company or a firm; or

(b) being a person other than a company or a firm, if his total income or the total income of any other person in respect of which he is assessable under this Act during the previous year exceeded the basic exemption limit,

to furnish a return of his income or the income of such other person during the previous year, in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed on or before the due date specified thereunder.

'Due date' means -

	Assessee	Due Date
(i)	Where the assessee, other than an assessee referred to in clause (ii), is - (a) a company, (b) a person (other than a company) whose accounts are required to be audited under the Income-tax Act, 1961 or any other law in force; or (c) a working partner of a firm whose accounts are required to be audited under the Income-tax Act, 1961 or any other law for the time being in force.	30th September of the assessment year
(ii)	in the case of an assessee who is required to furnish a report referred to in section 92E.	30th November of the assessment year
(iii)	in the case of any other assessee.	31st July of the assessment year

Section 139(1C) empowers the Central Government to exempt any class or classes of persons from the requirement of furnishing a return of income subject to such conditions as may be specified therein.

Accordingly, the Central Government has, vide Notification No. S.O.2672(E) dated 26.7.2019, specified the class of persons who are exempts from the requirement of furnishing a return of income under section 139(1) from A.Y.2019-20 onwards.

(i) Notified classes of person: *Non-corporate non-residents and foreign companies, having any income chargeable under the Income-tax Act, 1961 during a previous year from any investment fund sent up in an International Financial Services Centre (IFSC) located in India,*

(ii) Conditions: *The above mentioned class of persons are exempted from the requirement of furnishing a return of income under section 139(1), if*

- *any income-tax due on income of the abovementioned class of persons has been deducted at source and remitted to the Central Government by the investment fund at the tax rate in force as per section 194LBB and*

- *there is no other income during the previous year for which the above mentioned class of persons, is otherwise liable to file the return of income.*

However, the exemption from the requirement of furnishing a return of income would not be available to the abovementioned class of persons where a notice under section 142(1)/148/153A or 153C has been issued for filing return of income for the assessment year specified therein

(iii) Meaning of "investment fund": *Investment fund means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or Category II Alternative Investment Fund (AIF) and is regulated under the SEBI (AIF) Regulations, 2012 made under the SEBI Act, 1992.*

(2) Who may be regarded as Representative Assessee? [Section 160]

As per section 160(1)(i), in respect of the income deemed to accrue or arise in India to a non-resident under section 9(1), the agent of the non-resident including a person who is treated as an agent under section 163 would be treated as a representative assessee.

(3) Who may be regarded as agent? [Section 163]

An agent is considered a representative assessee but only if he is the agent of non-resident person. According to section 163, an agent, in relation to a non-resident person, includes any person in India:

(i) who is employed by or on behalf of the non-resident;

(ii) who is having any business connection with the non-resident;

(iii) from or through whom the non-resident is in receipt of any income, whether directly or indirectly;

(iv) who is trustee of the non-resident.

An agent also includes any other person who (whether resident or non-resident) has acquired a capital asset in India by means of a transfer.

A Broker: Can he be treated as an agent?

Where transactions are carried on in the ordinary course of business through a broker in India and the broker does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker, the broker in India cannot be treated as an agent in respect of the income arising to the non-resident from such transactions. Further, the non-resident broker should also carry on such transactions in the ordinary course of his business as a principal. Accordingly, where *bona fide* hedging transactions take place through a broker in India and a foreign broker acting for an undisclosed principal, the Indian broker cannot be deemed to be agent of the foreign principal. Thus, generally a broker is not deemed to be the agent of a non-resident person so long as he functions exclusively in his capacity as a broker.

Opportunity of being heard to be given before treating a person as an agent of a non-resident

Before a person can be treated as an agent of a non-resident he must be given a reasonable opportunity of being heard by the Assessing Officer as to his liability to be so treated.

(4) Liability of Representative Assessee [Section 161]

Every representative assessee has the same responsibilities, duties and liabilities as if the income were being received by or accruing to or in favour of him beneficially. He is liable to be assessed in his own name in respect of such income but the assessment is deemed to have been made upon him in his representative capacity. The tax is levied on and is recovered from such an assessee, in like manner and to the same extent as it would have been levied upon and recovered from the person represented by him.

If certain income is assessed in the hands of any person in the capacity of representative assessee, the same income shall not be assessed in his hands under any other provision of the Act.

(5) Rights of representative assessee to recover tax paid [Section 162]

Every representative assessee who pays any amount under the Act, is entitled to recover the sum so paid from the person on whose behalf he had paid it or to adjust it against any moneys in his possession, but belonging to the other persons. The representative assessee has the right to retain out of the moneys in his representative capacity, an amount equal to any sum paid by him under the Act in addition to the right to recover the same from the beneficial owner of the income.

Any representative assessee or any person who apprehends that he may be assessed in respect of any other person (principal) as a representative assessee, has the right to retain out of the money payable by him to such other person, amount to the extent of his estimated liability.

In case of disagreement between the principal and representative assessee, such representative assessee, may secure from the Assessing Officer a certificate stating the amount to be so retained pending final settlement of the liability. The certificate so obtained shall be treated as warrant authorising retention of the amount.

The amount recoverable from such representative assessee at the time of final settlement should not exceed the amount specified in such certificate. However, where a representative assessee holds, in his hands, any additional assets of the principal at the time of final settlement, then the Assessing Officer may initiate the recovery of the balance tax liability of the principal from such representative to the extent of assets held by him.

(6) Direct assessment or recovery not barred [Section 166]

Direct assessment of the person on whose behalf or for whose benefit income is receivable, or the recovery from such person of the tax payable in respect of such income is not barred by any provision in Chapter XV of the Income-tax Act, 1961.

(7) Remedies against property in cases of representative assessees [Section 167]

The Assessing Officer has the same remedies against all property of any kind vested in or under the control or management of any representative assessee as he would have against the property of any person liable to pay any tax, and in as full and ample a manner, irrespective of whether the demand is raised against the representative assessee or directly against the beneficiary.

(8) Recovery of tax in respect of non- resident from his assets [Section 173]

In a case where the person entitled to the income arising from any business connection in India or from any property in India or through or from any asset or source of income in India or through the transfer of a capital asset situated in India is a non-resident, the tax chargeable thereon, whether in his name or in the name of his agent who is liable as a representative assessee, may be recovered by deduction under any of the provisions of Chapter XVII-B. Further, any arrears of tax may be recovered also in accordance with the provisions of this Act from any assets of the non-resident which are, or may at any time come, within India. These provisions are without prejudice to the provisions of section 161(1) or of section 167.

(9) Recovery against the assessee's property in foreign countries [Section 228A]

Where an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may, if the assessee ***is a resident of a country*** (being a country with which the Central Government has entered into an agreement for the recovery of income tax under this Act and the corresponding law in force in that country) ***or has any property in that country***, forward to the CBDT a certificate drawn up by him under section 222. Thereafter, the CBDT may take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country.

Similarly, the Government of the other country or any authority under that Government may send to the CBDT a certificate of recovery of any tax due under such corresponding law from a person having property in India and the CBDT may forward such certificate to Tax Recovery Officer ***having jurisdiction over the resident or*** within whose jurisdiction such property is situated, for recovery of such tax. Tax Recovery Officer can proceed to recover the amount specified in the Certificate by –

(a) attachment and sale of assessee's movable or immovable property

(b) arrest of the assessee and his detention in prison.

(c) appointing a receiver for the management of assessee's movable and immovable property.

He shall thereafter remit the sum so recovered to the CBDT.

(10) Submission of statement by a non-resident having liaison office [Section 285]

(i) A non-resident can operate in India through a branch or a liaison office set up after getting the approval of the Reserve Bank of India. Since the branch constitutes a permanent establishment of the non-resident, it has to file its return of income. However, prior to 1.6.2011, there was no such requirement as regards a liaison office since no business activity is allowed to be carried out in India *via* a liaison office of a non-resident.

(ii) With effect from 1.6.2011, such a non-resident is required to file a statement in the prescribed form [Form No.49C] to the Assessing Officer having jurisdiction, within 60 days from the end of the financial year, providing the details in respect of activities carried out by the liaison office in India during the financial year.

(iii) This requirement has to be complied with by every person, being a non-resident having a liaison office in India set up in accordance with the guidelines issued by the RBI under the Foreign Exchange Management Act, 1999.

(iv) The statement of a particular financial year should be filed on or before 30th May, of the succeeding financial year in electronic form along with digital signature. For example, the statement for F.Y. 2019-20 should be filed on or before 30th May, 2020. Further, the statement is to be verified by a Chartered Accountant or by the Authorized Signatory i.e., the person authorized by the non-resident in this behalf.

(11) Furnishing of information or documents by an Indian Concern [Section 285A]

(i) There shall be a reporting obligation on the Indian concern through or in which the Indian assets are held by a foreign company or entity.

(ii) For the purposes of determination of any income accruing or arising in India under section 9(1)(i), an Indian concern has to furnish, within the prescribed period to the prescribed income-tax authority, the information or documents, in prescribed manner, if -

- any share of, or interest in, a company or an entity registered or incorporated outside India derives, directly or indirectly, its value substantially from the assets located in India, as referred to in *Explanation 5* to section 9(1)(i), and

- such company or, entity, holds, directly or indirectly, such assets in India through, or in, the Indian concern.

(iii) The information has to be furnished in Form No.49D electronically within a period of 90 days from the end of the financial year in which the transfer of such share or interest referred to above takes place.

(iv) If any Indian concern fails to furnish the information or documents, the income-tax authority, as may be prescribed under the said section, may direct that such Indian concern shall pay, by way of penalty under section 271GA,—

(a) @2% of the value of the transaction in respect of which such failure has taken place, if such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern;

(b) ₹ 5,00,000 in any other case.

Rule 114DB, prescribing the time limit and information or documents to be furnished under section 285A, has been given as Annexure – 4 at the end of this material.

Note – *In this Chapter, the provisions of income-tax law which specifically relate to non-residents have been dealt with in detail. Further, certain significant general provisions of income-tax law, which are also applicable to non-residents in the same or modified form are discussed in some length. In addition to these provisions, there may be other general provisions of income-tax law, which are also applicable to non-residents. For a detailed discussion of these provisions, students are advised to refer to the Study Material of Paper 7: Direct Tax Laws and International Taxation, wherein the entire income-tax law is discussed in detail. Students are expected to be aware of such provisions and apply the same while solving problems and addressing issues related to non-residents in this Elective Paper.*

CHAPTER 3

DOUBLE TAXATION RELIEF

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the need for double taxation relief;
- **identify** the types of double taxation relief available;
- **Integrate, analyse and apply** the provisions relating to double taxation relief contained in the Income-tax Act, 1961 and Income-tax Rules, 1962 in problem solving and addressing related issues;
- **appreciate** the procedure for claiming deduction where there is no double taxation avoidance agreement between India and the other country where the income has been taxed and **compute** the amount of deduction;
- **appreciate** the concept of Permanent Establishment under double taxation avoidance agreements and its relevance.

3.1 CONCEPT OF DOUBLE TAXATION RELIEF

In the present era of cross-border transactions across the globe, the effect of taxation is one of the important considerations for any trade and investment decision in other countries. One of the most significant results of globalisation is the visible impact of one country's domestic tax policies on the economy of another country. This has led to the need for continuously assessing the tax regimes of various countries and bringing about necessary reforms.

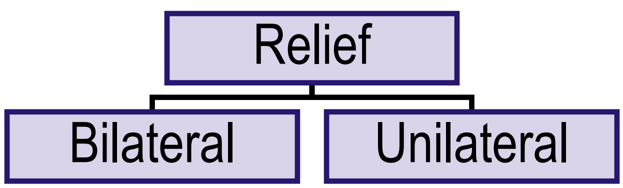
Where a taxpayer is resident in one country but has a source of income situated in another country it gives rise to possible double taxation. This arises from the two basic rules that enables the country of residence as well as the country where the source of income exists to impose tax namely, (i) the source rule and (ii) the residence rule. The source rule holds that income is to be taxed in the country in which it originates irrespective of whether the income accrues to a resident or a non-resident whereas the residence rule stipulates that the power to tax should rest with the country in which the taxpayer resides. If both rules apply simultaneously to a business entity and it were to suffer tax at both ends, the cost of operating on an international scale would become prohibitive and would deter the process of globalisation. It is from this point of view that Double Taxation Avoidance Agreements (DTAA) become very significant.

DTAAs lay down the rules for taxation of the income by the source country and the residence country. Such rules are laid for various categories of income, for example, interest, dividend, royalties, capital gains, business income etc. Each such category is dealt with by separate article in the DTAA.

Double taxation means taxing the same income twice in the hands of an assessee. A particular income may be taxed in India in the hands of a person based on his/its residence. However, the same income may be taxed in his/its hands in the Source Country also, as per the domestic laws of that country. This gives rise to double taxation. It is a universally accepted principle that the same income should not be subjected to tax twice. In order to take care of such situations, the Income-tax Act, 1961 has provided for double taxation relief.

3.2 TYPES OF RELIEF

Relief from double taxation can be provided in mainly two ways:



(1) Bilateral Relief: Under this method, the Governments of two countries can enter into an agreement to provide relief against double taxation by mutually working out the basis on which the relief is to be granted. India has entered into agreements for relief against or avoidance of double taxation with more than 100 countries which include Sri Lanka, Switzerland, Sweden, Denmark, Japan, Federal Republic of Germany, Greece, etc.

Bilateral Relief may be granted in either one of the following methods:

Exemption Method
- A particular income is taxed in only one of the two countries.

Tax Credit Method
- Income is taxable in both countries in accordance with their respective tax laws read with double taxation avoidance agreement.
- The country of resident of the tax payer, however, allows him credit for the tax charged thereon in the country of source.

In India, double taxation relief is provided by a combination of the two methods.

(2) Unilateral Relief: This method provides for relief of some kind by the home country even where no mutual agreement has been entered into by the two countries.

3.3 DOUBLE TAXATION RELIEF PROVISIONS UNDER THE INCOME TAX ACT, 1961

Sections 90 and 91 of the Income-tax Act, 1961 provide for double taxation relief in India.

(1) Agreement with foreign countries or specified territories - Bilateral relief [Section 90]

(i) Section 90(1) provides that the Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

(a) for the granting of relief in respect of—

(i) income on which income-tax has been paid both in India and in that country or specified territory; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment; or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory; or

Accordingly, the Central Government has notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement *[Notification No. 91/2008, dated 28.8.2008].*

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance; or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory.

The Central Government may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(ii) Where the Central Government has entered into such an agreement with the Government of any country outside India or specified territory outside India for granting relief of tax, or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

(iii) However, the provisions of Chapter X-A, General Anti-Avoidance Rule, shall apply to the assessee even if such provisions are not beneficial to him.

(iv) **Meaning of terms used in any DTAA with a foreign country or specified territory**

	Particulars	Meaning of the term
(1)	Term used in any DTAA with a foreign country or specified territory, and not defined in the agreement or the Act but assigned a meaning in the notification issued by the Central Government in the Official Gazette, which is still in force.	The term shall have the meaning assigned in the said notification and the meaning shall be deemed to have effect from the date on which the DTAA came into force.
(2)	Term used in any DTAA with a foreign country or specified territory, which is defined in the DTAA itself.	The term shall have the same meaning assigned to it in the DTAA.
(3)	Term used in any DTAA with a foreign country or specified territory, which is not defined in the said DTAA, but defined in the Income-tax Act, 1961.	The term shall have the meaning assigned to it in the Income-tax Act, 1961 and explanation, if any, given to it by the Central Government.

(v) The DTAAs under section 90 are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, section 90(4) provides that the non-resident to whom the agreement referred to in section 90(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory, is furnished declaring his residence of the country outside India or the specified territory outside India, as the case may be.

(vi) Therefore, a certificate issued by the Government of a foreign country would constitute proof of tax residency, without any further conditions regarding furnishing of "prescribed particulars" therein. In addition to such certificate issued by the foreign Government, the assessee would be required to provide such other documents and information, as may be prescribed, for claiming the treaty benefits.

(vii) 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.

(viii) *Circular No. 333 dated 2.4.1982*, issued by CBDT provides that a specific provision of the DTAA will prevail over the general provisions of the Income-tax Act, 1961. Therefore, where a DTAA provides for a particular mode of computation of income, this mode will take precedence over the Income-tax Act, 1961. However, where there is no specific provision in the treaty, then the Income-tax Act will apply.

(ix) *Notification No. 91/2008 dated 28.8.2008* issued by CBDT states that any income of a resident of India which "may be taxed" in the other country (Source Country) as per the DTAA shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961. Thereafter, relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

Tax treaties are generally based on certain models. The most common ones are:

Model Tax Conventions

- OECD Model Tax Convention
- U.N. Model Tax Convention

These model tax conventions will be discussed in detail in Chapter 9 "Overview of Model Tax Conventions".

ILLUSTRATION 1

Examine the correctness or otherwise of the following statement with reference to the provisions of Income-tax Act, 1961.

The double taxation avoidance treaties entered into by the Government of India override the domestic law.

SOLUTION

The statement is correct.

Section 90(2) provides that where a double taxation avoidance treaty is entered into by the Government, the provisions of the Income-tax Act, 1961 would apply to the extent they are more beneficial to the assessee.

In case of any conflict between the provisions of the double taxation avoidance agreement and the Income-tax Act, 1961, the provisions of the DTAA would prevail over the Act in view of the provisions of section 90(2), to the extent they are more beneficial to the assessee [*CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654 (SC)].*

ILLUSTRATION 2

Cosmos Limited, a company incorporated in Mauritius, has a branch office in Hyderabad opened in April, 2019. The Indian branch has filed return of income for assessment year 2020-21 disclosing income of ₹ 50 lacs. It paid tax at the rate applicable to domestic company i.e. 30% plus higher education cess@4% on the basis of paragraph 2 of Article 24 (Non-Discrimination) of the Double Taxation Avoidance Agreement between India and Mauritius, which reads as follows:

"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 in the same circumstances."

However, the Assessing Officer computed tax on the Indian branch at the rate applicable to a foreign company i.e. 40% plus higher education cess@4%.

Is the action of the Assessing Officer in accordance with law?

SOLUTION

Under section 90(2), where the Central Government has entered into an agreement for avoidance of double taxation with the Government of any country outside India or specified territory outside India, as the case may be, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to the assessee. Thus, in view of paragraph 2 of Article 24 (Non-discrimination of the DTAA, it appears that the Indian branch of Cosmos Limited, incorporated in Mauritius, is liable to tax in India at the rate applicable to domestic company (30%), which is lower than the rate of tax applicable to a foreign company (40%).

However, *Explanation 1* to section 90 clarifies 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. Therefore, in view of this *Explanation*, the action of the Assessing Officer in levying tax@40% on the Indian branch of Cosmos Ltd. is in accordance with law.

ILLUSTRATION 3

Arif is a resident of both India and another foreign country in the previous year 2019-20. He owns immovable properties (including residential house) in both the countries. He earned income of ₹ 50 lacs from rubber estates in the foreign country during the financial year 2019-20. He also sold some house property situated in foreign country resulting in short-term capital gain of ₹ 10 lacs during the year. Arif has no permanent establishment of business in India. However, he has derived rental income of ₹ 6 lacs from property let out in India and he has a house in Lucknow where he stays during his visit to India.

Article 4 of the Double Taxation Avoidance Agreement between India and the foreign country where Arif is a resident, provides that "where an individual is a resident of both the Contracting States, then, he shall be deemed to be resident of the Contracting State in which he has permanent home available to him. If he has permanent home in both the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests)".

You are required to examine with reasons whether the business income of Arif arising in foreign country and the capital gains in respect of sale of the property situated in foreign country can be taxed in India.

SOLUTION

Section 90(1) of the Income-tax Act, 1961 empowers the Central Government to enter into an agreement with the Government of any country outside India for avoidance of double taxation of income under the Indian law and the corresponding law of that country. Section 90(2) provides that where the Central Government has entered into an agreement with the Government of any other country for granting relief of tax or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

Arif has residential houses both in India and foreign country. Thus, he has a permanent home in both the countries. However, he has no permanent establishment of business in India. The Double Taxation Avoidance Agreement (DTAA) with foreign country provides that where an individual is a resident of both the countries, he shall be deemed to be resident of that country in which he has a permanent home and if he has a permanent home in both the countries, he shall be deemed to be resident of that country, which is the centre of his vital interests i.e. the country with which he has closer personal and economic relations.

Arif owns rubber estates in a foreign country from which he derives business income. However, Arif has no permanent establishment of his business in India. Therefore his personal and economic relations with foreign country are closer, since foreign country is the place where –

(a) the property is located and

(b) the permanent establishment (PE) has been set-up

Therefore, he shall be deemed to be resident of the foreign country for A.Y. 2020-21.

The fact of the case and issues arising therefrom are similar to that of *CIT vs. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654*, where the Supreme Court held that if an assessee is deemed to be a resident of a contracting State where his personal and economic relations are closer, then in such a case, the fact that he is a resident in India to be taxed in terms of sections 4 and 5 would become irrelevant, since the DTAA prevails over sections 4 and 5.

However, as per section 90(4), in order to claim relief under the agreement, Arif has to obtain a certificate [Tax Residency Certificate (TRC)] declaring his residence of the country outside India from the Government of that country. Further, he also has to provide such other documents and information, as may be prescribed.

Therefore, in this case, Arif is not liable to income tax in India for assessment year 2020-21 in respect of business income and capital gains arising in the foreign country provided he furnishes the Tax Residency Certificate and provides such other documents and information as may be prescribed.

(2) Double taxation relief to be extended to agreements between specified associations adopted by the Central Government [Section 90A]

(i) Section 90A provides that any specified association in India may enter into an agreement with any specified association in the specified territory outside India and the Central Government may, by notification in the Official Gazette, make the necessary provisions for adopting and implementing such agreement for -

(a) grant of double taxation relief,

(b) avoidance of double taxation of income,

(c) exchange of information for the prevention of evasion or avoidance of income- tax, or

(d) recovery of income-tax.

Section 90A(1) provides that an agreement may be entered into by any specified association in India with any specified association in the specified territory outside India which may be adopted by the Central Government by way of notification in the Official Gazette, for granting relief of tax or, as the case may be, for avoidance of double taxation.

The Central Government has, vide *Notification No.90/2008 dated 28.8.2008*, notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

(ii) In relation to any assessee to whom the said agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

(iii) However, the provisions of Chapter X-A, General Anti-avoidance rule, shall apply to the assesse even if such provisions are not beneficial to him.

(iv) **Meaning of terms used in any agreement which any specified association in India may enter into with any specified association in the specified territory outside India for double taxation relief**

	Particulars	Meaning of the term
(1)	Term used in any such agreement, and not defined in the agreement or the Act but assigned a meaning in the notification issued by the Central Government in the Official Gazette, which is still in force	The term shall have the meaning assigned in the said notification and the meaning shall be deemed to have effect from the date on which the agreement came into force.
(2)	Term used in any such agreement, which is defined in the agreement itself	The term shall have the same meaning assigned to it in the said agreement
(3)	Term used in any such agreement, which is not defined in the said agreement, but defined in the Income-tax Act, 1961	The term shall have the meaning assigned to it in the Income-tax Act, 1961 and explanation, if any, given to it by the Central Government

(v) The DTAAs under section 90A are intended to provide relief to the taxpayer, who is resident of one of the contracting country to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a contracting country also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, section 90A(4) provides that the non-resident to whom the agreement referred to in section 90A(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, declaring his residence of the country outside India or the specified territory outside India, as the case may be.

(vi) Therefore, a certificate issued by the Government of a foreign country would constitute proof of tax residency, without any further conditions regarding furnishing of "prescribed particulars" therein. In addition to such certificate issued by the foreign Government, section 90A(5) requires the assessee to provide such other documents and information, as may be prescribed, for claiming the treaty benefits.

Documents and information, to be furnished by the assessee for claiming treaty benefits, prescribed by CBDT vide *Notification No. 57/2013 dated 01.08.2013*:

(i) Status (individual, company, firm etc.) of the assessee;

(ii) Nationality (in case of an individual) or country or specified territory of incorporation or registration (in case of others);

(iii) Assessee's tax identification number in the country or specified territory of residence and in case there is no such number, then, a unique number on the basis of which the person is identified by the Government of the country or the specified territory of which the assessee claims to be a resident;

(iv) Period for which the residential status, as mentioned in the certificate referred to in section 90(4) or section 90A(4), is applicable; and

(v) Address of the assessee in the country or specified territory outside India, during the period for which the certificate, as mentioned in (iv) above, is applicable.

However, the assessee may not be required to provide the information or any part thereof, if the information or the part thereof, as the case may be, is already contained in the TRC referred to in section 90(4) or section 90A(4).

The assessee shall keep and maintain such documents as are necessary to substantiate the information provided. An income-tax authority may require the assessee to provide the said documents in relation to a claim by the said assessee of any relief under an agreement referred to in section 90(1) or section 90A(1), as the case may be.

(vii) The charge of tax at a higher rate for a company incorporated in the specified territory outside India as compared to a domestic company would not be considered as less favourable charge or levy of tax in respect of such company.

(viii) For the purpose of this section, the 'specified association' means any institution, association or body, whether incorporated or not, functioning under any law for the time being in force in India or the laws of the specified territory outside India and which may be notified as such by the Central Government and 'specified territory' means any area outside India which may be notified by the Central Government.

ILLUSTRATION 4

The Income-tax Act, 1961 provides for taxation of a certain income earned in India by Mr. X, a non-resident. The Double Taxation Avoidance Agreement, which applies to Mr. X provides for taxation *of such income in the country of residence. Is Mr. X liable to pay tax on such income earned by him in India? Examine.*

SOLUTION

Section 90(2) makes it clear that where the Central Government has entered into a Double Taxation Avoidance Agreement with a country outside India, then **in respect of an assessee to whom such agreement applies, the provisions of the Act shall apply to the extent they are more beneficial to the assessee.** This means that where tax liability is imposed by the Act, the Double Taxation Avoidance Agreement may be resorted to for reducing or avoiding the tax liability.

However, as per section 90(4), the assessee, in order to claim relief under the agreement, has to obtain a certificate [Tax Residence Certificate (TRC)] from the Government of that country, declaring the residence of the country outside India. Further, he also has to provide the following information in Form No. 10F:

(i) Status (individual, company, firm etc.) of the assessee;

(ii) PAN of the assessee, if allotted;

(iii) Nationality (in case of an individual) or country or specified territory of incorporation or registration (in case of others);

(iv) Assessee's tax identification number in the country or specified territory of residence and in case there is no such number, then, a unique number on the basis of which the person is identified by the Government of the country or the specified territory of which the assessee claims to be a resident;

(v) Period for which the residential status, as mentioned in the certificate referred to in section 90(4) or section 90A(4), is applicable; and

(vi) Address of the assessee in the country or specified territory outside India, during the period for which the certificate, as mentioned in (v) above, is applicable.

However, the assessee may not be required to provide the information or any part thereof, if the information or the part thereof, as the case may be, is already contained in the TRC referred to in section 90(4) or section 90A(4).

The Supreme Court has held, in *CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654,* that in case of any conflict between the provisions of the Double Taxation Avoidance Agreement and the Income-tax Act, 1961, the provisions of the Double Taxation Avoidance Agreement would prevail over those of the Income-tax Act, 1961. Mr. X is, therefore, not liable to pay tax on the income earned by him in India provided he submits the Tax Residence Certificate obtained from the government of the other country, and provides such other documents and information as may be prescribed.

(3) Countries with which no agreement exists – Unilateral Agreements [Section 91] In the case of income arising to an assessee in countries with which India does not have any double taxation agreement, relief would be granted under Section 91 provided all the following conditions are fulfilled:

(a) The assessee is a resident in India during the previous year in respect of which the income is taxable.

(b) The income accrues or arises to him outside India.

(c) The income is not deemed to accrue or arise in India during the previous year.

(d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee.

(e) The assessee has paid tax on the income in the foreign country.

(f) There is no agreement for relief from double taxation between India and the other country where the income has accrued or arisen.

In such a case, the assessee shall be entitled to a deduction from the Indian income-tax payable by him. The deduction would be a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax in the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

Meaning of important terms:

(i) "Indian rate of tax" means the rate determined by dividing the amount of Indian income-tax after deduction of any relief due under the provisions of the Act but before deduction of any double taxation relief due to the assessee.

(ii) "Rate of tax of the said country" means income-tax and super-tax actually paid in that country in accordance with the corresponding laws in force in the said country after deduction of all relief due, but before deduction on account of double taxation relief due in the said country, divided by the whole amount of income assessed in the said country.

(iii) The expression "income-tax" in relation to any country includes any excess profits tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

ILLUSTRATION 5

Nandita, an individual resident retired employee of the Prasar Bharati aged 60 years, is a well-known dramatist deriving income of ₹ 1,10,000 from theatrical works played abroad. Tax of ₹ 11,000 was deducted in the country where the plays were performed. India does not have any Double Tax Avoidance Agreement under section 90 of the Income-tax Act, 1961, with that country. Her income in India amounted to ₹ 6,10,000. In view of tax planning, she has deposited ₹ 1,50,000 in Public Provident Fund and paid contribution to approved Pension Fund of LIC ₹ 32,000. She also contributed ₹ 28,000 to Central Government Health Scheme during the previous year and gave payment of medical insurance premium of ₹ 26,000 to insure the health of her father, a non-resident aged 84 years, who is not dependent on her. Compute the tax liability of Nandita for the Assessment year 2020-21.

SOLUTION

Computation of tax liability of Nandita for the A.Y. 2020-21

Particulars	₹	₹
Indian Income		6,10,000
Foreign Income		1,10,000
Gross Total Income		**7,20,000**
Less: Deduction under section 80C		
Deposit in PPF	1,50,000	
Under section 80CCC		
Contribution to approved Pension Fund of LIC	32,000	
	1,82,000	
Under section 80CCE		
The aggregate deduction under section 80C, 80CCC and 80CCD(1) has to be restricted to ₹ 1,50,000	1,50,000	
Under section 80D		
Contribution to Central Government Health Scheme ₹ 28,000 is also allowable as deduction under section 80D. Since she is a resident senior citizen, the deduction is allowable to a maximum of ₹ 50,000 **(See Note 1)**	28,000	
Medical insurance premium of ₹ 26,000 paid for father aged 84 years. Since the father is a non-resident in India, he will not be entitled for the higher deduction of ₹ 50,000 eligible for a senior citizen, who is resident in India. Hence, the deduction will be restricted to maximum of ₹ 25,000.	25,000	2,03,000
Total Income		**5,17,000**
Tax on Total Income		
Income-tax (See Note below)		13,400
Add: Health and Education Cess @4%		536
		13,936
Average rate of tax in India		
(i.e. ₹ 13,936/ ₹ 5,17,000 × 100)	2.696%	
Average rate of tax in foreign country		
(i.e. ₹ 11,000/ ₹ 1,10,000 ×100)	10%	
Deduction under section 91 on ₹ 1,10,000 @ 2.696% (lower of average Indian-tax rate or average foreign tax rate)		2,966
Tax payable in India (₹ 13,936 – ₹ 2,966)		**10,970**

Notes:

1. Section 80D allows a higher deduction of up to ₹ 50,000 in respect of the medical premium paid to insure the heath of a senior citizen. Therefore, Nandita will be allowed deduction of ₹ 28,000 under section 80D, since she is a resident Indian of the age of 60 years.
2. The basic exemption limit for senior citizens is ₹ 3,00,000 and the age criterion for qualifying as a "senior citizen" for availing the higher basic exemption limit is 60 years. Accordingly, Nandita is eligible for the higher basic exemption limit of ₹ 3,00,000, since she is 60 years old.
3. An assessee shall be allowed deduction under section 91 provided all the following conditions are fulfilled:-
   (a) The assessee is a resident in India during the relevant previous year.
   (b) The income accrues or arises to him outside India during that previous year.
   (c) Such income is not deemed to accrue or arise in India during the previous year.
   (d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and the assessee has paid tax on such income in the foreign country.
   (e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.

In this case, since all the above conditions are satisfied, Nandita is eligible for deduction u/s 91.

ILLUSTRATION 6

Mr. Kamesh, an individual resident in India aged 52 years, furnishes you the following particulars of income earned in India, Country "X" and Country "Y" for the previous year 2019-20. India has not entered into double taxation avoidance agreement with these two countries.

Particulars	*₹*
Income from profession carried on in India	*7,50,000*
Agricultural income in Country "X" (gross)	*50,000*
Dividend received from a company incorporated in Country "Y" (gross)	*1,50,000*
Royalty income from a literary book from Country "X" (gross)	*6,00,000*
Expenses incurred for earning royalty	*50,000*
Business loss in Country "Y" (Proprietary business)	*65,000*
Rent from a house situated in Country "Y" (gross)	*2,40,000*
Municipal tax paid in respect of the above house in Country "Y" (not allowed as deduction in country "Y")	*10,000*

Note: *Business loss in Country "Y" not eligible for set off against other incomes as per law of that country.*

The rates of tax in Country "X" and Country "Y" are 10% and 20%, respectively.

Compute total income and tax payable by Mr. Kamesh in India for Assessment Year 2020-21.

SOLUTION

Computation of total income of Mr. Kamesh for A.Y.2020-21

Particulars	₹	₹
Income from House Property [House situated in country Y]		
Gross Annual Value[1]	2,40,000	
Less: Municipal taxes	10,000	
Net Annual Value	2,30,000	
Less: Deduction under section 24 – 30% of NAV	69,000	
		1,61,000
Profits and Gains of Business or Profession		
Income from profession carried on in India	7,50,000	
Royalty income from a literary book from Country X (after deducting expenses of ₹ 50,000)	5,50,000	
Less: Business loss in country Y set-off[2]	65,000	
		12,35,000
Income from Other Sources		
Agricultural income in country X	50,000	
Dividend received from a company in country Y	1,50,000	2,00,000
Gross Total Income		**15,96,000**
***Less:* Deduction under Chapter VIA**		
Under section 80QQB – Royalty income of a resident from literary work[3]		3,00,000
Total Income		**12,96,000**

Computation of tax liability of Mr. Kamesh for A.Y.2020-21

Particulars	₹
Tax on total income [30% of ₹ 2,96,000 + ₹ 1,12,500]	2,01,300
Add: Health and Education cess@4%	8,052
	2,09,352

[1] Rental Income has been taken as GAV in the absence of other information relating to fair rent, municipal value etc.

[2] As per section 70(1), inter-source set-off of income is permitted.

[3] It is assumed that the royalty earned outside India has been brought into India in convertible foreign exchange within a period of six months from the end of the previous year.

Less: Deduction under section 91 **(See Working Note below)**	69,739
Tax Payable	**1,39,613**
Tax payable (rounded off)	1,39,610

Working Note: Calculation of Rebate under section 91

	₹	₹
Average rate of tax in India [i.e., ₹ 2,09,352 / ₹ 12,96,000 x 100]	**16.154%**	
Average rate of tax in country X	**10%**	
Doubly taxed income pertaining to country X		
Agricultural Income	50,000	
Royalty Income [₹ 6,00,000 – ₹ 50,000 (Expenses) – ₹ 3,00,000 (deduction under section 80QQB)][4]	2,50,000	
	3,00,000	
Deduction under section 91 on ₹ 3,00,000 @10% [being the lower of average Indian tax rate (16.154%) and foreign tax rate (10%)]		30,000
Average rate of tax in country Y	**20%**	
Doubly taxed income pertaining to country Y		
Income from house property	1,61,000	
Dividend	1,50,000	
	3,11,000	
Less: Business loss set-off	65,000	
	2,46,000	
Deduction u/s 91 on ₹ 2,46,000 @16.154% (being the lower of average Indian tax rate (16.154%) and foreign tax rate (20%)]		39,739
Total rebate under section 91 (Country X + Country Y)		**69,739**

Note: Mr. Kamesh shall be allowed deduction u/s 91, since the following conditions are fulfilled:-

(a) He is a resident in India during the relevant previous year (i.e., P.Y.2019-20).

(b) The income in question accrues or arises to him outside India in foreign countries X and Y during that previous year and such income is not deemed to accrue or arise in India during the previous year.

[4] Doubly taxed income includes only that part of income which is included in the assessee's total income. The amount deducted under Chapter VIA is not doubly taxed and hence, no relief is allowable in respect of such amount – *CIT v. Dr. R.N. Jhanji (1990) 185 ITR 586 (Raj.).*

(c) The income in question has been subjected to income-tax in the foreign countries X and Y in his hands and it is presumed that he has paid tax on such income in those countries.

(d) There is no agreement u/s 90 for the relief or avoidance of double taxation between India and Countries X and Y where the income has accrued or arisen.

(4) Foreign Tax Credit [Rule 128 of Income-tax Rules, 1962]

(i) Year of availability of credit for foreign tax paid

An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule.

However, in a case where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.

(ii) Meaning of "Foreign tax" :

	Country/Specified Territory	Foreign Tax
(i)	in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A	the tax covered under the said agreement
(ii)	in respect of any other country or specified territory outside India	the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in section 91. For this purpose, income-tax in relation to any country includes any excess profits tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

(iii) Components of income-tax in respect of which FTC is available

Foreign Tax Credit (FTC) is available against the amount of tax, surcharge and cess payable under the Income-tax Act, 1961. However, it is not available in respect of any sum payable by way of interest, fee or penalty.

(iv) Manner of computing FTC

The credit of foreign tax would be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:-

(a) the credit would be the lower of the tax payable under the Income-tax Act, 1961 on such income and the foreign tax paid on such income.

However, where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess has to be ignored.

(b) the credit would be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.

***Note** – Students are advised to refer to Rule 128 of Income-tax Rules, 1961 given as Annexure 5 at the end of the Study Material.*

ILLUSTRATION 7

An individual resident in India, having income earned outside India in a country with which no agreement under section 90 exists, asks you to examine whether the credit for the tax paid on the foreign income will be allowed against his income-tax liability in India.

SOLUTION

The assessee is a resident in India and accordingly, the income accruing or arising to him globally is chargeable to tax in India. However, section 91 specifies that if a person resident in India has paid tax in any country with which no agreement under section 90 exists, then, for the purpose of relief or avoidance of double taxation, **a deduction is allowed from the Indian income-tax payable by him, of a sum calculated on such doubly taxed income at Indian rate of tax or the rate of tax of such foreign country, whichever is lower, or at the Indian rate of tax, if both the rates are equal.** Accordingly, the assessee shall not be given any credit of the tax paid on the income in other country, but shall be allowed a deduction from the Indian income-tax payable by him as per the scheme of section 91 read with Rule 128 on Foreign Tax Credit.

Summary

DT Relief under the Income-tax Act, 1961

Bilateral Relief [Section 90/90A]

Agreement with foreign countries or specified territories

Objective

- **The Central Government may enter into an agreement with the Government of any country outside India or specified territory or specified assn outside India,—**
  - for the granting of relief in respect of doubly taxed income
  - for the avoidance of double taxation of income
  - for exchange of information for the prevention of evasion or avoidance of income-tax
  - for recovery of income-tax

Taxability

- Taxability of income would be detd based on DTAA or the Income-tax Act, 1961, whichever is more beneficial.

Charge of tax on foreign Company

- 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.

Tax Residency Certificate (TRC)

- In order to claim DT relief, the non-resident to whom such DTAA applies, has to obtain a TRC from the Government of that country or specified territory.
- The non-resident to also provide such other documents and information, as may be prescribed, for claiming treaty benefits.

Unilateral Relief [Section 91]

Countries with which no agreement exists

Applicability

- Assessee, who is a resident in India during the PY

Conditions

- The income accrues or arises to him outside India.
- The income is not deemed to accrue or arise in India during the PY.
- The income in question has been subjected to income-tax in the foreign country in the hands of the assessee.
- The assessee has paid tax on the income in the foreign country.
- There is no agrmt for relief from DT between India and the other country where the income has accrued or arisen.

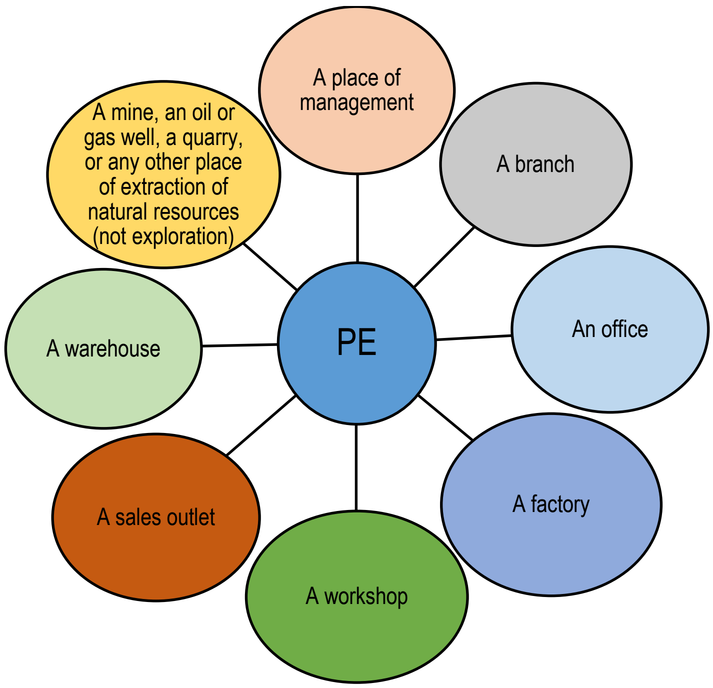
Computation of Relief

- Doubly taxed income **x** Indian rate of tax or Rate of tax in the said country, whichever is lower

3.4 CONCEPT OF PERMANENT ESTABLISHMENT

In order to determine the taxability of business income of foreign enterprises operating in India, it is important to determine the existence of a Permanent Establishment ('PE'). Article 5(1) of the DTAA provides that for the purpose 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. The term 'Enterprise' has been defined in section 92F(iii) [See discussion under section 92A in Chapter 1].

According to Article 5(2), the term PE includes



(1) Permanent establishment means a fixed place of business through which the business of an enterprises is wholly or partly carried on.

(2) Every DTAA has a specific clause, which will deal with an explanation of permanent establishment for the purpose of such DTAA.

(3) Business Income of a non-resident will not be taxed in India, unless such non-resident has a permanent establishment in India.

(4) Taxability of income under business connection and permanent establishment is explained here below:

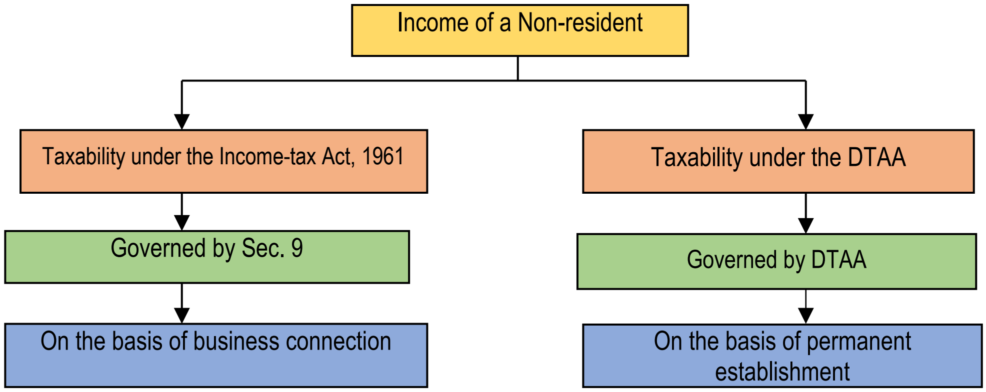


ILLUSTRATION 8

The concept of Permanent Establishment is one of the most important concepts in determining the tax implications of cross border transactions. Examine the significance thereof, when such transactions are governed by Double Taxation Avoidance Agreements (DTAA).

SOLUTION

Double Taxation Avoidance Agreements (DTAAs) generally contain an Article providing that business income is taxable in the country of residence, unless the enterprise has a permanent establishment in the country of source, and such income can be attributed to the permanent establishment.

As per section 92F(iiia), the term "Permanent Establishment" includes a fixed place of business through which the business of an enterprise is wholly or partly carried on.

As per this definition, to constitute a permanent establishment, there must be a place of business which is fixed and the business of the enterprise must be carried out wholly or partly through this place.

Section 9(1)(i) requires existence of business connection for deeming business income to accrue or arise in India. DTAAs however provide that business income is taxable only if there is a permanent establishment in India.

Therefore, in cases covered by DTAAs, where there is no permanent establishment in India, business income cannot be brought to tax due to existence of business connection as per section 9(1)(i).

However, in cases not covered by DTAAs, business income attributable to business connection is taxable.

3.5 TAXATION OF BUSINESS PROCESS OUTSOURCING UNITS IN INDIA

The provisions containing taxation of IT-enabled business process outsourcing units are not contained in the Income-tax Act, 1961 but are given in *Circular No.5/2004 dated 28.9.2004* issued by CBDT. The provisions are briefed hereunder -

(a) A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a Permanent Establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961.

(b) However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the Permanent Establishment of the non-resident entity.

(c) The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent Establishment.

(d) A non-resident or a foreign company is treated as having a Permanent Establishment in India if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the Permanent Establishment becomes taxable in India.

(e) If a foreign enterprise carries on business in another country through a Permanent Establishment situated therein, the profits of the enterprise may be taxed in the other country but only so much of them as is attributable to the Permanent Establishment.

(f) Profits are to be attributed to the Permanent Establishment as 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.

(g) In determining the profits of a Permanent Establishment there shall be allowed as deduction, 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.

(h) The expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961.

(i) The profits to be attributed to a Permanent Establishment are those which that Permanent Establishment would have made if, instead of dealing with its Head Office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle".

(j) Hence, in determining the profits attributable to an IT-enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of "arm's length principle".

CHAPTER 4

ADVANCE RULINGS

LEARNING OUTCOMES

After studying this Chapter, you will be able to–

- **appreciate** the meaning and scope of the term "advance ruling", the need for obtaining advance ruling and the restricted binding nature of an advance ruling;
- **appreciate** the constitution of Authority for Advance Rulings;
- **examine** the procedure for making an application to the Authority for Advance Rulings and the procedure to be followed by the Authority on receipt of application;
- **pinpoint** the circumstances when an advance ruling can be declared void;
- **integrate, analyse and apply** the advance ruling provisions for addressing relevant issues.

4.1 INTRODUCTION

Chapter XIX-B, consisting of sections 245N to 245V provides a scheme for giving advance rulings in respect of transactions involving non-residents and specified residents with a view to avoiding needless litigation and promoting better tax-payer relations.

4.2 DEFINITIONS

(1) Advance Ruling [Section 245N(a)]: The meaning of Advance Ruling is detailed hereunder:

Section	Determination by the Authority
245N(a)(i)	in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant.
245N(a)(ii)	in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident and such determination shall include the determination of any question of law or of fact specified in the application.
245N(a)(iia)	in relation to the tax liability of a resident applicant, arising out of a transaction which has been undertaken or is proposed to be undertaken by such applicant and such determination shall include the determination of any question of law or of fact specified in the application.
245N(a)(iii)	in respect of an issue relating to computation of total income which is pending before any Income-tax Authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or fact in relation to such computation of total income specified in the application.
245N(a)(iv)	or decision whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement as referred to in Chapter X-A or not.

(2) Applicant [Section 245N(b)(A)]: 'Applicant' means any person who –

(i) is a non-resident referred to in section 245N(a)(i) above; or

(ii) is a resident referred to in section 245N(a)(ii) above; or

(iii) is a resident referred to in section 245N(a)(iia) above falling within any such class or category of persons as the Central Government may, by notification in the Official Gazette, specify.

[A resident in relation to his tax liability arising out of one or more transactions valuing ₹ 100 crore or more in total which has been undertaken or is proposed to be

undertaken would be an applicant – Notification No.73/2014 dated 28.11.2014]; or

(iv) is a resident falling within such class or category of persons as the Central Government may, by notification in the Official Gazette, specify in this behalf *[Public sector company as defined under section 2(36A) of the Income-tax Act, 1961 – Notification No. 725(E) dated 3.8.2000]*; or

(v) is referred to in section 245N(a)(iv) above; and

who makes an application for advance ruling under section 245Q(1).

On account of the merger of Authority for Advance Rulings for income-tax, central excise, customs duty and service tax, the definition of applicant would now also include an applicant defined under the Central Excise Act, 1944, Customs Act, 1962 and the Finance Act, 1994[1].

Who can be an applicant in relation to different clauses of section 245N(a) defining advance ruling?

S. No.	Applicant u/s 245N(b)	Advance Ruling u/s 245N(a) means determination by the AAR in relation to
(i)	Non-resident (NR)	A transaction which has been undertaken or is proposed to be undertaken by him.
(ii)	Resident	The tax liability of a NR arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such NR and such determination shall include the determination of any question of law or of fact specified in the application.
(iii)	Resident of class or category of persons notified by Central Government	The tax liability of a resident applicant, arising out of a transaction which has been undertaken or is proposed to be undertaken by such applicant and such determination shall include the determination of any question of law or of fact specified in the application.
	Note: *The Central Government notified a resident, in relation to his tax liability arising out of one or more transactions valuing ₹ 100 crore or more in total.*	
(iv)	Resident of class or category of persons notified by Central Government	an issue relating to computation of total income which is pending before any Income-tax Authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or fact in relation to such computation of total income specified in the application.
	Note: *A public sector undertaking has been notified by the Central Government.*	

[1] No amendment has been made in pursuance of GST being effective from 01.07.2017

(v)	Resident or NR	whether an arrangement, which is proposed to be undertaken by any person being a resident or a NR, is an impermissible avoidance arrangement as referred to in Chapter X-A or not.

Restrictions on Appellate Authority: Section 245RR provides that where a resident applicant has made an application to AAR in respect of an issue for decision of AAR, then, any Income-tax Authority or Tribunal shall not take any decision in respect of such issues. In other words, a resident assessee cannot pursue both the remedies, i.e. an appeal or revision before Income-tax Authority/Appellate Authority as well as an application for Advance Ruling to AAR, in respect of an issue.

4.3 AUTHORITY FOR ADVANCE RULINGS [SECTION 245-O]

The Authority for Advance Rulings shall be constituted by the Central Government.

Particulars	Provisions
Composition of AAR	AAR to consist of a Chairman and such number of Vice Chairmen, revenue Members and law Members as the Central Government may, by notification, appoint. **Qualifications for appointment**: (a) **Chairman** – a person who has been a judge of the Supreme Court or the Chief Justice of a High Court or for at least seven years a judge of a High Court; (b) **Vice Chairman** – a person who has been a Judge of a High Court; (c) **A Revenue Member from the Indian Revenue Service** – a person who is, or is qualified to be, a Member of the Board on the date of occurrence of vacancy; (d) **A Revenue Member from the Indian Customs and Central Excise Service** – a person who is, or is qualified to be a Member of the Central Board of Excise and Customs on the date of occurrence of vacancy. (e) **A law Member from the Indian legal service** – a person who is, or is qualified to be, an Additional Secretary to the Government of India ('GOI') on the date of occurrence of vacancy. ***Note*** *– The above qualifications are relevant for appointments made before 26.5.2017. Appointments made on or after 26.5.2017 shall be governed by section 184 of the Finance Act, 2017* ***[Refer para 4.4 below]***
Terms & Conditions	The terms and conditions of service and the salaries and allowances payable to the Members shall be such as may be prescribed.

	Note** – The terms and conditions in respect of appointments made on or after 26.5.2017 shall be governed by section 184 of the Finance Act, 2017* ***[Refer para 4.4 below]
Officers & Employees	The Central Government shall provide to the Authority with such officers and employees, as may be necessary, for the efficient discharge of the functions of the Authority under the Act.
Location of AAR and benches	The Authority shall be located in the National Capital Territory of Delhi and its benches shall be located at places as notified by the Central Government.
Constitution of Benches	The powers and functions of the AAR may be discharged by its Benches as may be constituted by the Chairman from amongst its Members thereof.
Composition of Benches	A Bench shall consist of the Chairman or the Vice-Chairman and one revenue and one law Member. However, where the **Authority is dealing** with an application seeking advance ruling in **any matter relating to the Income-tax Act**, the **revenue member** of the Bench shall be such **Member from the Indian Revenue Service**, who is, or is qualified to be, a member of the Board.
Any vacancy in the office of the Chairman by reason of his death, resignation or otherwise	The senior-most Vice Chairman shall act as the Chairman until the date on which a new Chairman, appointed in accordance with the provisions of the Act to fill such vacancy, enters upon his office
In case the Chairman is unable to discharge his functions owing to absence, illness or other cause	The senior-most Vice Chairman shall discharge the functions of the Chairman until the date on which the Chairman resumes his duties.

4.4 QUALIFICATIONS, TERMS AND CONDITIONS OF SERVICE OF CHAIRMAN, VICE CHAIRMAN AND MEMBERS [SECTION 245-OA]

The qualifications, appointment, term of office, salaries and allowances, resignation, removal and the other terms and conditions of service of the Chairman, Vice-Chairman and other Members of the Authority appointed on or after 26.05.2017, being the date on which the provisions of Part XIV of Chapter VI of the Finance Act, 2017 came into force, shall be governed by the provisions of section 184 of Finance Act 2017.

However, the Chairman, Vice-Chairman and Member appointed before 26.05.2017 shall continue to be governed by the provisions of the Act and the rules made thereunder as if the provisions of section 184 of the Finance Act, 2017 had not come into force.

Section 184 of Finance Act, 2017

(1) **Power to Central Government to make rules:** The Central Government may, by notification, make rules to provide for qualifications, appointment, term of office, salaries and allowances, resignation, removal and the other terms and conditions of service of the Chairman, Vice-Chairman or Member of the Authority.

(2) **Term of Chairman, Vice-Chairman or Member of the Authority:** The Chairman, Vice-Chairman or Member of the Authority shall hold office for such term as specified in the rules made by the Central Government but not exceeding 5 years from the date on which he enters upon his office and shall be eligible for reappointment.

(3) **Age Criteria of Chairman, Vice-Chairman or Member of the Authority:** No Chairman, Vice-Chairman or Member of the Authority shall hold office as such after he has attained such age as specified in the rules made by the Central Government which shall not exceed -

In case of	*Age*
Chairman	*seventy years*
Vice-Chairman or any other Member	*sixty-seven years*

Accordingly, the Central Government had notified "Tribunal, Appellate Tribunal and other Authorities (Qualifications, Experience and other Conditions of Service of Members) Rules, 2017", to specify the qualifications, appointment, term of office, salaries and allowances, resignation, removal and the other terms and conditions of service of the Chairman, Vice-Chairman and other Members of the Authority. Qualifications and term of office of the Chairman, Vice-Chairman and other Members of the Authority is as follows:

Particulars	Provisions
Qualifications for appointment	(a) **Chairman** – a person who - is or has been or is qualified to be a judge of the Supreme Court or - is or has been a Chief Justice of a High Court or - has, for at least 7 years, been a Judge of a High Court or - has, for at least 3 years, been a Vice-Chairman, Revenue Member or Law Member of the Authority for Advance Ruling or - is a person of ability, integrity and standing, and having special knowledge of, and professional experience of not less than 25 years in economics, business, commerce,

	law, finance, accountancy, management, industry, public affairs, administration, taxation or any other matter which in the opinion of the Central Government is useful to the Authority. (b) **Vice Chairman** – a person who is, or has been, or is qualified to be, a Judge of a High Court; (c) **Revenue Member** - from the Indian Revenue Service is qualified to be a Member of the Central Board of Direct Taxes Board and - an officer of the Indian Customs and Central Excise Service, who is qualified to be a Member of the Central Board of Excise and Customs. (d) **A law Member from the Indian legal service** – a person who is an Additional Secretary to the Government of India ('GOI').
Term of Chairman, Vice-Chairman or Member of the Authority	The Chairman, Vice-Chairman or Member of the Authority shall hold office for a term of three years.
Age Criteria of Chairman, Vice-Chairman or Member of the Authority	***In case of*** — ***Age*** *Chairman* — *70 years* *Vice-Chairman* — *65 years* *Member* — *62 years*

4.5 VACANCIES, ETC., NOT TO INVALIDATE PROCEEDINGS [SECTION 245P]

No proceeding before, or pronouncement of advance ruling by, the Authority shall be questioned or shall be invalid on the ground merely of the existence of any vacancy or defect in the constitution of the Authority.

4.6 APPLICATION FOR ADVANCE RULING [SECTION 245Q]

Section 245Q(1) provides that an applicant desirous of obtaining an advance ruling may make an application stating the question on which the advance ruling is sought in the prescribed form and in the prescribed manner.

As per section 245Q(2), the application shall be made in quadruplicate and be accompanied by a fee of ₹ 10,000 or such fee as may be prescribed, whichever is higher.

Rule 44E prescribes the fees mentioned in column (3) to be paid by the applicant mentioned in column (1) in the cases of column (2).

Category of applicant	Category of case	Fee
(1)	(2)	(3)
An applicant referred to in sub-clauses (i) or (ii) or (iia) of clause (b) of section 245N	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought does not exceed ₹ 100 crore.	₹ 2 lacs
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds ₹ 100 crore but does not exceed ₹ 300 crore.	₹ 5 lacs
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds ₹ 300 crore.	₹ 10 lacs
Any other applicant	In all cases	₹ 10000

Rule 44E prescribes the form of application for obtaining an advance ruling. Every application under Rule 44E shall be accompanied by the proof of payment of fees.

Section 245Q(3) provides that an applicant may withdraw an application within 30 days from the date of the application.

ILLUSTRATION 1

Q, a non-resident, made an application to the Authority for Advance Rulings on 2.7.2019 in relation to a transaction proposed to be undertaken by him. On 31.8.2019, he decides to withdraw the said application. Can he withdraw the application on 31.8.2019?

SOLUTION

Section 245Q(3) of the Income-tax Act, 1961 provides that an applicant, who has sought for an advance ruling, may withdraw the application within 30 days from the date of the application. Since more than 30 days have elapsed since the date of application by Q to the Authority for Advance Rulings, he cannot withdraw the application.

However, the Authority for Advance Rulings (AAR), in *M.K.Jain AAR No.644 of 2004*, has observed that though section 245Q(3) provides that an application may be withdrawn by the applicant within 30 days from the date of the application, this, however, does not preclude the AAR from permitting withdrawal of the application after the said period, if the circumstances of the case so justify.

4.7 PROCEDURE ON RECEIPT OF APPLICATION [SECTION 245R]

The Authority on receipt of an application will send a copy to the Principal Commissioner or Commissioner concerned and wherever considered necessary, also call upon the Principal Commissioner or Commissioner to furnish relevant records. Such records will be returned to the Principal Commissioner or Commissioner as soon as possible.

The Authority may either allow or reject an application. However, the Authority **shall not allow** an application where the question raised in the application is:

Pending with income-tax authorities/ tribunal/court	is already pending before any income-tax authority, or Appellate Tribunal or any court. However, a resident falling within any class or category of persons as notified by the Central Government i.e., a public sector undertaking can seek for advance ruling even if question raised is pending before any income-tax authority or Appellate.
Determination of Fair Market Value	involves the determination of the fair market value of any property;
Transaction designed for avoidance of income-tax	relates to a transaction or issue which is designed *prima facie* for avoidance of income-tax (except in case of a resident applicant falling within any class or category of persons as notified by the Central Government i.e., a public sector undertaking or in the case of resident or a non-resident for determination of whether an arrangement, which is proposed to be undertaken is an impermissible avoidance arrangement).

However, no application shall be rejected unless an opportunity has been given to the applicant of being heard. Further, where an application is rejected, the reason for rejection shall be given in the order. A copy of every order shall be sent to the applicant and to the PCIT/CIT.

Where an application is allowed, the Authority would pronounce its advance ruling on that question specified in the application, after examining such further material as may be placed before it by the applicant or obtained by the Authority.

An applicant on request can appear either in person or can be represented through a duly authorised representative. The authority will pronounce the advance ruling **within 6 months** from the receipt of application by the authority and the copy of advance ruling pronounced, duly signed by the Members and certified, shall be sent to the applicant and to the PCIT/CIT.

ILLUSTRATION 2

An Irish company, Phi plc., entered into a contract with an Indian company, Beta Ltd., for provision of technical know-how and made an application to the Authority for Advance Rulings for advance *ruling on the rate of withholding tax on receipts from Beta Ltd. Beta Ltd. had also made an application to the Assessing Officer for determination of the rate at which tax is deductible on the said payment to Phi plc. The Authority for Advance Rulings rejected the application of Phi plc. on the ground that the question raised in the application is already pending before an income tax authority. Is the rejection of the application of Phi plc. justified in law?*

SOLUTION

This issue came up before the AAR in, *Nuclear Power Corporation of India Ltd. In Re, [2012] 343 ITR 220*, wherein it was held that an advance ruling is not only applicant specific, but is also transaction specific. The advance ruling is on a transaction entered into or undertaken by the applicant. That is why section 245S specifies that a ruling is binding on the applicant, **the transaction** and the Principal Commissioner or Commissioner of Income-tax and those subordinate to him, and not only on the applicant.

What is barred by the first proviso to section 245R(2) of the Act in the context of clause (i) thereof is the allowing of an application under section 245R(2) of the Act where "the question raised in the application is already pending before any Income-tax authority, or Appellate Tribunal or any court". The significance of the dropping of the words, "in the applicant's case" with effect from June 1, 2000, cannot be wholly ignored.

On the basis of this view expressed by the AAR in the above case, explaining the impact of the dropping of the words "in the applicant's case" with effect from 1.6.2000, a view can be taken that the AAR can reject the application made by Phi plc. before the AAR on the ground that similar issue is pending before the Assessing Officer in respect of the same transaction i.e., provision of technical know to Beta Ltd.

Note – *The issue relates to the admission or rejection of the application filed before the Advance Rulings Authority on the grounds specified in clause (i) of the first proviso to sub-section (2) of section 245R of the Income-tax Act, 1961.*

The first proviso to section 245R(2) has been substituted by the Finance Act, 2000 with effect from 1.6.2000. Clause (i) of the first proviso, prior to and post amendment, reads as follows:

Prior to 1.6.2000	***On or After 1.6.2000***
Provided that the Authority shall not allow the application ***except in the case of a resident applicant*** *where the question raised in the application is already pending* ***in the applicant's case*** *before any income-tax authority, the Appellate Tribunal or any court;*	*Provided that the Authority shall not allow the application where the question raised in the application is already pending before any income-tax authority or Appellate Tribunal or any court.*

The words "except in the case of a resident applicant" and "in the applicant's case" has been removed in clause (i) of the first proviso with effect from 1.6.2000. However, the Explanatory

Memorandum to the Finance Act, 2000, explaining the impact of the substitution, reads as follows "It is proposed to substitute the proviso to provide that the Authority shall not allow the application when the question raised is already pending in the applicant's case before any income-tax authority, Appellate Tribunal or any court in regard to a non-resident applicant and resident applicant in relation to a transaction with a non-resident". Therefore, according to the intent expressed in the Explanatory Memorandum, the AAR shall not allow the application both in the case of resident and non-resident applicant if the question raised is already ***pending in the applicant's case*** *before any income-tax authority. Thus, as per the Explanatory Memorandum, it is possible to take a view that even post-amendment, the Authority shall not allow the application only where a question is* ***pending in the applicant's case*** *before any income-tax authority. Thus, an alternative view is possible on the basis of the AAR ruling in Ericsson Telephone Corporation India AB v. CIT (1997) 224 ITR 203, which continues to hold good even after the amendment, if we consider the intent expressed in the Explanatory Memorandum.* ***Accordingly, based on this view, the AAR can allow the application made by Phi plc., even if the question raised in the application is pending before the Assessing Officer in Beta Ltd.'s case.***

4.8 APPLICABILITY OF ADVANCE RULING [SECTION 245S]

The advance ruling shall be binding only on

- **Applicant who had sought it**
- **In respect of the specific transaction in relation to which it was sought**
- **on the Principal Commissioner or Commissioner and the income-tax authorities subordinate to the Principal Commissioner or Commissioner in respect of the applicant and the said transaction.**

The advance ruling will continue to remain in force unless there is a change either in law or in fact on the basis of which the advance ruling was pronounced.

ILLUSTRATION 3

Mr. Balram is a non-resident. The appeal pertaining to the assessment year 2018-19 is pending before the Income-tax Appellate Tribunal, the issue involved being computation of export profit and tax thereon. The same issue persists for the assessment year 2019-20 as well. Mr. Balram's brother Mr. Krishna has obtained an advance ruling under Chapter XIX - B of Income-tax Act, 1961 from the Authority for Advance Rulings on an identical issue. Mr. Balram proposes to use *the said ruling for his assessment pertaining to the assessment year 2019-20. Can he do so?*

SOLUTION

As per section 245S(1), the advance ruling pronounced under section 245R by the Authority for Advance Rulings shall be binding only on the applicant who had sought it and in respect of the specific transaction in relation to which advance ruling was sought. It shall also be binding on the Principal Commissioner/Commissioner and the income-tax authorities subordinate to him, in respect of the concerned applicant and the specific transaction.

In view of the above provision, Mr. Balram cannot use the advance ruling, obtained on an identical issue by his brother, for his assessment pertaining to the assessment year 2019-20.

Note *– Though the ruling of the Authority for Advance Rulings is not binding on others but there is no bar on the Tribunal taking a view or forming an opinion in consonance with the reasoning of the Authority for Advance Rulings dehors the binding nature [CIT v. P. Sekar Trust (2010) 321 ITR 305 (Mad.)].*

4.9 ADVANCE RULING TO BE VOID IN CERTAIN CIRCUMSTANCES [SECTION 245T]

Where the Authority finds, on a representation made to it by the PCIT/CIT or otherwise, that an advance ruling has been obtained by the applicant by fraud or misrepresentation of facts, the Authority may, by order, declare such ruling to be *void ab initio.* The provisions of the Act shall apply (excluding the period beginning with the date of such advance ruling and ending with the date of order under this section) to the applicant as if such advance ruling had never been made. A copy of this order shall be sent to the applicant and the Principal Commissioner or Commissioner.

ILLUSTRATION 4

Examine when can an advance ruling pronounced by the Authority for Advance Rulings be declared void. What is the consequence?

SOLUTION

As per section 245T, an advance ruling can be declared to be *void ab initio* by the Authority for Advance Rulings if, on a representation made to it by the Principal Commissioner or Commissioner or otherwise, it finds that the ruling has been obtained by fraud or misrepresentation of facts. Thereafter, all the provisions of the Act will apply as if no such advance ruling has been made. A copy of such order shall be sent to the applicant and the Principal Commissioner or Commissioner.

4.10 POWERS OF THE AUTHORITY [SECTION 245U]

The Authority shall have all the powers of the Civil Court in respect of discovery and inspection, enforcing the attendance of any person, including any officer of a banking company and examining on oath, issuing commissions and compelling the production of books of accounts and other documents. The Authority shall be deemed to be a Civil Court for the purposes of section 195 of the Code of Criminal Procedure, 1973 which provides for prosecution for contempt of lawful authority of public servants, for offences against public justice. Every proceeding before the Authority shall be deemed to be a judicial proceeding under the Indian Penal Code.

However, the Authority shall not be deemed to a Civil Court for the purpose of Chapter XXVI of the Code of Criminal Procedure, 1973 containing the provisions as to offences affecting the administration of justice.

ILLUSTRATION 5

The Authority for Advance Rulings has the powers of compelling the production of books of account – Examine the correctness or otherwise of this statement.

SOLUTION

The statement is correct.

Under section 245U, the Authority for Advance Rulings shall have all the powers vested in the Civil Court under the Code of Civil Procedure, 1908 as are referred to in section 131.

Accordingly, the Authority for Advance Rulings shall have the same powers as are vested in a court under the Code of Civil Procedure, 1908, when trying a suit in respect of the following matters, namely -

(1) discovery and inspection;

(2) enforcing the attendance of any person, including any officer of a banking company and examining him on oath;

(3) compelling the production of books of account and other documents; and

(4) issuing commissions.

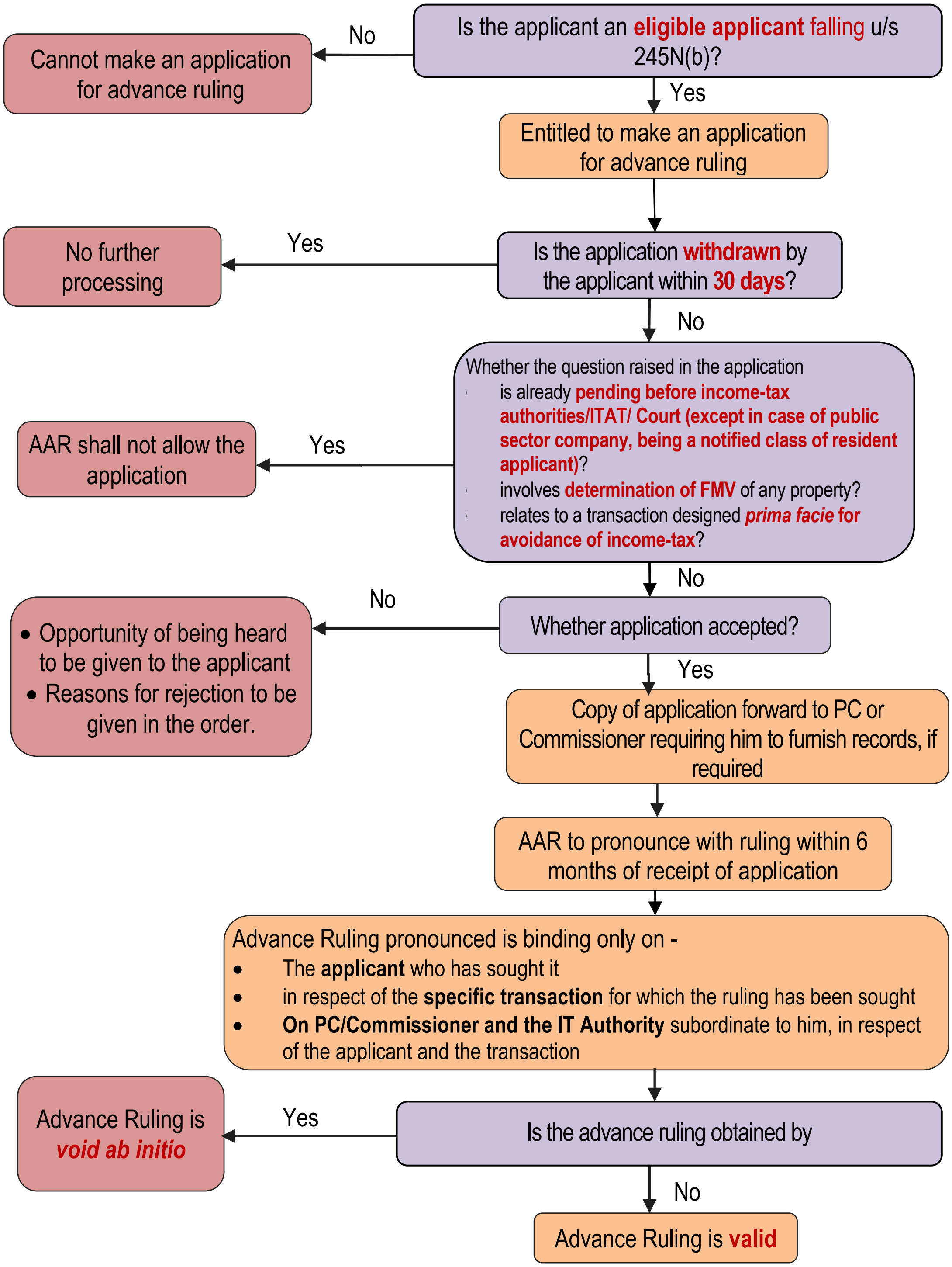
Therefore, the Authority for Advance Ruling has the powers of compelling the production of books of account.

4.11 PROCEDURE OF AUTHORITY [SECTION 245V]

The Authority shall, subject to the provisions of this Chapter, have power to regulate its own procedure in all matters arising out of the exercise of its powers under the Act.

For ease of reference, the process of application for Advance Ruling is explained below in a summarized form:

Overview of Advance Ruling Procedure



CHAPTER 5

OVERVIEW OF THE BLACK MONEY & IMPOSITION OF TAX LAW

[This Chapter provides an overview of the law and procedures under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 and the related rules]

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **determine** the value of an undisclosed asset;
- **appreciate** the scope of total undisclosed foreign income and asset;
- **compute** total undisclosed foreign income and asset for levy of tax under this Act;
- **identify** the powers of tax authorities under this Act;
- **appreciate** the provisions relating to assessment, appeal and revision under the provisions of this Act;
- **appreciate** the penalty and prosecution provisions for various offences under this Act;
- **integrate, analyse and apply** the relevant provisions of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 and related Rules to address relevant issues and make computations.

5.1 INTRODUCTION

The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, passed on 26.5.2015, provides for stringent taxation of any undisclosed income in relation to foreign income and assets. This new law has been formulated to act as a strong deterrent and curb the menace of black money stashed away abroad by Indians. This law would is effective from **A.Y.2016-17**, unless otherwise provided in any section of this Act, and extends to the **whole of India.**

5.2 BASIS OF CHARGE [CHAPTER II – SECTIONS 3 TO 5]

(i) **Charge of tax [Section 3]**

(A) **Rate of tax [Section 3(1)]** - Every assessee would be liable to tax@30% in respect of his undisclosed foreign income and asset of the previous year.

However, an **undisclosed asset located outside India** shall be charged to tax on its value in the previous year in which such asset comes to the notice of the Assessing Officer.

Meaning of certain terms:

Term	Section	Meaning
Undisclosed foreign income and asset	2(12)	The total amount of undisclosed income of an assessee from a source located outside India and the value of an undisclosed asset located outside India, referred to in section 4, and computed in the manner laid down in section 5
Undisclosed asset located outside India	2(11)	An asset (including financial interest in an entity) located outside India, - held by the assessee in his name or - in respect of which he is a beneficial owner, and - he has no explanation about the source of investment in such asset or the explanation given by him is in the opinion of the Assessing Officer unsatisfactory.
Assessee	2(2)	*A person,—* *(a) being a **resident in India** within the meaning of section 6 of the Income-tax Act, 1961 in the previous year; or* *(b) being a **non-resident or not ordinarily resident in India** within the meaning of section 6(6) of the Income-tax Act, 1961 in the previous year, **who was resident in India either in the previous year***

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to which the income referred to in section 4 relates*; or in the previous year in which* ***the undisclosed asset located outside India was acquired****:*

However, the previous year, in case of acquisition of undisclosed asset outside India, shall be determined ***<u>without giving effect to the provisions of section 72(c)</u>*** *which states that where any asset has been acquired or made prior to commencement of this Act, and no declaration in respect of such asset is made under Chapter VI (Tax Compliance for Undisclosed Foreign Income and Assets), such asset shall be deemed to have been acquired or made in the year in which a notice under section 10 is issued by the Assessing Officer and the provisions of this Act would apply accordingly*

In effect, it has been clarified that a person would be an assessee, if he is resident in the previous year in which the undisclosed asset located outside India was actually acquired by him and not the year in which notice under section 10 is issued by the Assessing Officer.
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<td>Previous year</td>
<td>2(9)</td>
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<table>
<tr><th rowspan="2"></th><th rowspan="2">Circumstance</th><th colspan="2">Period</th></tr>
<tr><th>Beginning with</th><th>Ending with</th></tr>
<tr><td>a</td><td>In case of a newly set up business</td><td>The date of setting up of a business</td><td>The date of closure of business or 31st March following the date of setting up of business, whichever is earlier.</td></tr>
<tr><td>b</td><td>Where a new source of income comes into existence</td><td>The date on which the new source comes into existence</td><td>The date of closure of business or 31st March following the date on which such new source comes into existence, whichever is earlier.</td></tr>
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		c	In case of discontinuance of business or dissolution/ liquidation	1st day of the FY	The date of discontinuance of business [other than business referred to in (b) above] or dissolution of an unincorporated body or liquidation of a company, as the case may be.
		d	In any other case	1st April of the relevant year	31st March following. (i.e., a period of 12 months commencing from 1st April and ending on 31st March)

(B) **Relevant previous year of chargeability to tax [Proviso to section 3(1)]** - Undisclosed asset located outside India to be charged to tax on its value in the previous year in which the asset comes to the notice of the Assessing Officer.

(C) **Value of an undisclosed asset [Section 3(2)]** - The **fair market value** of an asset (including financial interest in any entity) determined in the prescribed manner as laid down in Rule 3 of Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Rules, 2015, would be the value of an undisclosed asset. The following table gives the manner of determination of fair market value of different assets -

	Asset	Fair market value as per Rule 3(1)
(a)	Bullion, jewellery or precious stone	Higher of – (i) its cost of acquisition; and (ii) the price that the bullion, jewellery or precious stone shall ordinarily fetch if sold in the **open market on the valuation date.** For this purpose, the assessee may obtain a report from a valuer recognised by the Government of a country or specified territory outside India or any of its agencies for the purpose of valuation of

		bullion, jewellery or precious stone under any regulation or law.
(b)	Archaeological collections, drawings, paintings, sculptures or any work of art (artistic work)	Higher of - (i) Cost of acquisition; and (ii) the price that the artistic work shall ordinarily fetch if sold in the open market on the valuation date for which the assessee may obtain a report from a valuer recognised by the Government of a country or specified territory outside India or any of its agencies for the purpose of valuation of artistic work under any regulation or law;
(c)(I)	Quoted Shares and securities	Higher of – (i) cost of acquisition; and (ii) the price as determined in the following manner, namely:— (A) the average of the lowest and highest price of such shares and securities quoted on any established securities market on the valuation date; or (B) where on the valuation date there is no trading in such shares and securities on any established securities market, average of the lowest and highest price of such shares and securities on any established securities market on a date immediately preceding the valuation date when such shares and securities were traded on such securities market;
(c)(II)	Unquoted shares and securities	Higher of – (i) Cost of acquisition; and (ii) The value, on the valuation date, of such equity shares as determined in the following manner, namely:— the fair market value of unquoted equity shares = $\frac{(A + B - L)}{PE} \times PV$

		Where,	
		A	book value of all the assets (other than bullion, jewellery, precious stone, artistic work, shares, securities and immovable property) ***minus*** (i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any, and (ii) any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;
		B	fair market value of bullion, jewellery, precious stone, artistic work, shares, securities and immovable property as determined in the manner provided in this rule
		L	book value of liabilities, but not including the following amounts, namely:— (i) the paid-up capital in respect of equity shares; (ii) the amount set apart for payment of dividends on preference shares and equity shares; (iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation (iv) any amount representing provision for taxation, other than amount of income-tax paid, if any, less the amount of income-tax claimed as refund, if any, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto; (v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities; (vi) any amount representing contingent liabilities other than arrears of dividends

		payable in respect of cumulative preference shares; PE – total amount of paid up equity share capital as shown in the balance sheet; PV – the paid up value of such equity shares
(c)(III)	Unquoted share and security other than equity share in a company	Higher of,— (i) its cost of acquisition; and (ii) the price that the share or security shall ordinarily fetch if sold in the open market on the valuation date for which the assessee may obtain a report from a valuer recognised by the Government of a country or specified territory outside India or any of its agencies for the purpose of valuation of share and security under any regulation or law
(d)	Immovable property	Higher of,— (i) its cost of acquisition; and (ii) the price that the property shall ordinarily fetch if sold in the open market on the valuation date for which the assessee may obtain a valuation report from a valuer recognised by the Government of a country or specified territory outside India in which the property is located or any of its agencies for the purpose of valuation of immovable property under any regulation or law
(e)	An account with a bank	(I) the sum of all the deposits made in the account with the bank since the date of opening of the account; or (II) where a declaration of such account has been made under Chapter VI and the value of the account as computed under sub-clause (I) has been charged to tax and penalty under that Chapter, the sum of all the deposits made in the account with the bank since the date of such declaration. However, where any deposit is made from the proceeds of any withdrawal from the account, such deposit shall not be taken into consideration while computing the value of the account
(f) & (g)	value of an interest of a person in a partnership firm	The net asset of the firm, AOP or LLP on the valuation date shall first be determined. Thereafter, the portion of the net wealth of the firm, AOP or LLP as is equal to the amount of its capital shall be

<table>
<tr><td></td><td>or in an AOP or a LLP of which he is a member</td><td>allocated among its partners or members in the proportion in which capital has been contributed by them.
The residue of the net asset shall be allocated among the partners or members in the following manner:
<table><tr><th>Circumstance</th><th>Manner of allocation</th></tr><tr><td>In the event of dissolution of the firm or AOP</td><td>In accordance with the agreement of partnership or association for distribution of assets</td></tr><tr><td>In the absence of such agreement for distribution of assets on dissolution</td><td>in the proportion in which the partners or members are entitled to share profits</td></tr></table>The sum total of the amount so allocated to a partner or member shall be treated as the value of the interest of that partner or member in the partnership or association.
Net asset of the firm, AOP or LLP shall be (A + B - L), determined in the manner specified in C(II) above.</td></tr>
<tr><td>(h)</td><td>Any other asset</td><td>Higher of –
(I) its cost of acquisition or the amount invested; and
(II) the price that the asset would fetch if sold in the open market on the valuation date in an arm's-length transaction.</td></tr>
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FMV of an asset (other than bank account) transferred before the valuation date [Rule 3(2)]:

Where an asset (other than a bank account) was transferred before the valuation date, the FMV of such asset shall be **higher of its cost of acquisition and the sale price**. This is notwithstanding the valuation rules given in Rule 3(1),

However, where such asset was transferred without consideration or for inadequate consideration before the valuation date, the FMV of the asset shall be higher of its cost of acquisition and the FMV on the date of transfer.

FMV, in a case where a new asset is acquired out of consideration received on account of transfer of an old asset or withdrawal from a bank account [Rule 3(3)]:

In such a case, the fair market value of the old asset or the bank account, as the case may be, determined in accordance with Rule 3(1) and Rule 3(2), shall be reduced by the amount of the consideration invested in the new asset.

Example

House A located in a country outside India was bought in 1995 for ₹15 lakh. It was sold in 2000 for ₹ 22 lakh. This amount was deposited in a bank account in that country. In the year 2001 another House B was purchased for ₹35 lakh. The investment in House B was made through withdrawal from the bank account in the foreign country. House B has not been transferred before the valuation date and its value on the valuation date is ₹ 48 lakh. Assuming that the value of foreign bank account as computed under Rule 3(1)(e) is ₹ 60 lakh, the fair market value (FMV) of the assets would be computed in the following manner:

FMV of House A = ₹ 22 lakh (being higher of ₹ 15 lakh and ₹ 22 lakh) - ₹ 22 lakh (invested in foreign bank account) = Nil

FMV of Foreign Bank account = ₹ 60 lakh - ₹ 35 lakh (invested in House B) = ₹ 25 lakh

FMV of House B = Higher of ₹ 35 lakh and ₹ 48 lakh = ₹ 48 lakh

Rate of conversion of currency used to determine FMV of an asset [Rule 3(4) & 3(5)]: The fair market value of an asset determined in a currency which is one of the permitted currencies designated by the RBI under the Foreign Exchange Management Regulations, has to be converted into Indian currency as per the reference rate of the RBI on the date of valuation.

Where the FMV of an asset is determined in a currency other than one of the permitted currencies designated by the RBI, then, such value shall be converted into United States Dollar on the date of valuation as per the rate specified by the Central Bank of the country or jurisdiction in which the asset is located. Such value in United States Dollar shall be converted into Indian currency as per the reference rate of the RBI on the date of valuation:

However, where the Central Bank of the country or jurisdiction in which the asset is located does not specify the rate of conversion from its local currency to United States Dollar, then, such rate shall be the one as specified by any other bank regulated under the laws of that country or jurisdiction.

Meaning of certain terms [*Explanation 1 to Rule 3*]

	Term	Meaning
(a)	Established securities market	An exchange that is officially recognised and supervised by a Governmental entity in which the market is located and that has a meaningful annual value of shares traded on the exchange
(b)	Meaningful annual value of shares traded on the exchange	With respect to an exchange, it means it has an annual value of shares traded on the exchange (or a predecessor exchange) exceeding one billion United States Dollar during each of the three calendar years immediately preceding the calendar year in which the determination is being made.

(c)	Meaningful volume of trading on an on-going basis	With respect to each class of shares, it means,- (i) trades in each such class are effected, other than in *de minimis* quantities, on one or more established securities markets on at least 60 business days during the prior calendar year; and (ii) the aggregate number of shares in each such class that are traded on such market or markets during the prior year are at least 10% of the average number of shares outstanding in that class during the prior calendar year
(d)	Quoted share or security	The share or security which has a meaningful volume of trading on an ongoing basis on an established securities market and is regularly quoted by dealers where they actively do offer to, and in fact do, purchase the share from, and sell the share to, customers who are not related to the dealer in the ordinary course of a business.
(e)	Unquoted share and security	In relation to share or security, means share or security which is not a quoted share or security.

Relevant Date for determination of market value and conversion of currency [*Explanation 2* to Rule 3]

For the purpose of determining the market value as on valuation date referred to in Rule 3(1), and for the purpose of conversion into Indian currency or conversion of foreign currency into United States Dollar and thereafter into Indian currency, the date would be —

	Case	Date
(a)	in respect of asset declared under section 59 of the Act	1st July, 2015
(b)	in any other case	1st April of the previous year

(ii) **Scope of total undisclosed foreign income and asset [Section 4]**

(a) **Total undisclosed foreign income and asset** of any previous year would be -

(1) the income from a source located outside India **which has not been disclosed in the return of income** filed under the Income-tax Act, 1961 on or before the due u/s 139(1) or in the belated return of income u/s 139(4) or in the revised return of income u/s 139(5).

(2) the income from a source located outside India in respect of which a return is required to be filed under section 139 of the Income-tax Act, 1961, but **no return, belated return or revised return has been filed under section 139(1)/(4)/(5) of that Act.**

(3) the value of any **undisclosed asset located outside India**.

(b) Any variation made in the income from a source outside India in the assessment or reassessment of the total income of any previous year, of the assessee under the Income-tax Act, 1961 in accordance with the following provisions of the Income-tax Act, 1961 is not includible in the total undisclosed foreign income:

Section	Provision
29	Manner of computation of income under the head "Profits and gains of business or profession"
43C	Special provision for computation of cost of acquisition of an asset which becomes the property of an amalgamated company under a scheme of amalgamation and is sold by the amalgamated company as stock-in-trade of the business carried on by it.
57	Manner of computation of income chargeable under the head "Income from other sources"
59	Profits (Deemed income) chargeable to tax
92C	Computation of arm's length price

(c) **Non-inclusion of income included in undisclosed foreign income and asset in the total income under the Income-tax Act, 1961** - The income included in the total undisclosed foreign income and asset under this enactment would not form part of total income under the Income-tax Act, 1961.

(iii) **Computation of total undisclosed foreign income and asset [Section 5]**

(a) **Disallowance of expenditure and set-off of loss** - No deduction in respect of any expenditure or allowance or set off of any loss would be allowed in computing the total undisclosed foreign income and asset of any previous year of an assessee, irrespective of whether the same is allowable under the Income-tax Act, 1961.

(b) **Permissible deduction from value of undisclosed asset located outside India** - From the value of undisclosed asset located outside India, **any income which has so far been assessed to tax** for any assessment year under the Income-tax Act, 1961 prior to the assessment year to which the Act applies and **any income which is assessable or has been assessed to tax** for any assessment year under this Act, will be **reduced**.

However, the assessee has to furnish evidence to the satisfaction of the Assessing Officer that the asset has been acquired from the income which has been assessed or assessable to tax.

(c) **Permissible deduction from value of immovable property** - If the deduction referred to in (b) above in respect of income which is assessable or has been assessed to tax is in relation to an **immovable property**, the quantum of deduction would be the amount which bears to the value of the asset as on the first day of the financial year in which it comes to the notice of the Assessing Officer, the same proportion as the assessable or assessed foreign income bears to the total cost of the asset.

Example

A house property located in a country outside India was acquired by Mr. A, an assessee in the previous year 2009-10 for ₹ 60 lakh. Out of the investment of ₹ 60 lakh, ₹ 35 lakh was assessed to tax in the total income of the previous year 2009-10 and earlier years. Such undisclosed asset comes to the notice of the Assessing Officer in the year 2019-20. If the value of the house property in the year 2019-20 is ₹120 lakh, the amount chargeable to tax shall be X-Y=Z where,

X = ₹ 120 lakh,

Y = ₹ 120 lakh x 35/60 = ₹ 70 lakh,

Z = ₹ 120 lakh – ₹ 70 lakh = ₹ 50 lakh.

5.3 TAX MANAGEMENT [CHAPTER III – SECTIONS 6 TO 40]

(i) **Tax Authorities [Section 6]**

(a) Income-tax authorities specified under section 116 of the Income-tax Act, 1961 would be the tax authorities for the purpose of this Act.

(b) Such authorities have to exercise the powers and perform the functions of a tax authority under this Act in respect of a person within his jurisdiction.

(c) Jurisdiction of a tax authority under this Act to be the same as he has under the Income-tax Act, 1961 by virtue of the orders or directions issued under section 120 of that Act or any other provision of that Act.

(c) Jurisdiction of a tax authority in case of an assessee having no income assessable under the Income-tax Act, 1961 – The tax authority having jurisdiction in his case under this Act to be the tax authority having jurisdiction in respect of the **area in which the assessee resides or carries on its business or has its principal place of business**.

(ii) **Change of incumbent [Section 7]**

(a) The tax authority who succeeds another authority as a result of change in jurisdiction or for any other reason, has to continue the proceedings from the stage at which it was left by his predecessor.

(b) If the assessee makes a written requirement, he may be given an opportunity of being heard, before passing any order in his case.

(iii) **Powers regarding discovery and production of evidence [Section 8]**

(a) **Powers vested in a court under the Code of Civil Procedure, 1908** – The prescribed tax authorities, namely, the Assessing Officer, Joint Commissioner, Commissioner (Appeals), Commissioner or Principal Commissioner, Chief Commissioner and Principal Chief Commissioner, would have the same powers as are vested in a court under the Code of Civil Procedure, 1908, while trying a suit in respect of the following matters -

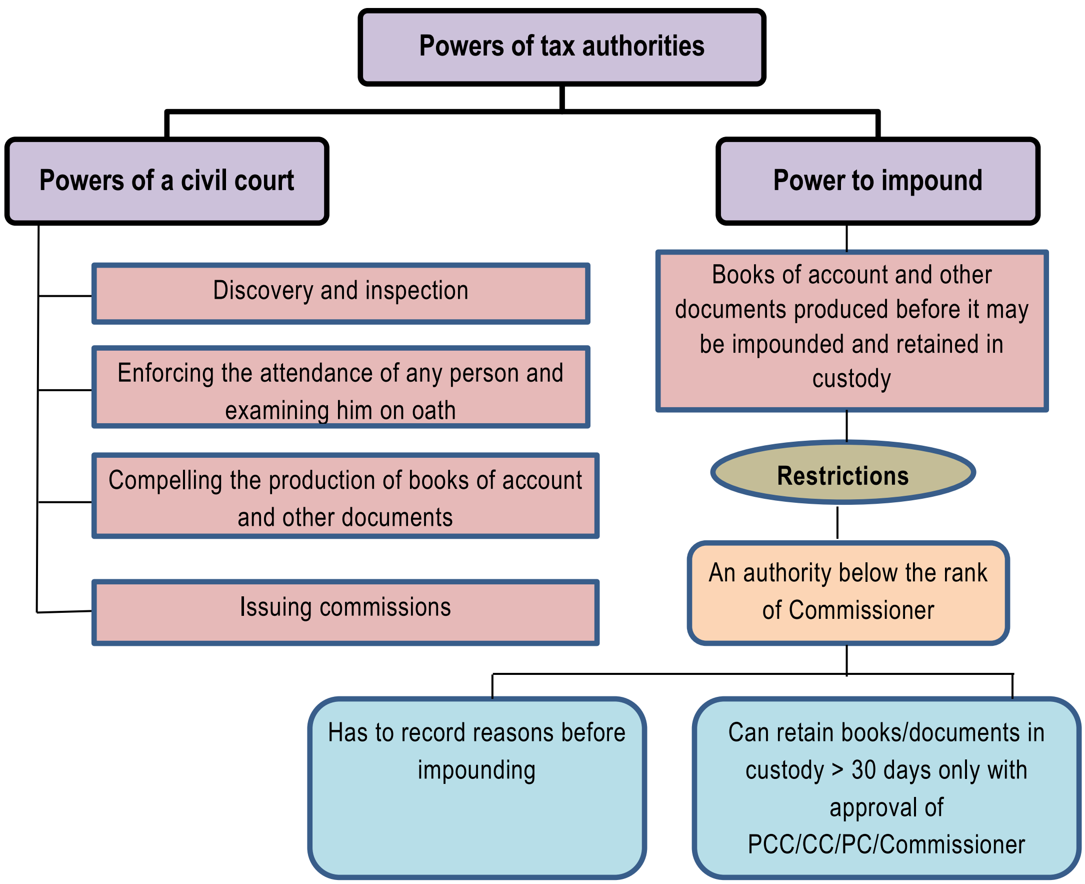
- Discovery and inspection

- Enforcing the attendance of any person, including an officer of a banking company and examining him on oath
- Compelling the production of books of account and other documents; and
- Issuing commissions.

(b) **Inquiry and Investigation** – The prescribed tax authorities are vested with these powers even for the purpose of making any inquiry or investigation, irrespective of whether any proceedings are pending before it.

(c) **Power to impound** - The prescribed tax authorities may impound any books of account or other documents produced before them and retain the same in their custody for such period as they think fit. However, this power is subject to Rules to be made in this regard.

(d) **Restrictions on power to impound** - A tax authority below the rank of Commissioner can impound any books of account or other documents only after recording reasons for doing so. Further, such authority can retain in his custody the books or documents impounded for a period exceeding 30 days only after obtaining the approval of the Principal Chief Commissioner/Chief Commissioner/Principal Commissioner/ Commissioner.



(iv) **Proceedings before tax authorities to be judicial proceedings [Section 9]**

(a) **Purposes for which a proceeding under this Act would be deemed to be a judicial proceeding -** Any proceeding under this Act before a tax authority to be deemed as a judicial proceeding within the meaning of sections 193 and 228 and for the purposes of section 196 of the Indian Penal Code.

Section of IPC	Heading	Provision
193	Punishment for false evidence.	Whoever intentionally gives false evidence in any of a judicial proceeding, or fabricates false evidence for the purpose of being used in any stage of a judicial proceeding, shall be punished with imprisonment of either description for a term which may extend to seven years, and shall also be liable to fine; and whoever intentionally gives or fabricates false evidence in any other case, shall be punished with imprisonment of either description for a term which may extend to three years, and shall also be liable to fine. A trial before a Court-martial is a judicial proceeding. An investigation directed by law preliminary to a proceeding before a Court of Justice, is a stage of a judicial proceeding, though that investigation may not take place before a Court of Justice. An investigation directed by a Court of Justice according to law, and conducted under the authority of a Court of Justice, is a stage of a judicial proceeding, though that investigation may not take place before a Court of Justice.
196	Using evidence known to be false	Whoever corruptly uses or attempts to use as true or genuine evidence any evidence which he knows to be false or fabricated, shall be punished in the same manner as if he gave or fabricated false evidence.
228	Intentional insult or interruption to public servant sitting in judicial proceeding	Whoever intentionally offers any insult, or causes any interruption to any public servant, while such public servant is sitting in any stage of a judicial proceeding, shall be punished with simple imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both.

(b) **Purposes for which a tax authority shall be deemed to be a civil court -** A tax authority shall be deemed to be a civil court for the purposes of section 195 of the Code of Criminal Procedure, 1973, which provides for prosecution for contempt of lawful authority of public servants, for offences against public justice and for offences relating to documents given in evidence. However, he would not be so deemed for the purposes of Chapter XXVI of the Code of Criminal Procedure, 1973, containing the provisions as to offences affecting the administration of justice.

(v) **Assessment [Section 10]**

(a) **Service of Notice** - Where the Assessing Officer receives information from an income-tax authority or any other authority under any other law or any information comes to his notice, he may, for the purpose making an assessment or reassessment under this Act, **serve a notice** on any person requiring him to produce, or cause to be produced, on the date to be specified, **such accounts or documents or evidence** which he may require for the purposes of this Act.

(b) **Service of further notices** - He may also serve further notices from time to time requiring production of such other accounts or documents or evidence as he may require.

(c) **Making inquiry** - The Assessing Officer may, for the purpose of obtaining full information in respect of undisclosed foreign income and asset of any person for the relevant financial year(s), **make such inquiry** as he considers necessary.

(d) **Passing an Assessment Order** - After considering the accounts, documents or evidence produced by the assessee, and any relevant material which he has gathered, the Assessing Officer has to **pass an order in writing assessing *or reassessing* the undisclosed foreign income and asset and determining the sum payable by the assessee**.

(e) **Best Judgement Assessment** - Where any person fails to comply with all the terms of the notice issued, the Assessing Officer shall, after giving the assessee an **opportunity of being heard** and after taking into consideration all the relevant material, make the assessment ***or reassessment*** of undisclosed foreign income and asset to the **best of his judgment** and determine the sum payable by the assessee.

(vi) **Time limit for completion of assessment and reassessment [Section 11]**

(a) **Two-year time limit** – The time limit for passing an order of assessment or reassessment under section 10 is two years from the end of the financial year in which notice under section 10(1) is issued by the Assessing Officer.

An order of fresh assessment in pursuance of an order passed under section 18 setting aside or cancelling an assessment may be made at any time before the expiry of 2 years from the end of the financial year in which the order under section 18 is received by the Principal Commissioner or Commissioner.

(b) **Non-applicability of the two-year time limit** – The time limit of two years would not apply in respect of the assessment or reassessment made in the consequence of, or to give effect to, **any finding or direction contained in the order of any appellate authority or a court** in a proceeding otherwise than by way of appeal.

Such assessment may be completed at any time before the expiry of two years from the end of the financial year in which such order is received by the Principal Commissioner or Commissioner.

Time limit for completion of assessment or reassessment [Section 11]

Where notice u/s 10(1) is issued by the A.O.	In case where an order of fresh assessment in pursuance of an order passed u/s 18 setting aside or cancelling an assessment is to be passed	Where an assessment/ reassessment is made to give effect to any finding or direction contained in an appellate order or proceeding
2 years from the end of the F.Y. in which notice is issued	2 years from the end of the F.Y. in which the order u/s 18 is received by the PC/Commissioner.	2 years from the end of the F.Y. in which such order is received by the PC/Commissioner

(c) **Exclusion of specified time period** - The time taken in reopening the whole or any part of the proceeding, the period during which the assessment proceeding is stayed by an order or injunction of any court or the period commencing from the date on which a reference or the first of the references for exchange of information is made by the competent authority (with reference to section 90/90A of the Income-tax Act, 1961 or under section 73 of this Act) and ending with the date on which the information requested is last received or a period of one year, whichever is less, shall be excluded in computing the period of limitation.

If, after exclusion of such time period, the period of limitation available to the Assessing Officer for making an assessment order is less than 60 days, **the period of limitation shall be deemed to be extended to 60 days.**

(vii) **Rectification of mistake [Section 12]**

(a) **Rectification of a mistake apparent from the record** – Any order passed by the tax authority can be amended by it to rectify any mistake apparent from the record**.**

(b) **Time period for rectification** – A **four year time period** has been prescribed and the same has to be reckoned from the end of the financial year in which the order sought to be amended was passed.

(c) **Opportunity of being heard** – Any amendment which has the effect of enhancing the undisclosed foreign income and asset or reducing a refund or otherwise increasing the liability of the assessee cannot be made without giving the assessee an opportunity of being heard.

(d) **Time limit for deciding an application** – Where a tax authority receives an application from the assessee or the Assessing Officer for amendment of an order, the time limit within which such application has to be decided is **six months from the end of the month in which the application is received by it**. The tax authority may also make an amendment on its own motion.

(e) **Rectification of an order which is a subject matter of appeal or revision** – In such a case, the power of the tax authority to amend the order would be restricted to matters other than those decided in appeal or revision.

(viii) **Notice of Demand [Section 13]**

(a) Service of notice of demand upon the assessee in the prescribed form and manner would be mandatory for a tax authority to demand any sum payable in consequence of an order made under this Act.

(b) Rule 5 provides that where any tax, interest or penalty is payable in consequence of any order passed under the provisions of the Act, the Assessing Officer shall serve upon the assessee a notice of demand in Form 1 specifying the sum so payable.

(ix) **No bar on Direct Assessment or Recovery [Section 14]**

The following are not barred by any provision in Chapter III of this Act:

(a) Direct assessment of the person on whose behalf or for whose benefit the undisclosed income from a source located outside India is receivable or undisclosed asset located outside India is held.

(b) Recovery of the tax or any other sum of money payable in respect of such income and asset from such person.

(x) **Appeal to Commissioner (Appeals) [Section 15]**

(a) **Who can file an appeal?** - The Act provides for appeal to Commissioner (Appeals) in the prescribed form [Form 2] and manner by any person who -

(1) objects to the amount of tax on undisclosed foreign income and asset for which he is assessed by the Assessing Officer; or

(2) denies his liability to be assessed under this Act; or

(3) objects to any penalty imposed by the Assessing Officer; or

(4) objects to a rectification order enhancing the assessment or reducing the refund; or

(5) objects to an order refusing to allow the rectification claim made by the assessee.

(b) **Manner of filing appeal** - Form 2, the grounds of appeal and the form of verification appended thereto relating to an assessee has to be signed and verified by the person who is authorised to sign the return of income under section 140 of the Income-tax Act, 1961, as applicable to the assessee.

(c) **Fees** - Every appeal filed under section 15 shall be accompanied by a fee of ₹10,000.

(d) **Payment of tax, interest and penalty: Pre-condition for filing appeal** - No appeal under section 15(1) shall be admitted unless, at the time of filing of the appeal, the assessee has paid the tax alongwith penalty and interest thereon on the amount of liability which has not been objected to by the assessee.

(e) **Time limit for filing appeal to Commissioner (Appeals) – 30 days from:**

Circumstance	Date
Where notice of demand relating to an assessment or penalty is served	the date of service of the notice of demand
In any other case	the date on which the intimation of the order sought to be appealed against is served.

(f) **Extension of time period for filing appeal** – The Commissioner (Appeals) may admit an appeal after the expiry of the 30 day period:

(1) if he is satisfied that the appellant had sufficient cause for not presenting it within that period; and

(2) the delay in preferring the appeal does not exceed one year.

(g) **Passing an order** - The Commissioner (Appeals) has to hear and determine the appeal. He may pass such orders as he thinks fit and such orders may include an order enhancing the assessment or penalty. However, an order enhancing the assessment or penalty cannot be made unless the assessee has been given a reasonable opportunity of being heard.

(xi) **Powers of Commissioner (Appeals) [Section 17]**

In disposing of an appeal, the Commissioner (Appeals) shall have the following powers, namely:—

	Order appealed against	Powers of Commissioner (Appeals)	Restriction on Power of Commissioner (Appeals)
(i)	Order of assessment	Power to confirm, reduce, enhance or annul the assessment;	Power to enhance an assessment or a penalty can be exercised only after giving the appellant an opportunity of being heard.
(ii)	Order imposing penalty	Power to confirm or cancel ***or vary such order either to enhance or reduce the penalty***;	
(iii)	Order, other than (i) and (ii) above	Power to determine the issues arising in the appeal and pass such orders thereon, as he thinks fit	

Note – *(1) The Commissioner (Appeals) may consider and decide any matter which was not considered by the Assessing Officer*

(2) In disposing of an appeal, the Commissioner (Appeals) may consider and decide any matter arising out of the proceedings in which the order appealed against was passed, notwithstanding that such matter was not raised before him by the appellant.

(xii) **Appeal to Appellate Tribunal [Section 18]**

(a) **Who can file an appeal?** - The following persons can make an appeal to the Appellate Tribunal -

(1) Any assessee who is aggrieved by an order passed by the Commissioner (Appeals);

(2) Any assessee who is aggrieved by an order passed by the Principal Commissioner or Commissioner under any provision of the Act;

(3) The Assessing Officer, on a direction received from the Principal Commissioner or Commissioner objecting to any order passed by the Commissioner (Appeals).

(b) **Time limit for filing an appeal -** The appeal has to be filed within **60 days** from the date on which the order sought to be appealed against is communicated to the assessee or the Principal Commissioner or the Commissioner, as the case may be.

(c) **Memorandum of Cross Objections -** The Assessing Officer or the assessee can file a memorandum of cross objections, within **30 days** of receipt of notice that an appeal against the order of Commissioner (Appeals) has been preferred by the other party. The memorandum can be filed against any part of the order of the Commissioner (Appeals). Such memorandum has to be disposed of by the Appellate Tribunal as if it were an appeal presented within the 60 day time period.

(d) **Extension of time period for filing an appeal or Memorandum of Cross Objections –** The Appellate Tribunal may admit an appeal or permit the filing of memorandum of cross objections after the expiry of the prescribed period mentioned in (b) and (c) above if –

(1) it is satisfied that there was sufficient cause for not presenting it within that period; and

(2) the delay in filing the appeal does not exceed a period of one year.

(e) **Prescribed Form [Rule 7]**

Form of Appeal [Rule 7(1)] - An appeal to the Appellate Tribunal has to be made in **Form 3**. Where the appeal is made by the assessee, the form of appeal, the grounds of appeal and the form of verification appended thereto shall be signed by the person who is authorised to sign the return of income under section 140 of the Income-tax Act, 1961, as applicable to the assessee.

Form of Memorandum of Cross Objections [Rule 7(2)] - The memorandum of cross-objections to the Appellate Tribunal has to be made in **Form 4**. Where the memorandum of cross objection is made by the assessee, the form of memorandum of cross-objections, the grounds of cross- objections and the form of verification appended thereto shall be signed by the person who is authorised to sign the return of income under section 140 of the Income-tax Act, 1961, as applicable to the assessee.

(f) **Fees [Rule 7(3)] -** Every appeal filed by the assessee to the Appellate Tribunal has to be accompanied by a fee of **₹ 25,000**.

(xiii) **Appeal to High Court [Section 19]**

(a) **Substantial question of law** - An appeal shall lie to the High Court from every order passed in appeal by the Appellate Tribunal, if the High Court is satisfied that the case involves a substantial question of law.

(b) **Time limit for filing appeal** - The time limit for filing an appeal is **120 days** from the date on which the order appealed against is received by the Principal Chief Commissioner/Chief Commissioner/Principal Commissioner/ Commissioner/ assessee. The appeal shall be in the form of a memorandum of appeal precisely stating therein the substantial question of law involved

(c) **Extension of time for filing appeal** - The High Court may admit an appeal after the expiry of the 120 day period, if it is satisfied that there was sufficient cause for not filing an appeal within that period.

(d) **Applicability of the Code of Civil Procedure, 1908 -** The provisions of Code of Civil Procedure, 1908, relating to appeals to the High Court shall, so far as may be, apply in the case of appeals under this section.

(xiv) **Appeal to Supreme Court [Section 21]**

(a) An appeal shall lie to the Supreme Court from any judgment of the High Court delivered under section 19 which the High Court certifies to be fit case for appeal to the Supreme Court.

(b) The provisions of the **Code of Civil Procedure, 1908**, relating to appeals to the Supreme Court shall, so far as may be, apply in case of appeal to the Supreme Court under this Act as they apply in the case of appeals from decrees of a High Court.

Summary of significant Appellate Provisions

Particulars	Appellate Authority		
	Commissioner (Appeals)	Appellate Tribunal	High Court
Form of Appeal	Form 2	Form 3	Memorandum of appeal stating the substantial question of law
Fees	₹10,000	₹ 25,000 (where appeal is filed by the assessee)	As per the High Court Rules of the respective State/Court Fees Act, 1870.
Time period for filing appeal	**30 days** of service of notice of demand relating to an assessment or penalty or in any other case, 30 days from the date on which the intimation of the order sought to be appealed against is served.	**60 days** from the date on which the order sought to be appealed against is communicated to the assessee or the Principal Commissioner or the Commissioner	**120 days** from the date on which the order appealed against is received by the Principal Chief Commissioner/ Chief Commissioner/ Principal Commissioner/ Commissioner/assessee
Extension of time period for filing appeal	Permitted	Permitted	Permitted
Permissible Reasons for extension	The Commissioner (Appeals) should be satisfied that the	The Appellate Tribunal should be satisfied that there	The High Court should be satisfied that there was sufficient cause for not

	appellant had sufficient cause for not presenting it within that period; and the delay in preferring the appeal does not exceed one year	was sufficient cause for not presenting it within that period; and the delay in filing the appeal does not exceed a period of one year.	filing an appeal within that period.

(xv) **Revision of orders prejudicial to revenue [Section 23]**

(a) **Examination of "record"** - The Principal Commissioner/Commissioner may call for and examine all available records for the purpose of revising any order passed in any proceeding under this Act by a tax authority subordinate to him. For this purpose, "record" shall include all records relating to any proceeding under this Act available at the time of examination by the Principal Commissioner or the Commissioner.

(b) **Opportunity of being heard to be given to the assessee before passing a revision order** - If he is satisfied that the order sought to be revised is erroneous in so far as it is prejudicial to the interests of the revenue, he may, after giving the assessee an opportunity of being heard, pass a revision order

(c) **Making inquiry before passing revision order** - The Principal Commissioner or the Commissioner may make, or cause to be made, such inquiry as he considers necessary for the purposes of passing the order.

(d) **Revision order cannot cancel assessment or direct fresh assessment** - The revision order passed by the Principal Commissioner or Commissioner may have the effect of enhancing or modifying the assessment but shall not be an order cancelling the assessment and directing a fresh assessment.

(e) **Revision of matter not considered and decided in appeal** - The power of the Principal Commissioner or the Commissioner for revising an order shall extend to such matters as have not been considered and decided in any appeal.

(f) **Time limit** - A revision order cannot be made after the expiry of a period of two years from the end of the financial year in which the order sought to be revised was passed. An order in revision under this section may, however, be passed at any time in respect of an order which has been passed in consequence of, or to give effect to, any finding or direction contained in an order of the Appellate Tribunal, the High Court or the Supreme Court.

(g) **Period to be excluded in determining the time limit** - In computing the above period of limitation, the following shall not be included, namely:—

(1) the time taken in giving an opportunity to the assessee to be reheard under section 7; or

(2) any period during which any proceeding under this section is stayed by an order or injunction of any court.

(h) **Circumstances when an order shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue** - Without prejudice to the generality of the foregoing provisions, an order passed by a tax authority shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue, if in the opinion of the Principal Commissioner or the Commissioner—

(1) the order is passed without making inquiries or verification which should have been made; or

(2) the order has not been made in accordance with any order, direction or instruction issued by the Board; or

(3) the order has not been passed in accordance with any decision, prejudicial to the assessee, rendered by the jurisdictional High Court or the Supreme Court in the case of the assessee or any other person under this Act or the Income-tax Act

(xvi) **Revision of other orders [Section 24]**

(a) **Revision of other orders *suo motu* by the Principal Commissioner/ Commissioner or on an application made by the assessee** - The Principal Commissioner/Commissioner may, either on his own motion or on an application made by the assessee, for the purposes of revising any order passed by an authority subordinate to him, other than an order prejudicial to revenue to which section 23 applies, call for and examine all available records relating thereto.

(b) **Revision Order not to be prejudicial to assessee** - The Principal Commissioner or the Commissioner may pass an order, as he considers necessary, which is not prejudicial to the assessee. An order by the Principal Commissioner or the Commissioner declining to interfere shall, however, be deemed **not** to be an order prejudicial to the assessee for the purposes of this section.

(c) **Orders which cannot be revised** - Such power of the Principal Commissioner or the Commissioner to revise an order would **not** extend to such order—

(1) against which an appeal has not been filed but the time for filing an appeal before the Commissioner (Appeals) has not expired;

(2) against which an appeal is pending before the Commissioner (Appeals); or

(3) which has been considered and decided in any appeal

(d) **Time limit for application for revision by assessee** - The assessee has to make the application for revision of any order, within a period of **one year** from the date on which the order sought to be revised was communicated to him, or the date on which he otherwise came to know of it, whichever is earlier.

(e) **Extension of time limit for making an application** - If the Principal Commissioner or the Commissioner is satisfied that the assessee was prevented by sufficient cause from making an application within the period of one year, he may admit the application made after the expiry of one year but before expiry of **two years** from the date on which the order sought to be revised was communicated to the assessee, or the date on which the assessee otherwise came to know of it, whichever is earlier.

(f) **Fees** - Every application by an assessee for revision under this section shall be accompanied by such fees as may be prescribed.

(g) **Time limit for passing Revision Order** - No Revision order under this section shall be made after the expiry of—

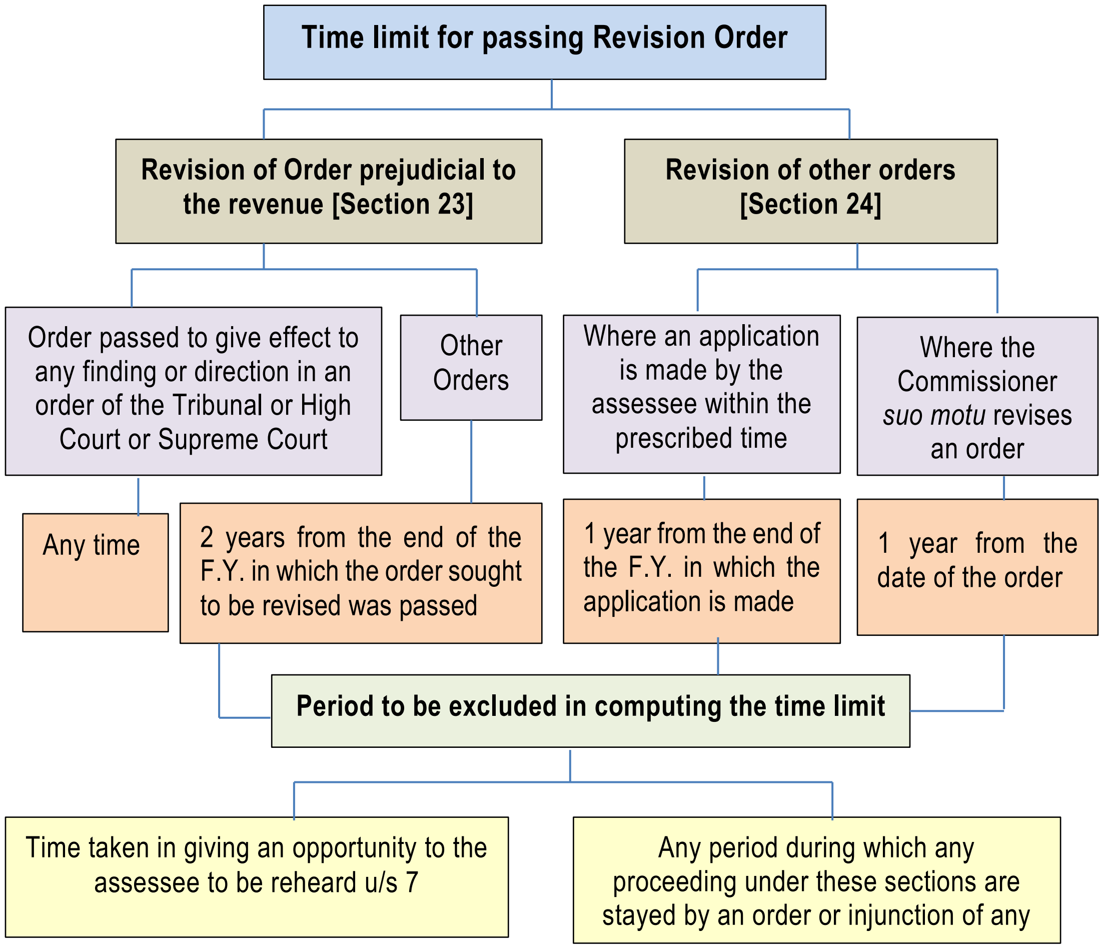
(1) a period of **one year** from the end of the financial year in which an **application is made** by the assessee or

(2) a period of **one year** from the **date of the order** sought to be revised, if the order is revised *suo motu* by the Commissioner.

(h) **Period to be excluded in computing the time limit** - The following period shall not be included, namely:—

(1) the time taken in giving an opportunity to the assessee to be reheard under section 7; or

(2) any period during which any proceeding under this section is stayed by an order or injunction of any court.



(xvii) **Tax to be paid pending appeal** – The tax has to be paid in accordance with the assessment made under this Act, irrespective of any appeal being preferred to the High Court or the Supreme Court

(xviii) **Recovery of Tax Dues [Sections 30 to 40]**

(a) **Recovery of tax dues by Assessing Officer [Section 30] –** The time period of payment of dues specified in the notice of demand to the credit of the Central Government is 30 days from the service of notice of demand. The period may be reduced by the Assessing Officer, with the previous approval of the Joint Commissioner, if he has reason to believe that allowing 30 day period is detrimental to the interests of revenue. An application for extension of time period or allowing payment by installments may be entertained by the Assessing Officer before the expiry of the 30 day period or the period reduced, subject to such conditions as he may think fit to impose. An assessee shall be deemed as an assessee-in-default for failure to pay tax arrears within such specified period.

(b) **Recovery of tax dues by Tax Recovery Officer [Section 31]** - The Tax Recovery Officer may draw up under his signature a statement of tax arrears of the assessee in the prescribed form [Form 5]. He has the power to rectify any mistake apparent from the record and the power to extend the time for payment or allow payment by installments, subject to such conditions as he may think fit to impose.

(c) **Modes of recovery of tax dues [Section 32]** – The modes of recovery of tax arrears, such as deduction by employer from payment to the assessee, recovery from the debtor of the assessee have been provided.

(d) **Tax Recovery Officer by whom recovery of tax dues is to be effected [Section 33]** – The Tax Recovery Officer, within whose jurisdiction the assessee carries on business or the principal place of business of the assessee is situated or the assessee resides or any movable or immovable property of the assessee is situated would be the Tax Recovery Officer competent to recover tax dues of the assessee.

(e) **Recovery of tax dues in case of a company in liquidation [Section 34]** – The liquidator has to inform the Assessing Officer, who has jurisdiction to assess the undisclosed foreign income and asset of the company, of his appointment within a period of thirty days of his becoming the liquidator. Within a period of three months from the date of receipt of such information, the Assessing Officer has to intimate to the liquidator the amount which, in his opinion, would be sufficient to provide for any tax arrears or any amount which is likely to become payable thereafter, by the company under this Act.

(f) **Liability of manager of a company [Section 35]** – Every person being a manager at any time during the financial year would be jointly and severally liable for the payment of any amount due under this Act in respect of the company for the financial year, if the amount cannot be recovered from the company. However, if the manager proves that non-recovery cannot be attributed to any neglect, misfeasance or breach of duty on his part in relation to the affairs of the company, he would not be so liable.

(g) **Joint and several liability of participants [Section 36]** – Every person, being a participant in an unincorporated body at any time during the financial year, or the representative assessee of the deceased participant, shall be jointly and severally liable, along with the unincorporated body, for payment of any amount payable by the unincorporated body under this Act. In case of a limited liability partnership, if the partner proves that non-recovery cannot be attributed to any neglect, misfeasance or breach of duty on his part in relation to the affairs of the partnership, he would not be so liable.

Meaning of participant [Section 2(7)]

In relation to	Participant
A firm	a partner thereof
An AOP/BOI	a member thereof

(h) **Recovery through State Government [Section 37]** – If the recovery of tax in any area has been entrusted to a State Government under clause (1) of article 258 of the Constitution, the State Government may direct, with respect to that area or any part thereof, that tax has to be recovered therein with, and as an addition to, any municipal tax or local rate, by the same person and in the manner as the municipal tax or local rate is recovered.

Note *– As per article 258(1) in the Constitution of India, the President may, with the consent of the Governor of a State, entrust either conditionally or unconditionally to that Government or to its officers, functions in relation to any matter to which the executive power of the Union extends, notwithstanding anything in the Constitution*

(i) **Recovery of tax dues in pursuance of agreements with foreign countries or specified territory [Section 38]**

(1) The Tax Recovery Officer may, in a case where an assessee has property in a country or a specified territory outside India, forward a certificate to the CBDT for recovery of the tax arrears from the assessee, where the Central Government or any specified association in India has entered into an agreement with that country or territory under section 90 or section 90A of the Income-tax Act or under section 73(1)/(2)/(4) of this Act, as the case may be, for the purposes of recovery of tax.

(2) The CBDT may, on receipt of the certificate from the Tax Recovery Officer, take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country or a specified territory

(j) **Recovery by suit or under other law not affected [Section 39]** – The modes of recovery in this Chapter would not affect in any manner any other law for the time being in force relating to the recovery of debts due to the Government or the right of the Government to institute a suit for the recovery of the tax arrears from the assessee.

The Assessing Officer or the Government shall have recourse to any such law or suit, notwithstanding that the tax arrears are being recovered from the assessee by any mode specified in this Chapter.

(k) **Interest for default in furnishing return and payment or deferment of advance tax [Section 40]**

(1) **Interest under section 234A** of the Income-tax Act, 1961 would be attracted for failure to disclose income from a source outside India in the return filed under section 139(1) or failure to furnish return of income under section 139(1) of the Income-tax Act, 1961.

(2) **Interest under sections 234B and 234C** of the Income-tax Act, 1961 would be attracted for failure to pay advance tax on undisclosed income from a source outside India in accordance with Part C of Chapter XVII of the Income-tax Act, 1961.

5.4 PENALTIES [CHAPTER IV – SECTIONS 40 TO 47]

(i) **Penalty in relation to undisclosed foreign income and asset [Section 41]** - In case, where tax has been computed in respect of undisclosed foreign income and asset, the Assessing Officer may direct the assessee to pay by way of penalty, in addition to tax, if any, payable by him, a sum equal to **three times the tax so computed**.

(ii) **Penalty for failure to furnish return in relation to foreign income and asset [Section 42]** - Failure to furnish return of income as required under section 139(1) before the end of the relevant assessment year by a person, being a resident other than not ordinarily resident in India, holding any asset (including financial interest in any entity) located outside India as a beneficial owner or otherwise or being a beneficiary of any asset (including financial interest in any entity) located outside India or having any income from a source located outside India, would attract penalty of **₹ 10 lakh**.

(iii) **Penalty for failure to furnish information in the return of income or for furnishing inaccurate particulars about an asset located outside India [Section 43]** - If such failure is in relation to an asset (including financial interest in any entity) held by a person, being a resident other than not ordinarily resident in India, as a beneficial owner or otherwise, or in respect of which such person was a beneficiary, or if such failure is in relation to any income from a source located outside India, at any time during such previous year, the Assessing Officer may direct such person to pay, by way of penalty, a sum of ₹10 lakh..

(iv) **Non-applicability of penalty under sections 42 & 43 in certain cases [Proviso to sections 42 & 43]** - Such penalty under sections 42 and 43 would, however, not apply in respect of an asset, being one or more bank accounts having an aggregate balance which does not exceed a value equivalent to ₹5 lakh at any time during the previous year

(v) **Determination of the value equivalent in rupees of the balance in an account maintained in foreign currency [*Explanation* to sections 42 & 43]** – For determining the value equivalent in rupees of the balance in an account maintained in foreign currency, the rate of exchange for calculation of the value in rupees shall be the telegraphic transfer buying rate of such currency as on the date for which the value is to be determined as adopted by the State Bank of India constituted under the SBI Act, 1955.

(vi) **Penalty for default in payment of tax arrear [Section 44]** – Penalty equal to the amount of tax arrears is leviable in case of an assessee in default or an assessee deemed to be in default in making payment of tax and in case of continuing default by such assessee. An assessee shall not cease to be liable to any penalty merely by reason of the fact that before levy of such penalty, tax has been paid by him.

(vii) **Penalty for other defaults [Section 45]** – Penalty of a sum not less than ₹50,000 but extending upto ₹ 2 lakh would be attracted in case a person liable to penalty has, without reasonable cause, failed to -

(a) answer any question put to him by a tax authority in exercise of his powers under the Act

(b) sign any statement made by him in the course of any proceedings under the Act which a tax authority may legally require him to sign

(c) attend or produce books of account or documents at the place or time, if he is required to attend or to give evidence or produce books of account or other documents at certain place and time in response to summons issued under section 8.

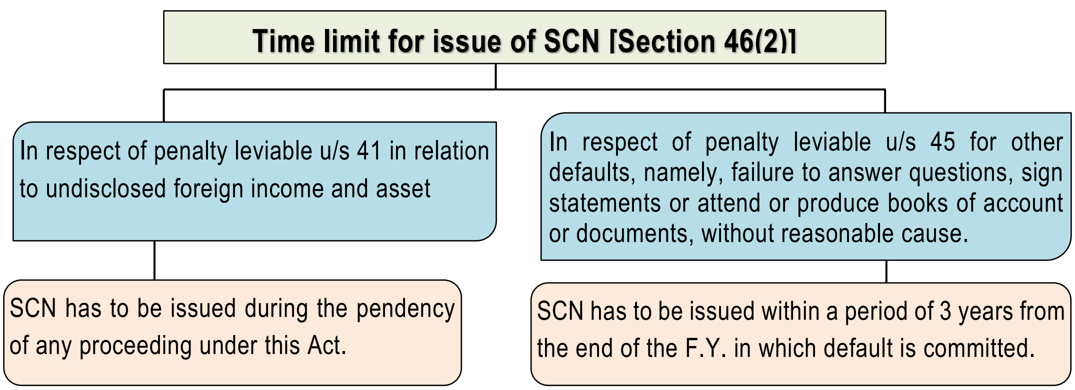
(viii) **Procedure [Section 46]**

(a) **Issue of show cause notice** - For the purposes of imposing any penalty under Chapter IV, the tax authority has to issue a notice to an assessee requiring him to show cause why the penalty should not be imposed on him

(b) **Time limit for issue of show cause notice [Section 46(2)]** - The show cause notice (SCN) has to be issued—

(1) during the pendency of any proceedings under this Act for the relevant previous year, in respect of penalty referred to in section 41;

(2) within a period of three years from the end of the financial year in which the default is committed, in respect of penalties referred to in section 45.

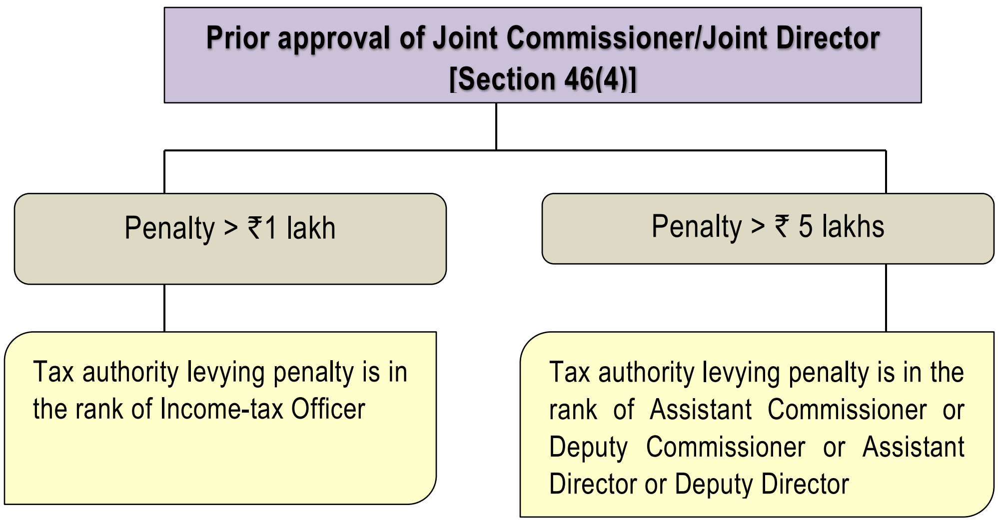


(c) **Opportunity of being heard to be given to the assessee** - An order imposing a penalty under this Chapter can be made only after giving the assessee an opportunity of being heard.

(d) **Prior approval of Joint Commissioner *or Joint Director*** - An order imposing a penalty under this Chapter shall be made with the approval of the Joint Commissioner or Joint Director, if –

(1) the penalty exceeds ₹1 lakh and the tax authority levying the penalty is in the rank of Income-tax Officer; or

(2) the penalty exceeds ₹ 5 lakhs and the tax authority levying the penalty is in the rank of Assistant Commissioner or Deputy Commissioner or Assistant Director or Deputy Director



(ix) Bar on Limitation for imposing penalty [Section 47]

(a) **Time limit for passing penalty order** – An order imposing a penalty under this Chapter cannot be passed after the expiry of a period of **one year** from the end of the financial year in which the notice for imposition of penalty is issued under section 46.

(b) **Revision or revival of penalty order** - An order imposing, or dropping the proceedings for imposition of, penalty under Chapter IV may be revised, or revived, as the case may be, on the basis of assessment of the undisclosed foreign income and asset as revised after giving effect to the order of the Commissioner (Appeals), the Appellate Tribunal, the High Court or the Supreme Court or order of revision under section 23 or section 24.

(c) **Time limit for revision or revival of penalty order** - An order revising or reviving the penalty cannot be passed after the expiry of a period of **six months** from the end of the month in which order of the Commissioner (Appeals), the Appellate Tribunal, the High Court or the Supreme Court is received by the Principal Chief Commissioner or the Chief Commissioner or the Principal Commissioner or the Commissioner or the order of revision under section 23 or section 24 is passed.

(d) **Period to be excluded while computing the period of limitation** - In computing the period of limitation for the purposes of this section, the following time or period shall not be included—

(1) the time taken in giving an opportunity to the assessee to be reheard under section 7; and

(2) any period during which a proceeding under Chapter IV for the levy of penalty is stayed by an order, or injunction, of any court

Summary of Penal Provisions contained in Chapter IV

Section	Failure/Default	Quantum of penalty
41	Where tax has been computed in relation to undisclosed foreign income and asset	In addition to tax, a sum equal to three times the tax so computed.
42	Failure to furnish return in relation to foreign income and asset	₹ 10 lakh
43	Failure to furnish information in the return of income or for furnishing inaccurate particulars about an asset located outside India	₹ 10 lakh
44	Default in payment of tax arrear	Amount equal to the amount of tax arrears
45	Failure, without reasonable cause, to answer any question put to him by a tax authority or to sign any statement made by him in the course of any proceedings under the Act or to attend or produce books of account or documents at the place or time in response to summons issued under section 8	₹ 50,000 to ₹ 2 lakh

5.5 OFFENCES AND PROSECUTION [CHAPTER V]

(i) **Provisions of Chapter V not in derogation of any other law or any other provision of the Act [Section 48]** – The provisions relating to offences and prosecution contained in Chapter V are in addition to, and not in derogation of, the provisions of any other law providing for prosecution for offences thereunder. Further, the provisions of Chapter V to be independent of any order under this Act that may be made, or has not been made, on any person. Also, it shall not be a defence that the order has not been made on account of time limitation or for any other reason.

(ii) **Punishment for failure to furnish return in relation to foreign income and asset [Section 49]** – Willful failure to furnish return required to be furnished under section 139(1) of the Income-tax Act, 1961 in due time, by a person, being a resident other than not ordinarily resident in India, who at any time during the previous year, held any asset (including financial interest in any entity) located outside India as a beneficial owner or otherwise, or was a beneficiary of such asset or had income from a source outside India, would be punishable with rigorous imprisonment for a term which would **not be less than six months but which may extend to seven years and with fine. However, prosecution would not be attracted if he furnishes such return before the expiry of the assessment year.**

(iii) **Punishment for failure to furnish information about an asset located outside India in the return of income [Section 50]** - If such failure in relation to an asset (including financial interest in any entity) held by a person, being a resident other than not ordinarily resident in India, as a beneficial owner or otherwise, or in respect of which he was a beneficiary, or if such failure in relation to any income from a source located outside India, at any time during such previous year, is willful, the punishment would be rigorous imprisonment for a term which would **not be less than six months but which may extend to seven years and with fine**.

(iv) **Punishment for willful attempt to evade tax [Section 51]** – Willful attempt to evade any tax, penalty or interest under this Act by a person, being a resident other than not ordinarily resident in India, is punishable with rigorous imprisonment for a term **not less than three years but extending to ten years and with fine**.

Willful attempt to evade payment of any tax, penalty or interest under the Act, is punishable with rigorous imprisonment for a term **not less than three months but extending upto three years** and also a fine, in the discretion of the Court.

Meaning of willful attempt to evade tax, penalty or interest

A willful attempt to evade any tax, penalty or interest chargeable or imposable under this Act or the payment thereof includes a case where any person—

(1) has in his possession or control any books of account or other documents (being books of account or other documents relevant to any proceeding under this Act) containing a false entry or statement; or

(2) makes or causes to be made any false entry or statement in such books of account or other documents; or

(3) willfully omits or causes to be omitted any relevant entry or statement in such books of account or other documents; or

(4) causes any other circumstance to exist which will have the effect of enabling such person to evade any tax, penalty or interest chargeable or imposable under this Act or the payment thereof.

(v) **Punishment for false statement in verification [Section 52] –** If a person, makes a statement in any verification under this Act or under any rule made thereunder, or delivers an account or statement which is false, and which he either knows or believes to be false, or does not believe to be true, he shall be punishable with rigorous imprisonment for a term **not less than six months but extending to seven years and with fine**.

(vi) **Punishment for abetment [Section 53] –** Rigorous imprisonment for a term **not less than six months but extending to seven years and fine** would be attracted for abetment to make and deliver an account or statement or declaration relating to tax payable under this Act which is false or to commit an offence under section 51(1).

(vii) **Presumption as to culpable mental state [Section 54] –** In any prosecution for any offence under this Act which requires a culpable mental state on the part of the accused, the court shall presume the existence of such mental state. However, it shall be a defence for the accused to prove the fact that he had no such mental state with respect to the act charged as an offence in that prosecution. "Culpable mental state" includes intention, motive or knowledge of a fact or belief in, or reason to believe, a fact. For this purpose, a fact is said to be proved only when the court believes it to exist beyond reasonable doubt and not merely when its existence is established by a preponderance of probability

(viii) **Prosecution to be at instance of Principal Chief Commissioner or Principal Director General or Chief Commissioner or Director General or Principal Commissioner or Commissioner. [Section 55] -** A person shall not be proceeded against for an offence under section 49 to section 53 except with the sanction of the Principal Commissioner or Commissioner or the Commissioner (Appeals), as the case may be. The Principal Chief Commissioner or the Chief Commissioner or the Principal Director General or the Director General may issue such instructions, or directions, to the tax authorities as he may think fit for the institution of proceedings under this section.

(ix) **Offences by companies [Section 56] -**

(a) **Persons incharge at the time when offence was committed deemed guilty of offence -** Where an offence under this Act has been committed by a company, every person who, at the time the offence was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company would be deemed to be guilty of the offence and would be liable to be proceeded against and punished accordingly. If, however, such person proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence, he would not be deemed guilty of the offence

(b) **Director/manager/secretary/officer of company deemed guilty of offence committed with their consent or connivance** - Where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

(c) **Fine and imprisonment** - Where an offence under this Act has been committed by a person, being a company, and the punishment for such offence is imprisonment and fine, then, such company shall be punished with fine. Further, every person, referred to in (a), or the director, manager, secretary or other officer of the company referred to in (b), would be proceeded against and punished in accordance with the provisions of this Act.

(d) **Meaning of certain terms for this section**

<table>
<tr><th></th><th>Term</th><th>Meaning</th></tr>
<tr><td>(1)</td><td>Company</td><td>Means a body corporate.
Includes —
(i) an unincorporated body (i.e., a firm, AOP or BOI);
(ii) a Hindu undivided family.</td></tr>
<tr><td>(2)</td><td>Director</td><td><table>
<tr><th></th><th>In relation to</th><th>Meaning of Director</th></tr>
<tr><td>(i)</td><td>A firm</td><td>A partner in the firm</td></tr>
<tr><td>(ii)</td><td>An AOP/BOI</td><td>A member of the AOP/BOI</td></tr>
<tr><td>(iii)</td><td>A HUF</td><td>an adult member of the family</td></tr>
<tr><td>(iv)</td><td>A company</td><td>a whole-time director</td></tr>
<tr><td>(v)</td><td>A company not having a whole-time director</td><td>any other director or manager or officer, who is in charge of the affairs of the company</td></tr>
</table></td></tr>
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(x) Proof of entries in records or documents [Section 57]

The entries in the records, or other documents, in the custody of a tax authority are admissible in evidence in any proceeding for the prosecution of any person for an offence under Chapter V of this Act. These entries may be proved by the production of –

(a) the records or other documents (containing such entries) in the custody of the tax authority; or

(b) a copy of the entries certified by that authority under its signature, as true copy of the original entries contained in the records or other documents in its custody.

(xi) Punishment for second and subsequent offences [Section 58]

If any person convicted of an offence under section 49 to section 53 is again convicted of an offence under any of the aforesaid provisions, he shall be punishable for the second and every subsequent offence with rigorous imprisonment for a term of three to ten years and with fine ranging from ₹ 5 lakh to ₹ 1 crore.

(xii) Summary of Prosecution Provisions in Chapter V

Section	Offence	Punishment
49	Willful failure to furnish return in relation to foreign income and asset (including financial interest in any entity) before the expiry of the assessment year by a person, being a resident other than not ordinarily resident in India	Rigorous Imprisonment: 6 months to 7 years **(+)** Fine
50	Willful failure to furnish in the return of income, any information about an asset (including financial interest in any entity) located outside India by a person, being a resident other than not ordinarily resident in India	Rigorous Imprisonment: 6 months to 7 years **(+)** Fine
51(1)	Willful attempt to evade any tax, penalty or interest chargeable or imposable under the Act by a person, being a resident other than not ordinarily resident in India	Rigorous Imprisonment: 3 to 10 years **(+)** Fine
51(2)	Willful attempt to evade payment of any tax, penalty or interest under the Act by any person	Rigorous Imprisonment: 3 months to 3 years **(+)** Fine, at the discretion of the court.
52	Making false statement in verification or delivering an account of statement which is false knowingly	Rigorous Imprisonment: 6 months to 7 years **(+)** Fine
53	Abetting or inducing a person to make or deliver a false statement, account or	Rigorous Imprisonment: 6 months to 7 years

	declaration knowingly or to commit an offence u/s 51(1)	**(+)** Fine
58	Second and subsequent offence	Rigorous Imprisonment: 3 to 10 years **(+)** Fine: ₹ 5 lakh to ₹1 crore.

5.6 GENERAL PROVISIONS [CHAPTER VII]

(i) **Agreement with foreign countries or specified territories [Section 73]** - The Central Government may enter into an agreement with the Government of any other country or specified territory outside India for the purposes mentioned in (a) and (b) below. Also, any specified association in India may enter into an agreement with any specified association in the specified territory outside India for such purposes:

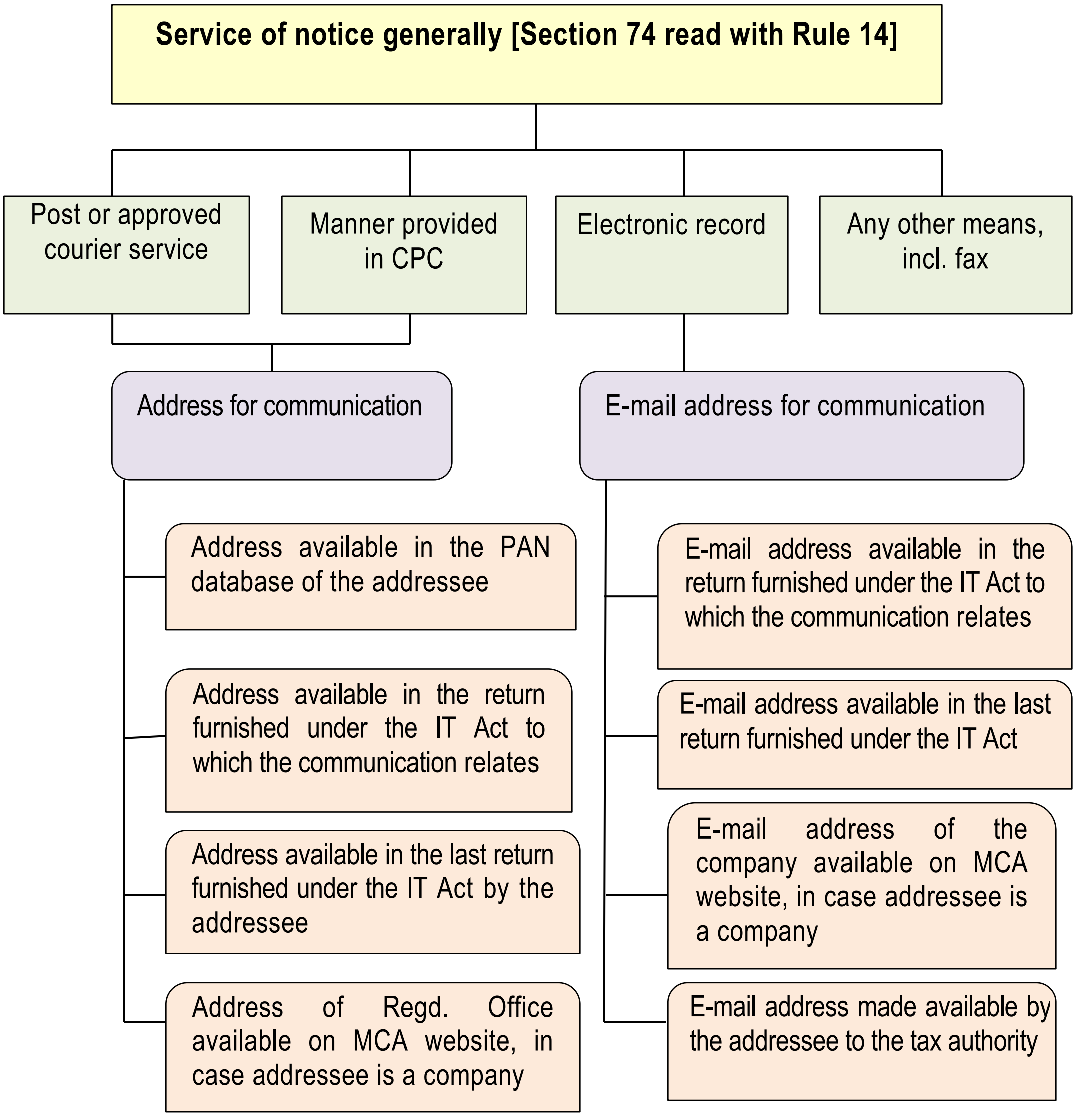
(a) Exchange of information for prevention of evasion or avoidance of tax on undisclosed foreign income chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance.

(b) Recovery of tax under this Act and under the corresponding law in force in that country.

The Central Government is empowered to notify such provisions as may be necessary for implementing such agreements entered into by it. Also, it is empowered to notify such provisions as may be necessary for adopting and implementing such agreements entered into by any specified association in India.

Terms used but not defined in this Act or in such agreements would have the meaning assigned in the notification issued by the Central Government, provided such meaning is not inconsistent with the provisions of the Act or the agreement or such term is not required to have any other meaning in the given context. The meaning assigned in the notification would be deemed to be effective from the date on which such agreement comes into force.

(ii) **Service of notice** – Any notice, summons, requisition, order or any other communication under this Act may be served by delivering or transmitting a copy thereof by post or approved courier service or in such manner as provided under the Code of Civil Procedure, 1908 (CPC) for service of summons or in the form of electronic record or by other means of transmission of documents, including fax message or electronic mail message as may be prescribed.



Note - In case of service of notice by post or approved courier service or in the manner provided in CPC, where the addressee furnishes in writing communication to the tax authority or any person authorised by such authority issuing the communication, the communication should not be sent to the any of the addresses mentioned above.

(iii) **Authentication of notices and other documents [Section 75]** - Every notice or other document required to be issued, served or given for the purposes of this Act by any tax authority shall be authenticated by that tax authority and the same shall be deemed to be authenticated, if the name and office of a designated tax authority is printed, stamped and otherwise written thereon. The designated tax authority means any tax authority authorised by the CBDT to issue, serve or give such notice or other document after such authentication.

(iv) **Notice deemed to be valid in certain circumstances [Section 76]** - The notice shall be deemed to be duly served upon a person, if the person has appeared in any proceeding or co-operated in any enquiry relating to assessment. Such person cannot take any objection in any proceeding or inquiry under the Act that the notice was not served upon him or was not served upon him in time or was served upon him in an improper manner. Notice shall, however, not be deemed to have been served if the person has raised the objection before the completion of an assessment.

(v) **Appearance by approved valuer in certain matters or authorized representative [Sections 77 & 78]** - Any assessee who is entitled or required to attend before any tax authority or Appellate Tribunal in connection with any proceeding under this Act may do so through an authorised representative. In the case of any matter relating to valuation of any asset, he may attend through a valuer as approved by Principal Commissioner or Commissioner in accordance with the prescribed Rules. However, the said provision would not apply in a case, where assessee is required to attend personally for examination on oath or affirmation under section 8.

Meaning of Authorised Representative:

(a) a person related to the assessee in any manner, or a person regularly employed by the assessee;

(b) any officer of a scheduled bank with which the assessee maintains a current account or has other regular dealings;

(c) any legal practitioner who is entitled to practice in any civil court in India;

(d) an accountant;

(e) any person who has passed any accountancy examination recognised in this behalf by the CBDT; or

(f) any person who has acquired a degree in Commerce or Law conferred by any Indian University incorporated by any law for the time being in force or certain prescribed foreign universities.

(vi) **Rounding off of income, value of asset and tax [Section 79]** - The amount of undisclosed foreign income and assets shall be rounded off to the nearest multiple of one hundred rupees. The amount payable or receivable by the assessee under this Act shall be rounded off to the nearest multiple of ten rupees. For this purpose, where such amount contains a part of a rupee consisting of paise then, if such part is fifty paise or more, it shall be increased to one rupee and if such part is less than fifty paise it shall be ignored.

(vii) **Cognizance of offences [Section 80]** - A court inferior to that of a metropolitan magistrate or a magistrate of First Class cannot try any offence under this Act.

(viii) **Assessment not to be invalid on certain grounds [Section 81]** - An assessment, notice, summons or other proceeding under this Act shall not be invalid or deemed to be invalid merely by reason of any mistake, defect or omission in such assessment, notice, summons or other proceedings if such assessment, notice, summons or other proceeding is in substance and effect, in conformity with the intent and purpose of this Act.

(ix) **Bar of suits in civil courts [Section 82]** – No suit shall be brought in any civil court to set aside or modify any proceeding or order under this Act. Further, no prosecution, suit or other proceeding shall lie against the Government or any officer of the Government, for anything done or intended to be done in good faith under this Act.

(x) **Income-tax papers to be available for the purposes of this Act [Section 83]** – All information contained in any statement or return furnished under Income-tax Act or obtained or collected for the purposes of that Act may be used for the purpose of this Act.

(xi) **Certain provisions of the Income-tax Act to apply to this Act [Section 84]** – The same will apply with necessary modifications as if the said provisions refer to undisclosed foreign income and asset instead of to income-tax.

Section	Provision
119	Instructions to subordinate authorities
133	Power to call for information
134	Power to inspect registers of companies
135	Power of Principal Director General or Director General or Principal Director or Director, Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner or Joint Commissioner to make an enquiry
138	Disclosure of information respecting assessees
***144A*[1]**	***Power of Joint Commissioner to issue directions in certain cases***
237	Refunds
240	Refund on appeal, etc.
245	Set off of refunds against tax remaining payable
280	Disclosure of particulars by public servants
280A	Special Courts
280B	Offences triable by Special Court

[1] *With effect from 1.9.2019*

280D	Application of Code of Criminal Procedure, 1973 to proceedings before Special Court
281	Certain transfers to be void
281B	Provisional attachment to protect revenue in certain cases
284	Service of notice in the case of discontinued business
Chapter XV	Liability in special cases – Firms, AOPs and BOIs.

(xii) **Power to make Rules [Section 86]** – The CBDT may, with the approval of the Central Government, notify Rules to carry out the provisions of this Act. The power to make rules conferred by this section includes the power to give retrospective effect to the rules or any of them from a date not earlier than the date of commencement of this Act. However, a retrospective effect should not be given to any rule so as to prejudicially affect the interest of assessees.

Every rule made under this Act has to be laid as soon as may be after it is made before each House of Parliament while it is in session for a total period of 30 days which may be comprised in one session or in two or more successive sessions. If, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or both Houses agree that the rule should not be made, the rule shall thereafter have effect only in such modified form or be of no effect, as the case may be. However, any such modification or annulment would be without prejudice to the validity of anything previously done under that rule.

(xiii) **Power to remove difficulties [Section 86]** – The Central Government may, by order not inconsistent with the provisions of the Act, remove any difficulty arising in giving effect to the provisions of this Act. However, no such order shall be made after the expiry of a period of two years from the date on which the provisions of this Act came into force. Every such order shall be laid before each House of the Parliament.

(xiv) **Amendment of PMLA [Section 88]** – The Prevention of Money Laundering Act (PMLA), 2002 has been amended to include offence of willful attempt to evade any tax, penalty or interest referred to in section 51 under this legislation as a scheduled offence under PMLA.

Note: *Students are advised to read the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 [As amended by the Finance (No.2) Act, 2019] and the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Rules, 2015 available at the website of the Income-tax Department, Government of India, www.incometaxindia.gov.in*

CHAPTER 6

TAXATION OF E-COMMERCE TRANSACTIONS

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the meaning of e-commerce and how business is transacted through E-commerce;
- **identify** the issues and problems in taxing e-commerce transactions;
- **appreciate** the need for equalization levy and provisions incorporated in Indian tax laws in respect of such levy;
- **compute** equalization levy;
- **integrate, analyse and apply** the above concepts and provisions in making computations and addressing relevant issues.

6.1 WHAT IS E-COMMERCE?

E-commerce or electronic commerce, in its widest sense, means consumer and business transactions conducted over a network, with the help of computers and telecommunications. In other words, e-commerce refers to the exchange of goods or services for value on the internet. E-commerce, *inter-alia,* includes, online shopping, online trading of goods and services, electronic fund transfers, electronic data exchanges and online trading of financial instruments. The Indian Foreign Direct Investment policy defines "e-commerce" to mean buying and selling of goods and services including digital products over a digital and electronic network.

[1]OECD defines e-commerce as the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing orders. Accordingly, whether a commercial transaction qualifies as e-commerce is determined by the ordering method rather than the characteristics of the product purchased, the parties involved, the mode of payment or the delivery channel. The ordering process is considered as a crucial determinant of an e-commerce transaction in the OECD definition.

E-commerce facilitates trade across borders, increases convenience for consumers, and enables firms to reach new markets. The e-commerce reforms has rapidly evolved through the development of new business models, which often integrate new and emerging digital technologies as well as new online payment mechanisms. Many e-commerce business models use online platforms, facilitating purchases between often unknown and dispersed buyers and sellers. Another emerging trend is the growth of subscription e-commerce business models, whereby users access goods and services in a continuous, recurring stream. E-commerce business models integrate digital ordering mechanisms alongside physical infrastructures, including within brick-and-mortar stores.

6.2 HOW IS BUSINESS TRANSACTED THROUGH E-COMMERCE?

E-commerce is but a method of conducting business transactions and not a business transaction by itself. Therefore, the contents of a business transaction done through e-commerce means is no different from that of a business transaction carried out through traditional means.

New business models push out the e-commerce frontier in two ways. First, new business models can enable more transactions to move online in a given market or for a given set of participants. Second, new business models can enable whole new markets to emerge for goods and services that previously could not have been bought or sold online, or allow new participants to enter the market.

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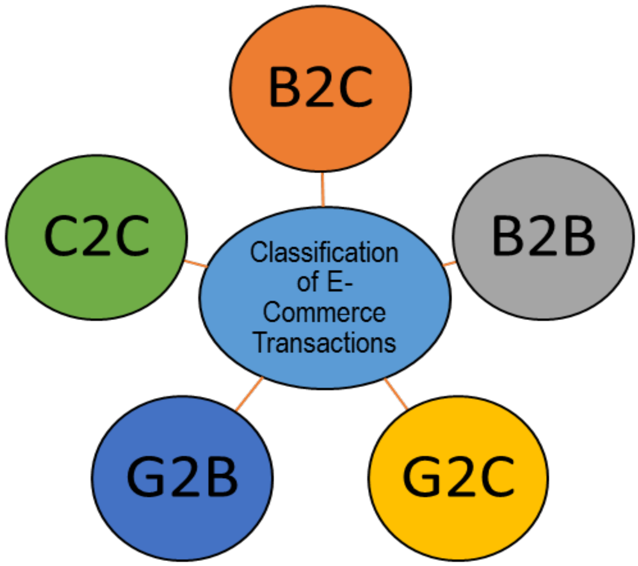
[1] OECD (2019), Unpacking E-commerce: Business Models, Trends and Policies, OECD Publishing, Paris, https://doi.org/10.1787/23561431-en.

Digital technologies enable e-commerce innovations and often serve as the backbone of business model developments. Some of these technologies, like smart assistants enabled by artificial intelligence (AI), constitute new channels for selling or purchasing products over electronic networks. Similarly, online payment innovations can help to unlock e-commerce potential by promoting trusted online transactions between unknown parties.

Classification of E-commerce based on parties involved in transactions. Major types are mentioned below:



(i) **Business to Customers (B2C):** In this type of e-commerce, transactions take place between businesses and consumers. In B2C e-commerce, products or services are sold to end-users (i.e. consumers).

__Examples:__ Amazon.in, Flipkart.com, Myntra.com, Snapdeal.com etc. are the examples of B2C e-commerce businesses, where consumers can find almost anything be it books, electronic products like washing machines, USB storage devices, clothes, shoes or personal care etc.

(ii) **Business to Business (B2B):** In B2B e-commerce, transactions take place between two businesses.

__Example:__ IndiaMART, TradeIndia, Alibaba, go4WorldBusiness.com (an online B2B marketplace for global exporters and importers), Amazon, the US-based ecommerce giant etc are the example of B2B online platforms.

(iii) **Government to Customers (G2C):** The online platform between a government and its citizens or consumers for paying taxes, registering vehicles, and providing information and services such as filing of income-tax return etc.

(iv) **Government to Business (G2B)/Business to Government(B2G):** In G2B/B2G e-commerce, an electronic exchange of any information between businesses and the government, usually using internet so the cooperation or communication takes place on the internet. In G2B, government agencies and business use websites, procurement marketplaces, applications, web services.

Example: *Government e-Marketplace (GeM), a one stop portal to facilitate online procurement of common use Goods & Services required by various Government Departments / Organizations / PSUs.*

INAM-Pro is a web based application, designed by National Highways and Infrastructure Development Corporation Ltd (NHIDCL) and launched by the Ministry as a common platform to bring cement buyers and sellers together.

(v) **Customer to Customer (C2C):** When goods or services are bought and sold between two consumers, C2C e-commerce business takes place.

Example: *Olx, an C2C e-commerce online platform where customer sells his used goods to other customer; eBay, an online marketplace in which an individual sells a product or service to another.*

E-Commerce Business Models

With the advancement of digitalization and emergence of new technologies, new forms of e-commerce business models are evolved. Some of such ways of transacting e-commerce business are discussed here below:

Online platform e-commerce business model:

In the context of e-commerce, online platforms act as intermediaries between buyers and sellers to facilitate the exchange of goods and services over the Internet. Buyers benefitted due to the presence of variety of products available with diverse sellers. Likewise, sellers discover many buyers to whom they can sell their products. As compared to the physical stores, digital marketplace deliver massive variety of goods and service.

Meaning of Marketplace based model and Inventory based model of e-commerce*[2]*:

Marketplace based model *of e-commerce means providing of an information technology platform by an e-commerce entity on a digital & electronic network to act as a facilitator between buyer and seller.*

Inventory based model of e-commerce *means an e-commerce activity where inventory of goods and services is owned by e-commerce entity and is sold to the consumers directly.*

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[2] *Consolidated FDI Policy Circular of 2017, dated 28.8.2017 read with Press Note dated 26.12.2018*

Subscription e-commerce business model: Subscription business model is characterised by regular and recurring payments for the repeated provision of a good or a service. The subscription business model can relate to recurring purchases of digital goods and services, or a combination of both digital and tangible products (such as a newspaper subscription that includes access to digital content). Some current e-commerce subscription business models, such as Spotify or Netflix etc.

Digital identity and its potential for e-commerce: Digital identity refers to the set of information used by a computer to authenticate an identity. For example, India's Aadhaar programme issues a unique number to every Indian citizen which is a valid means of identification *vis-à-vis* the government as well as private Internet sites including Airbnb, Uber and digital wallet services.

Subscription access to tangible and bundled goods and services: A recent e-commerce trend has been the growth of subscription business models for tangible goods, including in categories like beauty supplies (Birchbox), minerals (Celestial Minerals), groceries (Blue Apron, Hello Fresh), snack foods (Nature Box), cosmetics and self-care products (Dollar Shave Club, Harry's), and many more.

Online-offline e-commerce business models: These business models serve as extensions of e-commerce, pushing the edges of online purchases into physical stores. Some business models combine online ordering with offline distribution, which may be useful to enable the online purchase of products whose quality may not be assessed from a distance, such as perishable goods like groceries. Many businesses have taken advantage of the ubiquity of digital technologies to grow business models based on a combination of both online and offline features. Other online businesses are moving offline by adding brick-and-mortar elements to enable the online sale of other goods, like clothing, where fit may be difficult to assess from a distance.

Mobile technologies - Helping e-commerce to flourish in brick-and-mortar stores: Mobile technologies empower consumers to perform a range of digital activities, including online shopping. Consumers use digital technologies throughout the commercial process, but smartphones enable buyers to compare prices, to do research and finally make transactions from any networked location. A Google survey found that 82% of surveyed consumers research products on their smartphones before making purchases in brick-and-mortar stores.

Online groceries – A new e-commerce frontier: Many businesses have tried to develop processes to successfully sell perishable food and groceries online. Some online business models offer direct shipping of purchased groceries alongside guarantees related to quality and customer satisfaction to give consumers confidence in the purchase of perishable goods and services. This model, however, necessitates the development of a cold-chain direct fulfilment and logistics system, which made this model expensive.

Innovative payment mechanisms: Safely and remotely exchanging money online, including across borders, is fundamental to e-commerce. Safe and effective online payment mechanisms facilitate trusted online transactions, boosting the growth of e-commerce between unknown buyers and sellers. Many online payment mechanisms are closely associated with the rise of e-commerce. In fact, one of the earliest online payment models is "Paypal", which is emerged in combination with the pioneering online auction house and e-commerce platform eBay, to enable safe online payments between the parties involved.

Digital wallets: An online payment can be broadly considered to be a "purchase order placed using devices connected to the Internet", a definition that is relevant to many forms of e-commerce. One mechanism of enabling online payments includes the use of digital wallets, also known as "e-wallets" or "electronic wallets".

Digital wallets allow e-commerce by enabling trusted transactions online, without which most e-commerce purchases would not be possible. Consumers may be more willing to do a transaction online using a digital wallet as opposed to directly sharing financial information with online retailers.

Mobile money - Extending e-commerce to the unbanked: Another form of payment innovation that enables e-commerce is the rise of a specific form of mobile payment, also known as "mobile money", particularly for unbanked people (i.e. those without access to financial services). Mobile money differs from digital wallets insofar that the mechanism for payment is conducted via mobile communication networks, and does not necessarily require an existing relationship with a financial services provider.

Mobile money is facilitated by mobile network operators who use a system of agents to accept regular currency in the form of cash and store an equivalent value in a digital wallet, which can then be transferred to other users or can be withdrawn later. Mobile money is connected with a mobile phone number and often uses two-factor authentication through a personal identification number issued at the point of registration. Mobile money can be transferred to others who are also registered with the same mobile money system, exchanged with merchants for goods and services, or can be withdrawn as cash from a mobile money agent. Mobile money can therefore act as a means of storing and transferring value in a secure and convenient way for unbanked people.

Resources: *The discussion on E-commerce Business Models in this chapter is essentially based on the text published in "Unpacking E-commerce: Business Models, Trends and Policies, OECD Publishing, Paris" available at https://doi.org/10.1787/23561431-en.*

6.3 EQUALISATION LEVY: GENESIS & STATUTORY PROVISIONS

(1) Growth of e-commerce and concerns emerging therefrom:

(i) The rapid growth of information and communication technology has resulted in substantial expansion of the supply and procurement of digital goods and services globally, including India. The digital economy is growing at approximately 10% per annum, significantly faster than the global economy as a whole.

(ii) At present, in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. Hence, business in digital domain doesn't actually occur in any physical location but instead takes place in "cyberspace." Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

(2) Taxation issues relating to e-commerce:

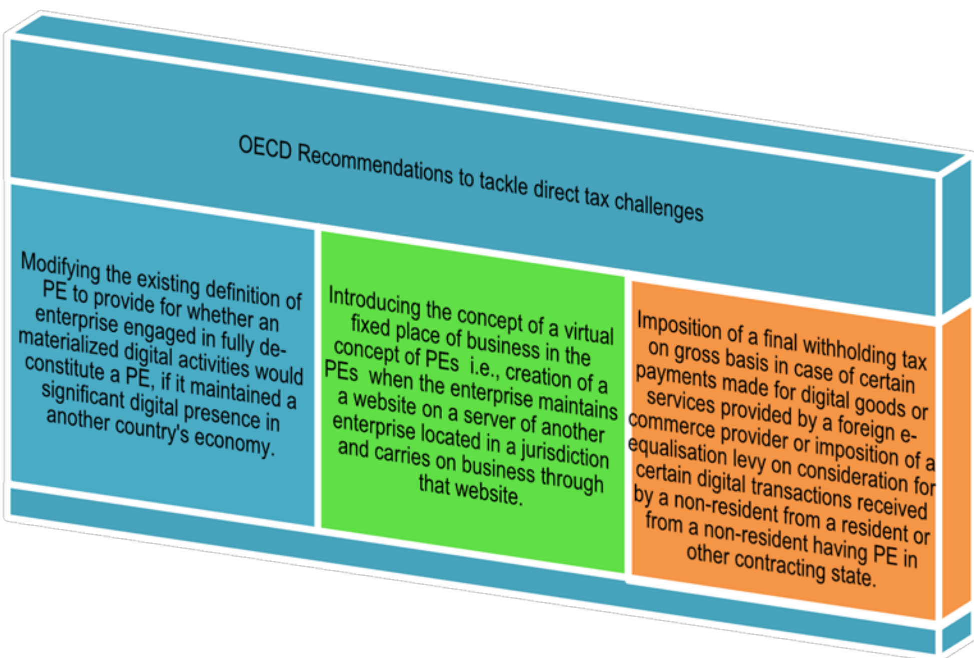
These new business models have created new tax challenges. The typical taxation issues relating to e-commerce are:

(i) the difficulty in characterizing the nature of payment and establishing a nexus or link between taxable transaction, activity and a taxing jurisdiction,

(ii) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e. place of business, location, and permanency must be reconciled with the new digital reality.

(3) OECD Recommendations under Action Plan 1 of the BEPS project:



Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

(4) Equalisation Levy - Insertion of Chapter VIII in the Finance Act, 2016:

In order to address these challenges, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having PE in India, from a resident in India who carries out business or profession, or from a non-resident having PE in India.

The CBDT issued a notification dated 27 May, 2016, stating that the provisions of Chapter VIII relating to the equalisation levy would come into effect from 1st June 2016. This Chapter extends to the whole of India except Jammu and Kashmir. It applies in respect of consideration received or receivable for specified services provided on or after 1.6.2016.

The key aspects related to Equalisation Levy have been discussed below.

(a) Meaning of "Equalisation Levy" [Section 164(d) of the Finance Act, 2016]:

Equalisation levy means the tax leviable on consideration received or receivable for any specified service

(b) Meaning of "Specified Service" [Section 164(i) of the Finance Act, 2016]:

(i) Online advertisement;

(ii) Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

(iii) Any other service as may be notified by the Central Government.

Note – 'Online' means a facility or service or right or benefit or access that is obtained through the internet or any other form of digital or telecommunication network.

(c) Charge of Equalisation Levy [Section 165 of Finance Act, 2016]:

(i) Equalisation levy @6% is leviable on the amount of consideration for specified service received or receivable by a person, being a non-resident from -

(a) a person resident in India and carrying on business or profession; or

(b) a non-resident having a PE in India.

(ii) Equalisation levy is not chargeable, where –

(a) the non-resident providing the specified service has a PE in India and the specified service is effectively connected with such PE;

(b) the aggregate amount of consideration for specified service received or receivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a PE in India, does not exceed ₹ 1 lakh; or

(c) where the payment for the specified service by the person resident in India, or the PE in India is not for the purposes of carrying out business or profession.

(d) Relief to small players in the digital domain:

In order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India and carrying on business or profession or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

Further, equalisation levy shall not be charged where the payment for the specified service by the person resident in India or the permanent establishment in India, is not for the purposes of carrying out business or profession.

(e) Provisions of Chapter on Equalisation Levy:

Section	Subject	Provisions
166	**Collection and recovery of equalisation levy**	
	Person responsible for deduction of equalisation levy	Every person, being a resident and carrying on business or profession or a non-resident having a permanent establishment in India shall deduct equalisation levy from the amount paid or payable to a non-resident in respect of the specified service.
	Rate of equalisation levy	**6%** of the amount of consideration for specified service paid or payable to a non-resident in respect of specified service by a person resident in India and carrying on business or profession or a non-resident having a PE in India. The amount of consideration of specified services, equalisation levy, interest and penalty payable and refund shall be **rounded off to the nearest multiple of ten rupees**. [Rule 3 of Equalisation Levy Rules, 2016]
	Threshold limit	Equalisation levy is deductible if the aggregate amount of consideration for specified service in a previous year exceeds **one lakh rupees**.
	Time period for remittance of	The equalisation levy so deducted during any calendar month shall be paid by every assessee to the credit of the

	equalisation levy	Central Government **by the 7th of the month immediately following the said calendar month**. Equalisation levy deducted during any calendar month is to be paid to the credit of the Central Government by remitting it to the Reserve Bank of India or the State Bank of India or any other authorised bank, accompanied by an equalisation levy challan. [Rule 4 of Equalisation Levy Rules, 2016]
	Consequence of failure to deduct equalisation levy	Any assessee who fails to deduct equalisation levy shall, notwithstanding such failure, be liable to pay the levy to the credit of the Central Government by the 7th of the month immediately following the said calendar month. Thus, if the assessee responsible for deducting equalisation levy, fails to so deduct, he has, in any case, to pay such levy to the credit of the Central Government by the 7th of the month immediately following the said calendar month.
167	**Furnishing of statement**	
	Statement in prescribed form within time	Every assessee shall, within the prescribed time after the end of each financial year, prepare and deliver or cause to be delivered to the Assessing Officer or to any other authority or agency authorised by the Board in this behalf, a statement in the prescribed form, verified in the prescribed manner and setting forth the prescribed particulars in respect of all specified services during such financial year. The statement in respect of all specified services chargeable to equalisation levy during any financial year is required to be furnished electronically in **Form No. 1** (verified through either a digital signature or an electronic verification code) **on or before 30th June** immediately following that financial year [Rule 5 of Equalisation Levy Rules, 2016]
	Time limit for filing a revised statement	An assessee who has not furnished the statement on or before 30th June immediately following the financial year or having furnished a statement within that time, notices any omission or wrong particulars therein, may furnish a statement or a revised statement, as the case may be. Such statement or revised statement has to be filed at any time **before the expiry of two years from the end of the financial year** in which the specified service was provided.

	Time limit for filing a statement in response to notice issued by the Assessing Officer	Where any assessee fails to furnish the statement within the prescribed time, the Assessing Officer may serve a notice upon such assessee requiring him to furnish the statement in the prescribed form, verified in the prescribed manner and setting forth the prescribed particulars, within such time, as may be prescribed. The Assessing Officer has been empowered to issue notice for furnishing such statement, which then has to be furnished, **within 30 days from date of serving of such notice** [Rule 6 of Equalisation Levy Rules, 2016]
168	**Processing of statement.**	
	Manner of processing of statement	Where a statement has been made under section 167 by the assessee, such statement shall be processed in the following manner, namely:— (a) the equalisation levy shall be computed after making the adjustment for any arithmetical error in the statement; (b) the interest, if any shall be computed on the basis of sum deductible as computed in the statement; (c) the sum payable by, or the amount of refund due to, the assessee shall be determined after adjustment of interest computed against the equalisation levy paid under section 166(2) or interest paid section 170 and any amount paid otherwise by way of tax or interest; (d) an intimation shall be prepared or generated and sent to the assessee specifying the sum determined to be payable by, or the amount of refund due to him; and (e) the amount of refund due to the assessee in pursuance of such determination shall be granted to him. However, no such intimation shall be sent after the expiry of **one year from the end of the financial year** in which the statement is furnished.
	Prescribed form for service of notice of demand on the taxpayer	Where any levy, interest or penalty is payable under the equalisation levy provisions, a notice of demand in Form No. 2 specifying the sum so payable shall be served upon the taxpayer. Further, intimation issued upon processing of the statement of specified services shall also be deemed to be a notice of demand. [Rule 7 of Equalisation Levy Rules, 2016]

<table>
<tr><td></td><td>Scheme for centralised processing of statements</td><td>For the purposes of processing of statements, the CBDT may make a scheme for centralised processing of such statements to expeditiously determine the tax payable by, or the refund due to, the assessee as required thereunder.</td></tr>
<tr><td rowspan="5">169</td><td>Rectification of mistake</td><td></td></tr>
<tr><td>Time limit for amending an intimation</td><td>With a view to rectifying any mistake apparent from the record, the Assessing Officer may amend any intimation issued under section 168.
Such intimation can be amended within one year from the end of the financial year in which the intimation sought to be amended was issued.</td></tr>
<tr><td>Amendment can be made suo motu or brought to notice by the assessee</td><td>The Assessing Officer may make an amendment to any intimation, either suo motu or on any mistake brought to his notice by the assessee.</td></tr>
<tr><td rowspan="2">Opportunity of being heard to be given by the Assessing Officer before amending an intimation</td><td>An amendment to any intimation, which has the effect of increasing the liability of the assessee or reducing a refund, shall not be made unless the Assessing Officer has given notice to the assessee of his intention so to do and has given the assessee a reasonable opportunity of being heard.</td></tr>
<tr><td>Where any such amendment to any intimation has the effect of enhancing the sum payable or reducing the refund already made, the Assessing Officer shall make an order specifying the sum payable by the assessee and the provisions of this Chapter shall apply accordingly.</td></tr>
<tr><td>170</td><td>Interest on delayed payment of equalisation levy</td><td>An assessee who fails to credit the equalisation levy or any part thereof within 7th of the month following the calendar month in which it is deducted, to the account of the Central Government, has to pay simple interest at the rate of 1% of such levy for every month or part of a month by which such crediting of the tax or any part thereof is delayed.</td></tr>
<tr><td>171</td><td>Penalty for failure to deduct or pay equalisation levy.</td><td><table><tr><th>Nature of default</th><th>Penalty</th></tr><tr><td>Failure to deduct whole or part of equalisation levy</td><td>In addition to payment of equalisation levy under section 166(3) and interest under section 170, penalty equal to the amount of equalisation levy that he failed to deduct would be leviable</td></tr></table></td></tr>
</table>

		Failure to remit equalisation levy to the Central Government on or before 7th of the following month, after deduction	In addition to paying the equalisation levy under section 166(2) and interest under section 170, a penalty of ₹ 1,000 for every day during which the failure continues is leviable. However, such penalty shall not exceed the amount of equalisation levy that he failed to pay.
172	**Penalty for failure to furnish statement**	For failure to furnish the statement within 30th June of the immediately following year or within 30 days from the date of service of notice by the Assessing Officer, penalty of **₹100 for each day during which the failure continues** is leviable.	
173	**Circumstances when penalty cannot be imposed under section 171 and 172**	No penalty for failure to deduct or pay equalisation levy or failure to furnish statement shall be imposable, if the assessee proves to the satisfaction of the Assessing Officer that there was reasonable cause for the said failure. Further, no order imposing a penalty under this Chapter shall be made unless the assessee has been given a reasonable opportunity of being heard.	
174	**Appeal to Commissioner of Income-tax (Appeals).**		
	Time limit for filing of appeal against an order imposing penalty	An assessee aggrieved by an order imposing penalty under this Chapter, may appeal to the Commissioner of Income-tax (Appeals) within a period of **30 days from the date of receipt of the order** of the Assessing Officer	
	Fee for filing appeal	An appeal shall be in the prescribed form [Form 3] and verified in the prescribed manner. It shall be accompanied by a **fee of ₹1,000**. It may be filed electronically under digital signature or electronically through EVC. Any document accompanying Form No.3 has to be furnished in the manner in which Form No.3 is furnished.[Rule 8 of Equalisation Levy Rules, 2016]	
	Provisions of the Income-tax Act,	Where an appeal has been filed, the provisions of sections 249 to 251 of the Income-tax Act, 1961 would, as far as	

	1961 applicable in case of such appeals	may be, apply to such appeal. Section 250 specifies the procedure in appeal and section 251 enlists the powers of the Commissioner (Appeals).
175	**Appeal to Appellate Tribunal**	
	Assessee/CIT may file appeal to Appellate Tribunal against an order passed by Commissioner (Appeals) under section 174	An assessee aggrieved by an order made by the Commissioner of Income-tax (Appeals) under section 174 may appeal to the Appellate Tribunal against such order. The Commissioner of Income-tax may, if he objects to any order passed by the Commissioner of Income-tax (Appeals) under section 174, direct the Assessing Officer to appeal to the Appellate Tribunal against such order.
	Time limit for filing appeal	An appeal shall be filed within **60 days** from the date on which the order sought to be appealed against is received by the assessee or by the Commissioner of Income-tax, as the case may be.
	Fee for filing appeal	The appeal shall be in the prescribed form [Form No.4] and verified in the prescribed manner. In the case of an appeal filed by an assessee, it shall be accompanied by a **fee of ₹1,000**. Also, the form of appeal, the grounds of appeal and the form of verification appended thereto shall be signed by the person specified in Form No.4 [Rule 9 of Equalisation Levy Rules, 2016]
	Provisions of the Income-tax Act, 1961 applicable in case of such appeals	Where an appeal has been filed before the Appellate Tribunal under sub-section (1) or sub-section (2), the provisions of sections 253 to 255 of the Income-tax Act, 1961 would, as far as may be, apply to such appeal.
176	**Punishment for false statement**	If a person - (a) ***makes a false statement in any verification*** under this Chapter or any rule made thereunder; or (b) ***delivers an account or statement, which is false***, and which he either knows or believes to be false, or does not believe to be true, he shall be punishable with imprisonment for a term which may extend to **three years and with fine**.
		An offence so punishable shall be deemed to be non-cognizable within the meaning of the Code of Criminal Procedure. This is irrespective of anything contained in the Code of Criminal Procedure, 1973.

<table>
<tr><td>177.</td><td>Institution of prosecution</td><td>Prior sanction of the Chief Commissioner of Income-tax is required for instituting prosecution against any person for any offence under section 176.</td></tr>
<tr><td>178.</td><td>Application of certain provisions of Income-tax Act, 1961</td><td>The following provisions of the Income-tax Act, 1961 shall so far as may be, apply in relation to equalisation levy, as they apply in relation to income-tax.
<table>
<tr><th>Section</th><th>Content</th></tr>
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<tr><td>131</td><td>Power regarding discovery, production of evidence, etc.</td></tr>
<tr><td>133A</td><td>Power of survey</td></tr>
<tr><td>138</td><td>Disclosure of information respecting assessees</td></tr>
<tr><td>156</td><td>Notice of demand</td></tr>
<tr><td>Chapter XV</td><td>Liability in special cases</td></tr>
<tr><td>220-227</td><td>- When tax payable and when assessee deemed in default,
- Penalty payable when tax in default,
- Certificate to Tax Recovery Officer,
- Tax Recovery Officer by whom recovery is to be effected,
- Validity of certificate and cancellation or amendment thereof,
- Stay of proceedings in pursuance of certificate and amendment or cancellation thereof,
- Other modes of recovery,
- Recovery through State Government.</td></tr>
<tr><td>229</td><td>Recovery of penalties, fine, interest and other sums</td></tr>
<tr><td>232</td><td>Recovery by suit or under other law not affected.</td></tr>
<tr><td>260A</td><td>Appeal to High Court</td></tr>
<tr><td>261</td><td>Appeal to Supreme Court</td></tr>
<tr><td>262</td><td>Hearing before Supreme Court</td></tr>
<tr><td>265 to 269</td><td>- Tax to be paid notwithstanding reference etc.,</td></tr>
</table></td></tr>
</table>

			- Execution for costs awarded by Supreme Court, - Amendment of assessment on appeal - Exclusion of time taken for copy, - Filing of appeal or application for reference by income-tax authority, - Definition of "High Court"
		278B	Offences by companies
		280A	Special Courts
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		280C	Trial of offences as summons case
		280D	Application of Code of Criminal Procedure, 1973 to proceedings before Special Court
		282	Service of notice generally
		288 to 293	- Appearance by authroised representative, - Rounding off of income, - Rounding off of amount payable and refund due, - Receipt to be given, - Indemnity, - Power to tender immunity from prosecution, - Cognizance of offences, - Section 360 of the Code of Criminal Procedure, 1973 and the Probation of Offenders Act, 1958, not to apply, - Return of income, etc., not to be invalid on certain grounds, - Notice deemed to be valid in certain circumstances, - Presumption as to assets, books of account etc., - Authorisation and assessment in case of search or requisition, - Bar of suits in civil courts
179	**Power to make rules**	The Central Government is empowered to make rules for the purposes of carrying out the provisions of this Chapter.	

		Also, every Rule made under this Chapter shall be laid before each House of Parliament.
		In particular, such rules may also provide for all or any of the following matters, namely:— (a) the time within which and the form and the manner in which the statement shall be delivered or caused to be delivered or furnished under section 167; (b) the form in which an appeal may be filed and the manner in which it may be verified under sections 174 and 175; (c) any other matter which is to be, or may be, prescribed.
		Every rule made under this Chapter shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of **30 days**. This period of 30 days may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree: (i) in making any modification in the rule, then, the rule shall thereafter have effect only in such modified form; (ii) that the rule should not be made, then, the rule would be of no effect. However, any such modification or annulment would be without prejudice to the validity of anything previously done under that rule.
180	**Power to remove difficulties**	The Central Government is empowered to remove any difficulty which arises in giving effect to the provisions of this Chapter. It may, by order published in the Official Gazette, not inconsistent with the provisions of this Chapter, remove the difficulty. However, no such order shall be made after the expiry of a period of **two years from the date on which the provisions of this Chapter come into force**. Every order made under this section shall be laid, as soon as may be after it is made, before each House of Parliament.

(f) Consequential provisions in the Income-tax Act, 1961:

	Section	Provision
(i)	10(50)	In order to avoid double taxation, section 10(50) provides to exempt any income arising from providing any specified service on or after the date on which the provisions of Chapter VIII of the Finance Act, 2016 comes into force, and chargeable to equalisation levy under that Chapter.
(ii)	40(a)(ib)	In order to ensure compliance with the provisions this Chapter, section 40(a)(ib) provides that if any consideration is paid or payable to a non-resident for a specified service on which equalisation levy is deductible, and such levy has not been deducted or after deduction, has not been paid on or before the due date under section 139(1), then, such expenses incurred by the assessee towards consideration for specified service shall not be allowed as deduction. However, where in respect of such consideration, if the equalisation levy has been deducted in any subsequent year or has been deducted during the previous year but paid after the due date specified under section 139(1), such sum shall be allowed as deduction in computing the income of the previous year in which such levy has been paid.

ILLUSTRATION

ABC ltd., an Indian company, is carrying on the business of manufacture and sale of teakwood furniture under the brand name "PUREWOOD". In order to expand its overseas sales/exports, it launched a massive advertisement campaign of its products. For the purpose of online advertisement, it utilized the services of PQR Inc., a London based company. During the previous year 2019-20, ABC Ltd. Paid ₹ 5 lakhs to PQR Inc. for such services. Discuss the tax implications/TDS implications of such payment and receipt in the hands of ABC Ltd. and PQR Inc., respectively, if –

(i) PQR Inc. has no permanent establishment in India

(ii) PQR Inc. has a permanent establishment in India, and the service is effectively connected to the permanent establishment in India

SOLUTION

Chapter VIII of the Finance Act, 2016, "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

"Specified Service" means

(1) online advertisement;

(2) any provision for digital advertising space or any other facility or service for the purpose of online advertisement and

(3) any other service as may be notified by the Central Government.

However, equalisation levy shall not be levied-

- where the non-resident providing the specified services has a permanent establishment in India and the specified service is effectively connected with such permanent establishment.
- the aggregate amount of consideration for specified service received or receivable during the previous year does not exceed ₹ 1 lakh.
- where the payment for specified service is not for the purposes of carrying out business or profession

(i) Where PQR Inc. has no permanent establishment in India

In the present case, equalisation levy @6% is chargeable on the amount of ₹ 5,00,000 received by PQR Inc., a non-resident not having a PE in India from ABC Ltd., an Indian company. Accordingly, ABC Ltd. is required to deduct equalisation levy of ₹ 30,000 i.e., @6% of ₹ 5 lakhs, being the amount paid towards online advertisement services provided by PQR Inc., a non-resident having no permanent establishment in India. Non-deduction of equalisation levy would attract disallowance under section 40(a)(ib) of 100% of the amount paid while computing business income.

(ii) Where PQR Inc. has permanent establishment in India and the service is effectively connected to the permanent establishment in India

Equalisation levy would not be attracted where the non-resident service provider (PQR Inc., in this case) has a permanent establishment in India and the service is effectively connected to the permanent establishment in India. Therefore, the ABC Ltd. is not required to deduct equalisation levy on ₹ 5 lakhs, being the amount paid towards online advertisement services to PQR Inc, in this case.

However, tax has to be deducted by ABC Ltd. at the rates in force under section 195 in respect of such payment to PQR Inc. Non-deduction of tax at source under section 195 would attract disallowance under section 40(a)(i) of 100% of the amount paid while computing business income.

Equalisation Levy (EL)

6% of amount of consideration received or receivable

For Specified Services

Meaning of Specified Services:

(i) **Online advertisement**

(ii) Prov. for **digital advertisement space** or any other facility or service for online **advertisement**

(iii) Any other service notified by the Government

By a NR not having PE in India or providing services not effectively connected with his PE in India

From a resident in India carrying on business or profession **(or)** **From** a NR having PE in India

Does the **aggregate amount of such consideration** received or receivable for specified services by a NR **exceed Rs.1 lakh** in any PY?

Yes: EL is attracted

No: EL is not attracted

Deduction of EL

EL@6% is deductible from consideration paid or payable for specified services by a –

- resident carrying on business or profession; or
- NR having PE in India

if the aggregate consideration exceeds Rs.1 lakh

Remittance of EL

EL deducted during any month to be paid to the credit of the Central Government by the **7th of the next month**

Consequences of failure to deduct EL

The person liable to deduct EL has to, in any case, pay the EL to the credit of the Central Government by the 7th of the next month.

Simple interest@**1% p.m.** or part of a month is attracted for the period of delay in remittance.

Penalty = the amount of EL deductible.

For delayed remittance, penalty@ **Rs. 1,000 per day** of failure attracted, not exceeding the amount of EL not paid.

6.4. "BUSINESS CONNECTION" CONSTITUTED THROUGH "SIGNIFICANT ECONOMIC PRESENCE"

For a long time, nexus based on physical presence was used as a proxy to regular economic allegiance of a non-resident. However, with the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Under these new business models, the non-resident enterprises interact with customers in another country without having any physical presence in that country resulting in avoidance of taxation in the source country. Therefore, the existing nexus rule based on physical presence do not hold good anymore for taxation of business profits in source country. As a result, the rights of the source country to tax business profits that are derived from its economy is unfairly and unreasonably eroded.

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on "significant economic presence". As per the Action Plan 1 Report, a non-resident enterprise would create a taxable presence in a country if it has a significance economic presence in that country on the basis of factors that have a purposeful and sustained interaction with the economy by the aid of technology and other automated tools. It further recommended that revenue factor may be used in combination with the aforesaid factors to determine 'significance economic presence'.

The scope of provisions of section 9(1)(i), prior to amendment by the Finance Act, 2018, were restrictive as it essentially provided for physical presence based nexus rule for taxation of business income of the non-resident in India. *Explanation 2* to the said section which defines 'business connection' was also narrow in its scope since it limited the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, were not covered within the scope of section 9(1)(i).

In view of the above, the Finance Act, 2018 has amended section 9(1)(i) to provide that 'significant economic presence' in India shall also constitute 'business connection'. For this purpose, "significant economic presence" means-

	Transaction/activity	Condition
(i)	any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India	the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed

(ii)	systematic and continuous soliciting of its business activities or engaging in interaction with users in India through digital means	The users would be of such number as may be prescribed.

Notes:

(i) Only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India.

(ii) Such transactions or activities shall constitute significant economic presence in India, whether or not the agreement for such transactions or activities is entered in India or whether or not the non-resident has a residence or place of business in India or renders services in India.

CHAPTER 7

TAX TREATIES: OVERVIEW, FEATURES, APPLICATION & INTERPRETATION

LEARNING OUTCOMES

After studying this chapter, you would be able to

- **identify** the connecting factors for determining the jurisdiction of taxation;
- **appreciate** the features of, and need for, tax treaties;
- **appreciate** the significance of, and need for, tax information exchange agreements as well as the legal framework for exchange of information in India;
- **appreciate** the importance of commentaries in interpretation of tax treaties and the role of Vienna Convention in application and interpretation of tax treaties;
- **integrate, analyze and apply** the above concepts and principles in addressing relevant issues.

7.1 INTRODUCTION

Article 38(1) of the International Court of Justice[1] provides that the court shall apply the following in deciding on a particular matter –

International Convention(s) [general or particular]

- establishing rules expressly recognised by the contesting states

International Customs

- serving as evidence of general practice accepted as law

General principles

- recognised by civilised nations

Judicial decisions and teachings of highly qualified publicists of various nations

- serving as subsidiary means for determination of rules of law

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret any law or agreement, one needs to understand the philosophy of law which has been kept in mind at the time of passing such law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

Tax has been a consequence of business for several hundreds of years; some of the principles would definitely have their bearing on the manner in which law is passed. International tax law has evolved so that conflict of national interests can be resolved (double taxation being the primary issue).

Source(s) of International Tax Law

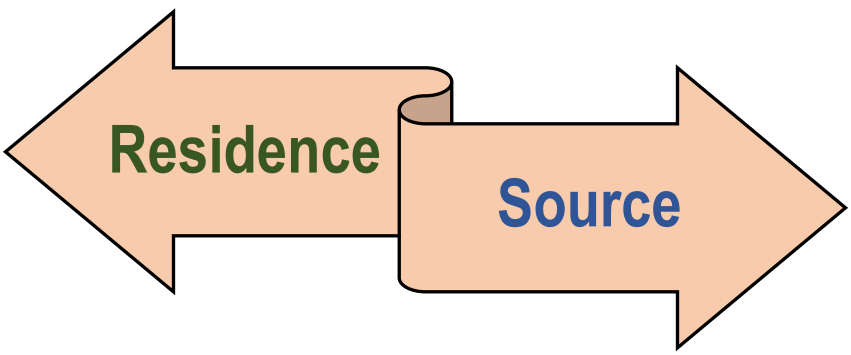
S. No.	Source	Particulars relating to the source/origin
(i)	Multilateral international agreements	For example, the Vienna Convention on Law of Treaties (VCLT)
(ii)	Double Taxation Avoidance	DTAAs may be comprehensive or otherwise. It is to be noted that along with the DTAA, it is the protocols, memorandum of

[1] https://www.icj-cij.org/en/statute#CHAPTER_II

	Agreement (DTAA)	understanding, and exchange of information, etc. forming part of the DTAA which enables interpretation of a DTAA.
(iii)	Customary international law and general principles of law	For example, principles of law recognised by civilized nations in their national legal systems, customary law and judicial decisions and the practices of international organizations. Customary international law is the aspect of international law that derives from customs and convention. Along with general principles of law and treaties, custom is also considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of the world's governments accept, in principle, the existence of customary international law, although there are many differing opinions as to what rules are contained therein.

7.2 DOUBLE TAXATION AND CONNECTING FACTORS

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is "connecting factors". There are two types of connecting factors, namely, "Residence" and "Source". It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business **with** another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business **in a** host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link.



- **Juridical double taxation**

  When source rules overlap, double taxation may arise i.e. tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise in their respective jurisdictions. This is known as "juridical double taxation".

In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or Double Taxation Convention–DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91, providing unilateral relief in the event of double taxation.

Example

Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.

If, instead of UK, ICO has a branch in a state with which India does not have tax treaty, then it can claim unilateral relief under section 91 of the Income-tax Act, 1961 in respect of taxes paid by its branch in that state.

- **Economic double taxation**

  'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different persons (because of lack of subject identity)

Example

When one state attributes an income/capital to its legal owner whereas the tax law of other state attributes it in the hands of the person in possession or having economic control over the income, it leads to economic double taxation.

Yet another classic example is tax on distributed surplus by a company which is taxed in the hands of the company distributing such surplus, while the other jurisdiction taxes the said income from distribution in the hands of the shareholder, thus leading to double taxation of the same income albeit in the hands of different persons.

7.3 TAX TREATIES: AN OVERVIEW

(1) Definition of "Treaty"

Treaty is a generic term embracing all instruments binding under international law, regardless of their formal designation, concluded between two or more international juridical persons.

The application of the term treaty, signifies that the parties intend to create rights and obligations enforceable under international law.

Article 2 of Vienna Convention on Law of Treaties, 1969 defines a "treaty" as an international **agreement** concluded between States **in written form** and **governed by international law**, whether embodied in a **single instrument or in two or more related instruments** and whatever its particular designation.

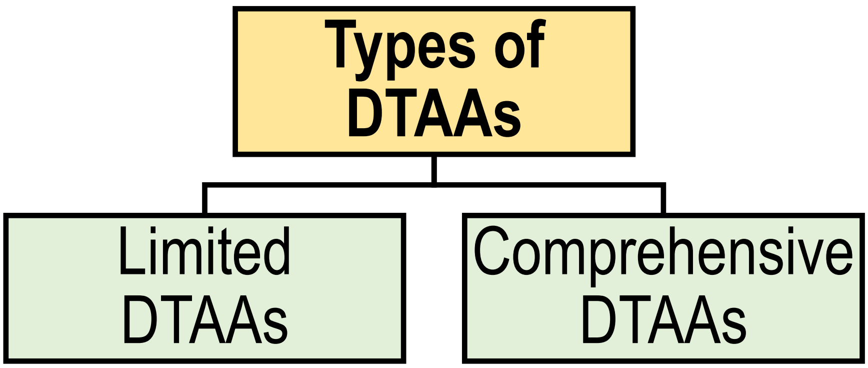
(2) Role of Tax Treaties

"Treaty" represents various compromises agreed upon by the respective Contracting States depending upon the economic expediency of a particular country.

Tax, in the country of source is considered as a cost, whereas the same is an obligation in the country of residence. Therefore, there is need to achieve tax efficiency. Double Tax Avoidance Agreements come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

(3) Types of DTAAs



Limited DTAAs are those which are limited to certain types of incomes only. e.g., DTAA between India and Pakistan is limited to income from international air transport only.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

(4) Directive Principles set out in the Indian Constitution

In the Indian context, Article 51 of the Indian Constitution has, *inter alia*, set out some directive principles which must be followed by the State in the context of International agreements and relationships. It has been provided that-

"The State shall endeavor to -

(a) Promote international peace and security;

(b) Maintain just and honourable relations amongst nations;

(c) Foster respect for international law and treaty obligations in the dealings of organised people with one another; and

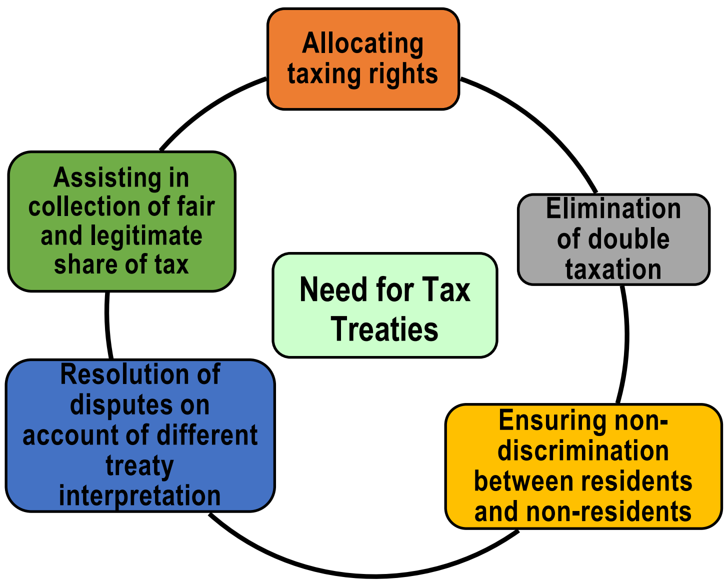
(d) Encourage settlement of international disputes by arbitration.

It is pertinent to note that entries 10 and 14 of List I of the Seventh Schedule to the Constitution of India confer the power on Parliament to legislate treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide sections 90 and 90A of the Income-tax Act, 1961.

(5) Need for tax treaties

The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force. In addition to allocating the taxing rights and eliminating double taxation, there are various other important considerations as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.



Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness:** Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) Neutrality and efficiency: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) Promotion of mutual economic relation, trade and investment: In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country's overall economic growth and development.'

(6) Tax Information Exchange Agreements : An Overview

A Tax Information Exchange Agreement (TIEA) is an agreement between two jurisdictions and creates for both parties, rights and obligations, which are to be respected. It is not a double taxation avoidance treaty between two states but an agreement between two jurisdictions only for the purpose of exchange of information.

Purpose of TIEAs

The purpose of the TIEA is to promote international co-operation in tax matters through exchange of information between two jurisdictions. Without such TIEAs, it would not be possible for a tax jurisdiction to exchange or request information from other jurisdictions for tax purposes.

TIEAs are intended for use with countries for which a DTAA is not considered appropriate, mainly because they have no, or low, taxes on income or profits. While TIEAs are much narrower in scope than DTAAs, they are more detailed than DTAAs on the subject of information exchange. They specify the rules and procedures for how such information exchange is to occur.

OECD Model Tax Information Exchange Agreement

In order to ensure the implementation of domestic laws, countries are executing agreements (TIEAs) based on the OECD Model Tax Information Exchange Agreement (TIEA)[2] The OECD, in 1998, in a report "Harmful Tax Competition: An Emerging Global Issue" identified "lack of effective exchange of information" as one of the key criterion in determining harmful tax practices. As a result of the OECD's Harmful Tax Practices Project, the OECD Global Forum Working Group was formed in 2001. This Forum includes many tax havens and secrecy jurisdictions such as Bermuda, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. The Working Group was entrusted with the task of developing a legal instrument that could

[2] http://www.oecd.org/tax/exchange-of-tax-information/2082215.pdf

be used to establish effective exchange of information. Accordingly, it developed the 'Agreement on Exchange of Information on Tax Matters. The OECD Model TIEA, published in 2002, represents the effective exchange of information for the purposes of the OECD's initiative on harmful practices. The Agreement serves both as a multilateral instrument and a model of bilateral treaties or agreements. The bilateral version is intended to serve as a model for bilateral exchange of information agreements. The Agreement came into force on January 1, 2004 with respect to exchange of information for criminal tax matters and on January 1, 2006 with respect to other matters.

The list of Articles of TIEA Model Agreement is given below:

Article	Heading
1	Object and scope of the Agreement
2	Jurisdiction
3	Taxes covered
4	Definitions
5	Exchange of information upon request
5A	Automatic Exchange of Information
5B	Spontaneous Exchange of Information
6	Tax Examinations Abroad
7	Possibility of declining a request
8	Confidentiality
9	Costs
10	Implementation Legislation
11	Language (May not be required in Bilateral agreements)
12	Other international agreements or arrangements (May not be required in Bilateral agreements)
13	Mutual Agreement Procedure
14	Depositary's functions (unnecessary in Bilateral agreements)
15	Entry into Force
16	Termination

Discussion of some of the important Articles of Tax Information Exchange Agreement:

(a) Scope and objective of TIEA and Jurisdiction

Article 1 of the Model agreement defines the scope to provide the assistance in tax matters to the competent authorities of the contracting parties through exchange of information. The agreement provides for exchange of such information that is foreseeably relevant for the administration and enforcement of their domestic laws concerning taxes covered by the

Agreement. Such information shall include information that is foreseeably relevant to the determination, assessment and collection of such taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters. However, as per Article 2 providing for jurisdictional scope of the agreement, a Contracting Party is not obligated to provide information which is neither held by its authorities nor in the possession or control of persons who are within its territorial jurisdiction.

(b) Exchange of Information upon request

Article 5 provides that the competent authority of the requested party must provide the information upon request. Such information shall be exchanged irrespective of whether or not the conduct being investigated would constitute a crime under the laws of the requested Party, if such conduct occurred in the requested Party country.

Upon receipt of information request, if the information in the possession of the competent authority of the requested Party is not sufficient to enable it to comply with the request for information, that Party must use all relevant information gathering measures to provide the applicant Party with the information requested. Such information must be exchanged without regard to whether the requested Party needs such information for its own tax purposes.

Model Agreement provides that each Contracting Party must ensure that its competent authorities have the authority to obtain and provide upon request:

(i) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees;

(ii) information regarding the ownership of companies, partnerships, trusts, foundations etc.

(c) Possibility of declining a request

Article 7 identifies the situations in which a Contracting Party is not required to supply information in response to a request.

(i) A Contracting Party shall not be required to obtain or provide information that the other Contracting Party would not be able to obtain under its own laws for purposes of the administration or enforcement of its own tax laws. The competent authority of a Contracting Party may decline to assist where the request is not made in conformity with this Agreement.

(ii) The competent authority of the Contracting Party may decline to assist a request for information if the same is not made in conformity with this Agreement.

(iii) A Contracting Party may decline a request for information if the disclosure of the information would be contrary to public policy (ordre public). “Public policy” or “*ordre public*” refer to information which concerns the vital interests of the Party itself.

(iv) A request for information shall, however, not be refused on the basis that the tax claim to which it relates is disputed.

(v) A Contracting Party may decline a request for information if the information is requested by the other Contracting Party to administer or enforce a provision of the tax law of that other Contracting Party, or any requirement connected therewith, which discriminates against a national of the first-mentioned Contracting Party as compared with a national of the other Contracting Party in the same circumstances.

(d) Confidentiality

Article 8 of the Agreement provides that any information received by a Contracting Party pursuant to this Agreement must be treated as confidential. The information may be disclosed only to persons or authorities (including courts and administrative bodies) of the Contracting Party involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement.

Such information can be used only for such purposes by such persons or authorities. The information may be disclosed in public court proceedings or in judicial decisions.

Unless the express written consent is given by the competent authority of the Contracting Party providing the information, the information may not be disclosed to any other person or entity or authority or any other jurisdiction.

Exchange of Information - Article 26 of OECD and UN Model tax Convention

Information can also be exchanged between two jurisdictions by way of entering into tax treaty. OECD and UN Model Tax Conventions provide a framework for negotiation between counties to enter into tax treaties. Article 26 of these Conventions deals with the international exchange of information between the tax authorities of Contracting States. Since international law does not allow a State to conduct a tax investigation in another State without its consent, this Article empowers both Contracting States to exchange information required under the tax treaties and the domestic tax laws. Its purpose is wider than mere tax compliance; it is also meant to counter tax evasion and avoidance. This article in no case 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 (ordre public).

However, a Contracting State cannot decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

Article 26 also provides for the information which may be exchanged and the manner in which such a request has to be made.

Legal framework for Exchange of Information in India

India has taken proactive steps to combat the menace of illicit funds generated both as a result of tax evasion and corruption. Firstly, the Government of India increased the co-operation with other countries by entering into tax treaties and Tax Information Exchange Agreements and secondly laying down anti avoidance regime in jurisdictions where there is a lack of effective exchange of information.

(a) India's Tax Information Exchange Agreement (TIEAs)

Section 90(1) of Income-tax Act, 1961 empowers the Central Government to enter into an agreement with the Government of any country outside India or specified territory outside India, *inter alia* for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance.

Accordingly, India has entered into TIEAs with certain countries like Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Jersey, Saint Kitts & Nevis, Argentina etc. The move is in line with the decision taken in G-20, which took up the issue of tax havens and tax evasions.

India signed its first treaty with Bermuda in the year of 2010. India and Bermuda signed a Tax Information Exchange Agreement to facilitate greater information exchange on potential cases of tax evasion. Thereafter, India signed information agreement with a popular tax haven, Isle of Man. That agreement would provide banking and ownership information on companies besides exchange of past information in criminal tax matters. Information will have to be treated as secret and could be disclosed only to specified persons or authorities, which are tax authorities or the authorities concerned with determination of tax appeal. The agreement also has a specific provision that mandates that the requested party shall have to provide upon request the information even though that party may not need such information for its own tax purposes.

(b) Introduction of specific anti avoidance measures in respect of transactions with persons located in notified jurisdictional area

The objective of anti-avoidance measures is to discourage assessees from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. Accordingly, section 94A of the Income-tax Act, 1961 empowers the Central Government to notify any such country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.

The following are the anti-avoidance measures introduced in respect to transactions with a person in a NJA

(i) A transaction, where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction and all parties to the transaction to be deemed as associated enterprises. Accordingly, all the provisions of transfer pricing is to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price [provided for in the second proviso to section 92C(2)] based on the rate notified by the Central Government would not be available in respect of such transaction.

(ii) Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.

(iii) No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.

(iv) Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.

(v) The rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –

(1) rates specified in the relevant provision of the Income-tax Act, 1961; or

(2) rate or rates in force; or

(3) 30%.

For example, the Central Government had, on 1st November 2013, invoked the provisions of section 94A and notified Cyprus as an NJA owing to inadequate exchange of information by Cyprus tax authorities. In November, 2016, the Central Government issued a press release announcing the signing of the revised Cyprus tax treaty. Subsequent to this notification, Government of Cyprus released the text of the revised Cyprus tax treaty. Thereafter, vide *Notification No.1 dated 14.12.2016*, the Government rescinded the earlier notification resulting in Cyprus not being a NJA under the Income-tax Act, 1961. In December, 2016, the Central Government, vide another press release, confirmed the completion of internal procedures to amend the Cyprus tax treaty and stated that Cyprus' status as an NJA under section 94A of the Act has been rescinded. Thus, the deeming fiction provided in section 94A to deem Cyprus tax residents or a person located in Cyprus as an associated enterprise and treat any transactions with them as an international transaction will no longer be applicable. The claim for deduction of any expenditure/ allowance arising on account of transactions with Cyprus tax resident or a person located in Cyprus would now be allowable under general provisions of the Act without documentation requirements prescribed under section 94A. Further, any taxable income accruing/ arising to a Cyprus tax resident or a person located in Cyprus would now be subject to the withholding tax rates prescribed under the Act or the revised Cyprus tax treaty, whichever is beneficial to the taxpayer.

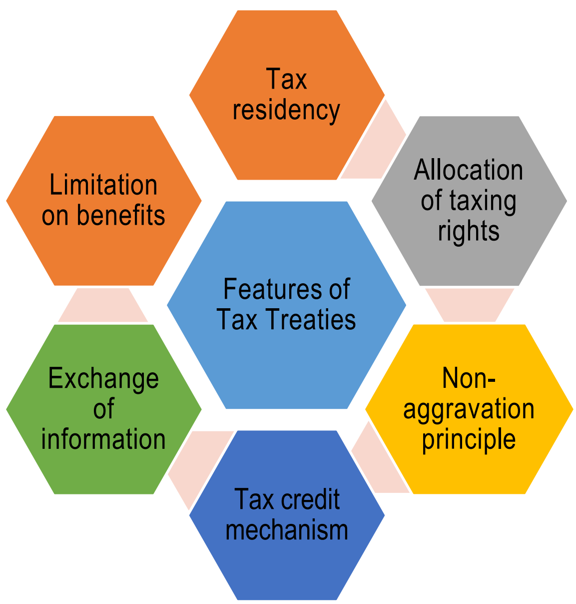
For example, payments made to Cyprus tax residents or persons located in Cyprus would now be subject to withholding tax as follows:

(i) Royalties/ fees for technical services, earlier liable to withholding under section 94A at the rate of 30%, would now be liable to withholding at 10% under the Act.

(ii) Interest income, earlier liable to withholding under section 94A at the rate of 30%, would now be liable to withholding at 10% under the Cyprus tax treaty or at an applicable lower rate under the Act, whichever is beneficial.

7.4 FEATURES OF TAX TREATIES

(1) Basic Features[3] of Tax treaties



[3] Illustrative features only

(i) Tax residency

Benefits of tax treaty would be available only if the person is a resident of one or both of the Contracting States. Generally, it is Article 4 of the tax treaty which governs provisions relating to residence.

In some cases, due to differences in the residential rules of the treaty countries, there are likely chances that a person may be considered to be a resident of both the Contracting States. In such cases, individuals would be considered to be resident of the Contracting State in accordance with Article 4(2) of the treaty whereas in case of persons other than individuals, Article 4(3) of the treaty, commonly referred to as 'tie breaker rule' would ultimately determine the residential status of such person. Determination of residence of companies under Article 4(3) would be under the case by case approach requested by the concerned taxpayer through Article 25 (Mutual Agreement Procedure).

Exception

As per Article 4(4) of the US Model Convention, where a company is a resident of both Contracting States, such company shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention.

However, Article 4(3) of the India – U.S. DTAA provides that *"where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry into Force)".*

(ii) Allocation of taxing rights

Generally, articles 6 – 22 characterises a particular income for the purpose of allocation in the country of source and in the country of residence. One such exception to the general rule is contained in Article 7 i.e., 'business profits', which provides that business profits of a resident of a Contracting State shall be taxable only in the country of residence unless a person has a permanent establishment in the other Contracting State (i.e. source country).

(iii) Non-aggravation principle

Tax treaties provide for allocation of taxing rights between the Contracting States. It is pertinent to note that treaty provisions work on non-aggravation principle. In other words, if an income is not taxable under the domestic tax law; such income cannot be taxed even if it is so taxable in accordance with tax treaty provisions. Thus, it is safe to conclude that no new charge can be created under the treaty.

(iv) Tax Credit mechanism

Under this system, the harshness of double taxation is either eliminated or is restricted to a reasonable level. Presently, there are two methods in vogue i.e. the credit method[4] or the exemption method. In some cases, certain types of income are relieved from double taxation by using the credit method while some get relieved from double taxation by using the exemption method. Further, it is possible that the treaty partners (say, Country A and Country B) may use different methods to grant relief from double taxation to its residents.

Difficulties arise in cases of timing mismatch i.e. where two countries follow different tax years, proof of tax payment, rate of currency conversion, computation mechanism, etc. Many of these aspects lack clarity and therefore, result in litigation.

(v) Exchange of Information

In an era where tax evasion and tax avoidance are heavily targeted by Governments the world over, Article 26 assumes a lot of significance. According to this Article, the competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this agreement or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States.

(vi) Limitation on benefits/Entitlement to benefits

Limitation on benefits is yet another powerful anti-avoidance provision in a tax treaty. India has taken an aggressive stand on anti-avoidance and has included limitation on benefits Article in its treaties with the USA, Singapore, U.A.E, Mauritius, etc. Treaty shopping, although legal, is generally discouraged by various countries, including India.

(2) Structure of Tax Treaties

Tax Treaties, namely Double Tax Avoidance Agreements are based on Model Conventions like OECD/UN/US Model Convention. They are exhaustive and self-contained in nature. The OECD /UN Model conventions are composed of the following Articles-

Article	Heading	Content
1	Persons Covered	To whom applicable
2	Taxes Covered	Specific taxes covered
3	General Definitions	Person, company, enterprise, inter-national traffic, competent authority etc.
4	Resident	Cases when a person is said to be resident of a Contracting State who can access treaty.

[4] Indian treaties by and large follow credit method for elimination of double taxation

Article	Heading	Content
5	Permanent Establishment (PE)	• What constitutes PE • What does not constitute PE
6	Income from Immovable Property	Immovable property and income there from
7	Business Profits	Determination and taxation of profits arising from business carried on through PE
8	International shipping and Air Transport	Place of deemed accrual of profits arising from activities and mode of taxation thereon
9	Associated Enterprises	Enterprises under common management and taxation of profits owing to close connection (other than transactions of arm's length nature)
10	Dividends	• Definition and taxation of dividends • Concessional rate of tax in certain situations;
11	Interest	• Definition and taxation of interest; • Concessional rate of tax in certain situations; • Taxation of interest paid in excess of reasonable rate, on account of special relationship;
12/12A	12: Royalties/12A: Fees for technical services (FTS) ***[Note:** Only the UN Model Convention contains Article 12A on FTS]*	• Definition of royalties/FTS – what it includes and covers, and its taxation; • Treatment of excessive payment of royalties/FTS due to special relationship; • Country where taxable.
13	Capital Gains	• Definition – Taxation aspects; • Concessional rates / exemption from tax if any; • Country where taxable
14	Independent Personal Services *[**Note:** OECD Model Convention does not have this Article]*	• Types of services covered • Country where taxable
15	Income from employment / Dependent Personal Services	• Definition • Country where taxable

Article	Heading	Content
16	Directors' Fees and Remuneration for Top Level Managerial Officials	• Definition • Mode and Country where taxable.
17	Entertainers and sportspersons/Artists and sportspersons	• Types of activities covered • Mode and Country where taxable.
18	Pensions and Social Security Payments	Country where taxable
19	Government Services	Type of remuneration, and country where taxable
20	Students	Taxation / Exemption of payments received by students.
21	Other Income	Residual Article to cover income not covered under other 'Articles', mode of taxation and country where taxable
22	Capital (Tax on Wealth)	Definition – mode – and country where taxable
23 A/B	Methods of Elimination of double taxation	Exemption Method / Credit Method
24	Non Discrimination	(Equitable) Basis of taxing Nationals and Citizens of Foreign State
25	Mutual Agreement Procedure	• Where taxation is not as per provisions of the convention, a 'person' may present his case to Competent Authorities of respective states. • Procedure in such cases
26	Exchange of Information	• Competent Authorities to exchange information for carrying out the provisions of the convention. • Methodology.
27	Assistance in collection of taxes	Competent Authorities to settle the mode of application of this Article
28	Members of Diplomatic missions and Consular posts	Privileges of this category to remain unaffected
29	Entitlement to benefits	To eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance,

Article	Heading	Content
		including through treaty shopping arrangements. This article inserted in both OECD and UN Model Conventions 2017 corresponding to BEPS Action Plan 6: Preventing Treaty Abuse.
30	Territorial Extension *[**Note:** The UN Model Convention does not contain this article]*	To include territory not included earlier; by following appropriate steps mutually and as allowed by the constitution.
31/30	Entry into Force [**Note –** *Since UN Model convention does not contain an Article on Territorial Extension, this article is numbered as 30 therein*]	• Effective date from which convention comes into force; • Assessment year from which it comes into force.
32/31	Termination *[**Note –** Since UN Model convention does not contain an Article on Territorial Extension, this article is numbered as 31 therein]*	Time – Notice period – Mode.

Broadly, Articles of tax treaties can be divided into six groups i.e., Scope provisions, definition provisions, substantive provisions, provisions for elimination of double taxation, anti-avoidance provisions and miscellaneous provisions, as indicated in the table below:

	Groups	Article[5]	Heading	Comment
(1)	**Scope Provisions**	1	Scope of the convention	The provisions contained in these Articles determine scope of persons, taxes, and time period covered by a treaty.
		2	Taxes Covered	
		30	Entry into Force	
		31	Termination	
(2)	**Definition Provisions**	3	General Definitions	The terms dividend, interest, royalty, fees for technical services etc., are separately defined in the respective Articles.
		4	Residence	
		5	Permanent Establishment	
(3)	**Substantive Provisions**	6	Income from Immovable Property	These Articles are applicable to particular categories of incomes, capital gains or
		7	Business Profits	

[5] Article of UN Model Convention, 2017

	Groups	Article[5]	Heading	Comment
		8	Shipping, Inland Waterways, Transport and Air Transport	capital and allocate tax jurisdictions between the two Contracting States
		9	Associated Enterprises	
		10	Dividends	
		11	Interest	
		12	Royalties	
		12A	Fees for technical services	
		13	Capital Gains	
		14	Independent Personal Services	
		15	Income from employment / Dependent Personal Services	
		16	Directors' Fees and Remuneration for Top Level Managerial Officials	
		17	Income earned by Entertainers and Athletes	
		18	Pension and Social Security Payments	
		19	Remuneration and Pensions in respect of Government Services	
		20	Payment Received by Students and Apprentices	
		21	Other Income	
		22	Capital (Tax on Wealth)	
(4)	**Provisions for elimination of double taxation**	23	Method of elimination of double taxation	Both these Articles are very important as they deal with the central objective of the DTAA i.e. avoidance or elimination of double taxation.
		25	Mutual Agreement Procedure	

	Groups	Article[5]	Heading	Comment
(5)	**Anti-Avoidance Provisions**	9	Associated Enterprises	Entitlement to benefits inserted corresponding to BEPS Action Plan 6: Preventing Treaty Abuse. These Articles are gaining importance day by day, and used widely by the tax authorities to prevent treaty shopping or abuse of treaty benefits.
		26	Exchange of information	
		29	Entitlement to benefits	
(6)	**Miscellaneous Provisions**	24	Non-Discrimination	The Article on Non-Discrimination is used to ensure justice and fair tax treatment to the assessee of one of the Contracting State by the other Contracting States. Article 28 on Diplomats ensures that privileges of this category of persons remain unaffected.
		27	Assistance in collection of taxes	
		28	Diplomats	

7.5 APPLICATION OF TAX TREATIES

In various countries, unless the context otherwise requires, the provisions of the DTAA shall prevail over the domestic tax provisions. No two treaties between the countries are alike. DTAA signed by India with USA is different in comparison to the DTAA signed with other countries like Netherlands. These differences include taxpayers to resort to tax arbitrage strategies. This frustrates Government's objective and results in unintended tax benefits. Therefore, in specified circumstances, treaty benefits are denied. Some of the circumstances in the Indian context induce (i) General Anti-Avoidance Rules (GAAR)[6] (ii) Targeted anti avoidance rules (transfer pricing), etc. (iii) Beneficial Ownership Conditions (iv) Entitlement to Benefits/Limitation on Benefits Clause/ Articles, etc.

In recent past, India has re-negotiated DTAAs with countries like Mauritius, Singapore, etc. to prevent fiscal evasion with respect to taxes on income and capital gains of the investor[7].

[6] GAAR provisions in India are applicable from Assessment Year 2018-19

[7] Effective from 01 April 2017

Article 4 of DTAA – Gateway to avail tax benefits

It is a well-accepted proposition in a tax treaty scenario that a person shall be entitled to a tax treaty only if he is a resident of one or both of the Contracting States.

This provision aims at curbing the 'treaty shopping' practices. It must be noted that though 'Article 4' of the tax treaty deals with residential status of a person, it does not provide rules for determination of residence. Instead, it refers to the determination in accordance with the provisions of domestic tax law of the respective Contracting State. This is clear from the language which provides that "*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.............*". Therefore, the primary requirement is for a person to qualify as a resident under the law of the concerned Contracting State.

Determination of residential status of a person is crucial since it is ultimately the country of residence that may have full right to tax the worldwide income of its resident. Further, in addition to taxing the global income, the country of residence would grant relief in respect of tax paid in the country of source.

Place of effective management is an important criterion for availing treaty benefits by a corporate. India-U.A.E DTAA (as revised) further limits the application of treaty by providing that the treaty would be applicable to U.A.E company only if it is incorporated in U.A.E and is controlled wholly in U.A.E. Only such company would be regarded as resident of U.A.E. Further, the India–U.A.E DTAA provides that if a person other than an individual is resident of both the States, then it should be deemed to be resident of the State in which its Place of effective management is situated.

Computation of income liable for the purpose of taxation

The provisions of tax treaty *inter alia* allocates taxing rights between the treaty partners, provides relief or reduces or eliminates the harmful effects of double taxation. However, it is to be noted that except for the provisions under *'Article 7 i.e. Business Profits taxation',* generally the treaty does not provide rules for computation of income. It would depend upon the domestic tax law provisions. Treaties, at best, distribute the taxing rights between two states. It may limit the rate of tax (generally, in the state of source) or provide the upper limit up to which taxes can be levied. Certain treaties do reduce the incidence of tax by providing or restricting the scope of the subject matter of taxation.

Distributive Rule

Tax treaties only distribute or assign taxing jurisdiction. It does not impose tax. Having assigned the jurisdiction of tax between the State of Residence and State of Source, the domestic tax laws of the respective State determine taxing rules. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

English lawyers called it "Classification and Assignment Rule", whereas German jurists called it the **"Distributive Rule".** According to this principle, "to the extent that an exemption is agreed to, its effect is, in principle, independent of whether the Contracting States imposes a tax, in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax". The point here is that having agreed to give the right of tax to the other state, that state may or may not levy tax and if the state in whose favour right to tax is devolved, chooses not to tax such income, then, it may result in double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, this rule ensures that double taxation does not arise in future also, if the source states decides to levy tax.

(A) Treaties are entered into for "Mutual Benefits"

Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally.

Treaties are negotiated and entered into at a political level and have several considerations as their basis. Thus, treaties should be seen in the context of aiding commercial relations between treaty partners.

(B) A tax treaty provision may have an unequal effect[8]

State A imposes tax but state B does not impose a tax, yet wordings of the treaty are reciprocal – so that if and when State 'B' does introduce such a tax, the treaty rates would be operative in State 'B'. Until such time there would be an unequal effect. Moreover, State 'A' may make a distributive rule operative upon fulfilment of certain condition or comparable feature.

7.6 INTERPRETATION OF TAX TREATIES

(1) Introduction

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the Vienna Convention on Law of Treaties (VCLT). These rules of interpretation are not restricted to tax treaties but also apply to any treaty between two countries. Therefore, any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD/UN Model Conventions has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation.

In India, even before insertion of Section 90(2) by the Finance (No.2) Act, 1991, with retrospective effect from 1-4-1972, CBDT had clarified *vide Circular No. 333 dated 2-4-1982* that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income.

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[8] Tax Treaty Interpretation – The International Tax Treaties Service"

The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAAs which are applicable to the taxpayers, then, the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer.

Interpretation of any statute, more so international tax treaties, requires that we follow some rules of interpretation. In subsequent paragraphs, we shall deal with rules of interpretation of tax treaties.

(2) Basic Principles of Interpretation of a Treaty

Principles or rules of interpretation of a tax treaty would be relevant only where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible. If words are clear or unambiguous, then there is no need to resort to different rules for interpretation.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Just as each country's legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law. We would be discussing some of the rules of interpretation of Vienna Convention on law of Treaties in the later part of this chapter.

Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) **Golden Rule – Objective Interpretation:** Ideally, any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. The term has to be interpreted contextually.

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the intention of the parties, it should not be adopted[9].

(ii) **Subjective Interpretation:** Under this approach, the terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

In *Abdul Razak A. Meman's case [2005] 276 ITR 306,* the Authority for Advance Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

(iii) **Purposive Interpretation:** In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the 'objects and purpose' method.

In case of *Union of India v. Azadi Bachao Andolan 263 ITR 706,* the Supreme Court of India observed that "the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international

[9] Prof. J. G. Starke in Introduction to International Law 10th Edition

treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases."

The Apex Court also agreed with the contention of the Appellant that "the preamble to the Indo-Mauritius DTAA recites that it is for 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty".

(iv) **The Principle of Effectiveness:** According to this principle, a treaty should be interpreted in a manner to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which 'on the whole' will render the treaty 'most effective and useful', in other words, enabling the provisions of the treaty to work and to have their appropriate effects[10].

(v) **Principle of *Contemporanea Expositio*:** A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

In *Abdul Razak A. Meman's* case *[2005] 276 ITR 306*, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material *contemporanea exposition,* which means that a statute is best explained by following the construction put upon it by judges at the time it was made, or soon after. This proposition is embodied in Article 32 of the Vienna Convention, referred to above, and is also referred to in the decision of the Hon'ble Supreme Court in *K. P. Varghese v. ITO [1981] 131 ITR 597*."

(vi) **Liberal Construction:** It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

In *John N. Gladden v. Her Majesty the Queen* [11], the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed that "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. 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 under consideration is concerned."

The Court further recognised that "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."

(vii) **Treaty as a Whole – Integrated Approach:** A treaty should be construed as a whole and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

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[10] Prof. J. G. Starke in Introduction to International Law 10th Edition

[11] 85 D.T.C. 5188 at 5190, Source: UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)

(viii) **Reasonableness and consistency[12] :** Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.

An important aspect to be noted regarding the rules of interpretation is that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act.

(3) Extrinsic Aids to Interpretation of a Tax Treaty

A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y?

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

International Articles/Essays/Reports

International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained "useful material" through international articles.

Cahiers published by International Fiscal Association (IFA), Netherlands

"Cahiers de Droit Fiscal International" is the main publication of the IFA, which is published annually and deals with two major topics each year. Cahiers were relied upon in case of *Azadi Bachao Andolan's* (supra) case by the Supreme Court.

[12] Prof. J. G. Starke in Introduction to International Law 10th Edition

Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

MFN clause is usually found in Protocols and Exchange of Notes to DTCs. Under this clause a country agrees to extend the benefits to the residents of the other country, which it had (first country) promised to the residents of third country. It tries to avoid discrimination between residents of different countries.

Normally, the benefit under this clause is restricted to a specific group like OECD countries or developing countries. The nature of benefits under MFN clause could either be application of lower rate of tax or narrowing the scope of the income liable to tax or allowing higher deduction in respect of executive and general administrative expenses of head office.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of *Azadi Bachao Andolan*, the Apex Court observed that 'the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty'. These observations are very significant whereby the Apex Court has upheld 'economic considerations' as one of the objectives of a Tax Treaty.

Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also serve as precedence in case of subsequent applications.

Basic Principles of Interpretation of a Treaty

- **Golden Rule - Objective Interpretation**: Any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind.
- **Subjective Interpretation**: Terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.
- **Teleological or Purposive Interpretation**: Treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as 'objects and purpose' method.
- **The Principle of Effectiveness**: A treaty should be interpreted in a manner to have effect rather than make it void.
- **Principle of *Contemporanea Expositio***: A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.
- **Liberal Constructi on**: It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.
- **Integrated Approach**: Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.
- **Reasonable ness and consistency**: Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument.

Extrinsic Aids to Interpretation of a Tax Treaty

- Provisions in Parallel Tax Treaties
- International Articles/Essays/Reports
- Protocol
- Preamble
- Mutual Agreement Procedure [MAP]

(4) Commentaries on OECD/UN Models and their importance

Interpretation of any statute, more so international tax treaties requires that we follow some rules of interpretation. Commentaries are one of the important rules of interpretation of tax treaties.

There are two commentaries available – one by OECD and the other by UN, based on their respective models. OECD Commentary is authentic and revised from time to time. UN Commentary is by and large based on OECD commentary. UN commentary was published in 1980 and has been revised from time to time. One can refer to the commentaries for interpretation and application of various provision contained in a DTAA.

Views expressed in the commentaries carry great authority. Where Contracting States adopt the text of the Article as per OECD Model convention without any change, and if these countries happen to be OECD Countries, the OECD commentary is directly applicable. In case of a DTAA between developed and developing countries, normally UN model is followed. UN Model and UN Commentary both being largely based on OECD Model and Commentary respectively, OECD Commentary is also quite helpful in interpretation of treaties based on UN Model.

OECD Model Commentary has been widely used in interpretation of tax treaties. The Commentary on the OECD Model Convention states that: “the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge’s deliberations.”

The OECD has framed a model convention to guide countries to draft DTAAs. In the *Azadi Bachao Andolan* case, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

Both UN and OECD Model Commentaries are a great help in interpretation of tax treaties. Their importance in interpretation of tax treaties can hardly be over emphasized *[Credit Lyonnais v. DCIT (2005) 94 ITD 401 (Mum)]*. OECD, however, plays a greater role in providing standardized or systematized approach in interpretation of tax treaties.

Model Commentaries give the authoritative interpretation of the provisions of DTAAs *[Sonata Information Technology Ltd. v. ACIT (2006) 103 ITD 324 (Bang)]*

(5) Foreign Courts’ Decisions

In *CIT v. Vishakhapatnam Port Trust’s* case *[1983] 144 ITR 146*, the Andhra Pradesh High Court observed that, “in view of the standard OECD Models which are being used in various countries, a new area of genuine ‘international tax law’ is now 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 adoption is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant.”

In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

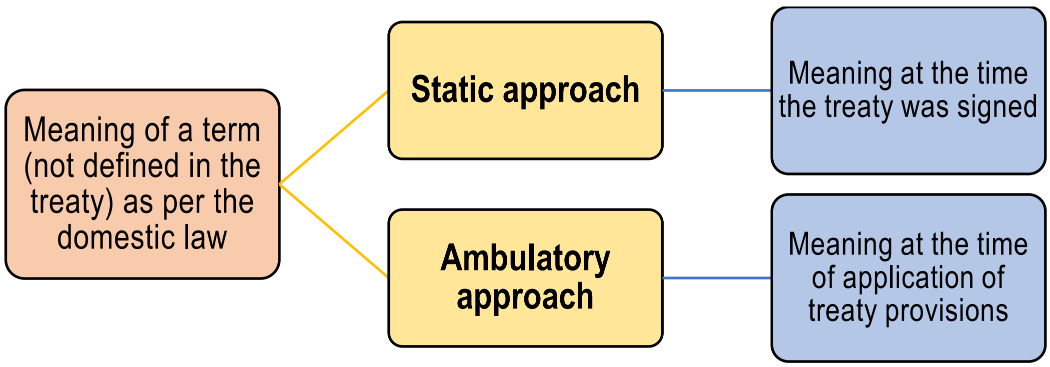
Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

CIT v. Vishakhapatnam Port Trust [1983] 144 ITR 146

Abdul Razak A. Meman's case [2005] 276 ITR 306(AAR)

(6) Ambulatory v. Static Approach

Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, a question often arises what meaning to be assigned to the said term – the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two views on the subject, namely, Static and Ambulatory.



All Model Commentaries including the Technical Explanation on US Model Tax Convention favors ambulatory approach, however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the term.

India-Australia Treaty, in Article 3(2) adds the expression "from time to time in force" to provide for an "ambulatory" interpretation.

(7) Ambulatory Approach subject to Contextual Interpretation

Article 3(2) of the OECD Model Convention provides that meaning of the term not defined in the treaty shall be interpreted in accordance with the provisions of the tax laws of the Contracting State that may be applying the Convention. However, this provision is subject to one caveat and that is if the context requires interpreting the term 'otherwise', then the meaning should be assigned accordingly. For example, India-US treaty provides that assignment of meaning under the domestic law to any term not defined in the treaty shall be according to the common meaning agreed by the Competent Authorities pursuant to the provisions of Article 27 (Mutual Agreement Procedure). And if it is not so agreed, only then, the meaning would be assigned from the domestic tax law and that too, provided the context does not require otherwise.

In case of *Union of India v. Elphistone Spinning and Weaving Co. Ltd [2003] 4 SCC 139*, the Supreme Court observed that "when the question arises as to the meaning of a certain provisions in a Statute it is not only legitimate but proper to read that provision in its context. The Context means the statute as a whole, the previous state of law, other statutes in *pari materia*, the general scope of statute and the mischief that it was intended to remedy."

In *Pandit Ram Narain v. State of Uttar Pradesh*[1956] SCR 664, the Supreme Court observed that the meaning of words and expressions used in an Act must take their colour from the context in which they appear.

As per section 90(3) of the Income-tax Act, 1961, any term used but not defined in the Act or in the DTAA, shall, unless the context otherwise requires, and is not inconsistent with the provisions of the Act or the DTAA, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Further, in this regard, Finance Act, 2017 has amended the provisions of section 90/90A of the Act by way of insertion of an *Explanation*, according to which, the term not defined in DTAA, but defined in the Act, to be assigned the meaning given in the Act and explanation, if any, given to it by the Central Government.

(8) Objectives of Tax Treaties

Objectives for signing a tax treaty also play a significant role in its interpretation as they determine the context in which a particular treaty is signed. For example, OECD and UN Model Conventions have different objectives to achieve. The same are as follows:

(i) **OECD Model Convention:** Principal objectives of the OECD Model Convention are as follows:

The principal purpose of double taxation conventions is to develop economic relationship between the Contracting States and to enhance their cooperation in tax matters. It is intended for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

(ii) **UN Model Convention:** The principal objectives of the UN Model Convention are as follows:

- To protect tax payers against double taxation (whether direct or indirect)
- To eliminate double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)
- To encourage free flow of international trade and investment
- To encourage transfer of technology

- To prevent discrimination between tax payers
- To provide a reasonable element of legal and fiscal certainty to investors and traders
- To arrive at an acceptable basis to share tax revenues between two States
- To improve the co-operation between taxing authorities in carrying out their duties

(iii) **Indian Tax Treaties:** Section 90 of the Income-tax Act, 1961 contains the objectives of signing tax treaties in general. The same are as follows:

(a) for granting of relief in respect of –

(i) income on which taxes have been paid, both income-tax under this Act and income-tax in that country; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

Thus, it can be observed that there are several objectives for entering into tax treaties by the Government of India besides the primary objective of avoidance of double taxation as enumerated above.

(9) Process of negotiating a tax treaty[13]:

(i) Entering into a tax treaty involves the following steps or stages: Signature, Ratification, Conclusion and Entry into force.

(ii) The process of negotiating a tax treaty typically begins with initial contacts between the countries.

(iii) In deciding whether to enter into tax treaty negotiations with other countries, a country will consider many factors, the most important of which is the level of trade and investment between the countries.

(iv) Once the countries have decided to negotiate, they will exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations.

[13] http://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf

(v) Typically, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams will agree on a particular text — usually one of the countries' model treaties — to use as the basis for the negotiations. After presentations by both sides about their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of the treaty is agreed on, the parties initial it.

(vi) After such agreement has been reached, arrangements will be made for the treaty to be signed by an authorized official (often an ambassador or government official).

(vii) After signature, each State must ratify the treaty in accordance with its own ratification procedures. The treaty is generally concluded when the countries exchange instruments of ratification.

(viii) The treaty enters into force in accordance with the specific rules in the treaty.

7.7 ROLE OF VIENNA CONVENTION IN APPLICATION AND INTERPRETATION OF TAX TREATIES

The International Law Commission initiated the work on the Vienna Convention on Law of Treaties in the year 1949 which was completed in the year 1969. It came into force in the year 1980. As of January, 2018, it was ratified by 116 Countries.

Since tax treaty is a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty). Therefore, it would be worthy to understand some of the Articles of the Vienna Convention of Law of Treaties which would help appreciate the manner of application and interpretation of tax treaties.

Principles enunciated in the Vienna Convention on Law of Treaties[14]

Article No.	Article Heading	Principle enunciated
26	***Pacta Sunt Servanda (in good faith)***	Every treaty in force is binding upon the parties and must be followed by them in good faith.
28	**Non-retroactivity of treaties**	Unless a different intention appears from the treaty or is otherwise established, treaty provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party. In other words, unless otherwise provided, treaties cannot

[14] https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf

Article No.	Article Heading	Principle enunciated
		have retrospective application
29	**Territorial Scope of Treaties**	Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.
31	**General Rule of Interpretation**	• A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose. • The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure (a) Any agreement relating to the treaty which was made between all the parties in connection with the 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 the other parties as an instrument related thereto. • The following shall be taken into account, together with the context in that: (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 to relation between the parties. • A special meaning shall be given to a term if it is established that the parties so intended.
32	**Supplementary means of interpretation**	Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

Article No.	Article Heading	Principle enunciated
		(a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.
33	**Interpretation of Treaties Authenticated in two or more languages**	• When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail. • A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree. • The terms of the treaty are presumed to have the same meaning in each authentic text. • Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.
34	**General Rule regarding third states**	A treaty does not create either obligations or rights for a third State without its consent.
42	**Validity and Continuance in force of treaties**	• The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention. • The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty
60	**Termination or Suspension of the operation of a treaty as a consequence of a breach**	• A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part. • A material breach of a multilateral treaty by one of the parties entitles:

Article No.	Article Heading	Principle enunciated
		(a) the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations amongst themselves and the defaulting State, or (ii) as between all the parties; (b) a party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State; (c) any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty. • A material breach of a treaty, for the purposes of this Article, consists in: (a) a repudiation of the treaty not sanctioned by the Convention; or (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty. • The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
61	**Supervening impossibility of performance**	• A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it, if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation. • Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation

Article No.	Article Heading	Principle enunciated
		under the treaty or of any other international obligation owed to any other party thereto.
62	**Fundamental change of circumstances**	• A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless – (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. • A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty – (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. • If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation.
64	**Emergence of new peremptory norm of general international law**	If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated

CHAPTER 8

ANTI AVOIDANCE MEASURES

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the concept of controlled foreign corporations (CFCs), the need for, and the components of, CFC regulations;
- **appreciate** the concept of Base Erosion and Profit Shifting (BEPS), significance of the various Action Plans of BEPS and the provisions incorporated in Indian tax laws in line with the different Action Plans of BEPS;
- **identify and examine** the various anti-avoidance measures incorporated in the Income-tax Act, 1961 and rules thereunder to prevent tax avoidance in respect of international transactions;
- **appreciate** the concept of GAAR and examine the GAAR provisions incorporated in the Income-tax Act, 1961 and rules thereunder;
- **integrate, analyse and apply** the above concepts, principles, measures and provisions in making computations and addressing relevant issues.

8.1 CONTROLLED FOREIGN COPRORATIONS

(1) INTRODUCTION

CFC Regulations: A significant anti-avoidance measure

Tax avoidance has been accepted as an area of concern in international tax arena, which is the reason why several countries have been legislating anti-avoidance measures in their domestic tax code. Controlled Foreign Company (CFC) Regulations are one such set of anti-avoidance measures. Taxation of foreign passive income is at the heart of CFC Regulations.

Income from a foreign source is usually taxed after it is accrued or received as income in the country of residence of the recipient. Therefore, it is possible to defer or avoid the tax on foreign dividend income until it is repatriated. Many residence states regard this tax deferral as unjustifiable loss of tax revenue. Moreover, it gives the residents who invest overseas a tax advantage over those who invest at home.

Controlled Foreign Corporations: Meaning

Controlled Foreign Corporations (CFCs) are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State). Since each corporate entity is treated as a separate legal entity, the profits earned by such CFCs are not taxed at the owner level until they are distributed. CFCs tend to earn passive income; such income is not distributed, thereby resulting in tax deferral in the Parent State. It is to curb such tax avoidance that CFC Regulations are legislated by various countries.

CFC Legislation: Protecting domestic tax base from erosion

In order to protect the domestic tax base from erosion through certain tax structuring in CFCs and at the same time not denying the foreign subsidiaries income from their genuine business in the same foreign country, many countries have introduced targeted CFC legislation.

The International Bureau of Fiscal Documentation has explained CFC legislations as under:

"The term is generally used in the context of tax avoidance rules designed to combat the diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation. Under these rules income of the controlled company is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the controlled company's income is dealt with in this way, typically passive income such as dividends, interest and royalties (tainted income). Many but not all controlled foreign company regimes apply only to corporate shareholders."

CFC legislations target the income earned and accumulated in non-resident entities that are under the influence or control of its own tax residents, who are subject to worldwide taxation. It is generally presumed that, in such situations, they can influence the profit distribution or repatriation policies as shareholders. Different countries, depending upon their fiscal need and tax environment, develop different types of rules and regulations to tax profit earned by their CFCs. The basic mechanism and details may, therefore, vary among jurisdictions. Countries with CFC rules include, but are not limited to, the United States, the United Kingdom, Germany, and Japan.

(2) NEED FOR CFC LEGISLATION

As explained above, under the tax laws of several countries, a shareholder of a corporation is generally not taxed on the corporation's income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in low-tax jurisdictions or tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. In some countries, this dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many developed countries (where global multi-nationals are generally based) have high tax rates as compared to developing countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

In the USA, the volume of profits held offshore was so large that a special ‘amnesty’ was introduced in 2004, whereby companies could repatriate dividends for a one year period, and pay tax on these dividends at an effective rate of 5.25% as against the normal 35% tax rate then prevailing. This is an indicator that ‘deferral trap’ is a major issue for companies around the globe.

In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These laws are generally referred to as Controlled Foreign Corporation (CFC) laws.

(3) OVERVIEW OF CFC REGIMES

The CFC legislation sets out rules for determining the type of entity which will be viewed as ‘controlled’ for the purposes of its CFC regime, with the starting point generally being the entities which are not tax resident in the parent jurisdiction. One important point here is that, while we refer to the rules as ‘controlled foreign corporation’ rules, they are not necessarily limited to dealing with entities viewed as corporate entities.

Ownership/Control Test

The rules generally have an ownership/control test, so that an entity will be treated as a CFC, only if a certain percentage of ownership/control is in the hands of residents of the parent country. CFC rules may have a threshold for domestic ownership, below which a foreign entity is not considered a CFC. Alternatively, or in addition, domestic members of a foreign entity owning less than a certain portion or class of shares may be excluded from the deemed income regime.

Most CFC rules only apply to those CFCs (entity) over which the domestic shareholder or a number of domestic shareholders have a certain degree of control. Control may be defined as the voting power to influence the business of a CFC, and/or simply having a significant stake in the CFC's assets, profits or liquidation proceeds (i.e., controlling ownership). Under most CFC regimes, control of more than 50% of resident shareholders is required. If there is more than one shareholder who is treated as an unrelated shareholder, a minimum stake of these unrelated shareholders may or may not be required. CFC rules apply to both direct and indirect subsidiaries of resident shareholder, so that taxpayers do not resort to creating multiple layers of holding companies.

Consequence of being deemed as a CFC: Passive income subject to tax in the hands of the resident parent entity

Once the CFC has been identified, the rules then set out the consequences of being treated as a CFC. The significant consequence is to tax certain income of the CFC 'currently' in the hands of the parent, as if it had been remitted to the parent or was the income of the parent, even though there is no actual remittance and the income clearly remains in the legal ownership of the CFC itself.

The methods of taxing CFC income and the type of CFC income taxed will vary, but in general, CFC rules attempt to tax 'passive' type income (dividend, certain types of interest and royalties), income received by foreign entities taxed at a lower tax rate than applicable in the parent country or income from related parties. CFC regimes which target income taxed at a lower rate typically do so by either listing countries with low tax rates or by setting a minimum tax rate threshold, or by a combination of both.

The most complicated part of CFC rules are the rules of defining what kind of income is "low taxed". What is "low" taxation is determined by comparing the taxes levied abroad on such income at the relevant rates, which would have been payable at home country and what has actually been paid abroad.

Components of CFC's income includible in the hands of the domestic person

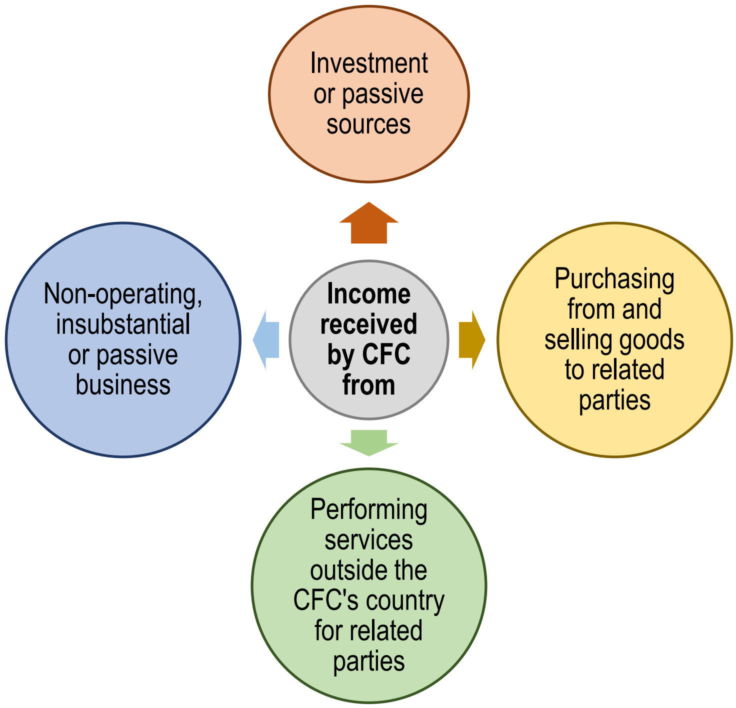
The rules vary between countries, and therefore, this paragraph does not specifically describe the tax system of any particular country. However, the features listed are prevalent in many CFC systems. A domestic person who is a member of a foreign corporation (a CFC) that is controlled by domestic members must include in its income, its share of the CFC's subject income. The includible income (usually determined net of expenses) generally comprises of income received by the CFC from -

(1) investment or passive sources, including interest, unrelated party dividends, rents from unrelated parties, and royalties from unrelated parties;

(2) purchasing goods from related parties or selling goods to related parties where the goods are both produced and for use outside the CFC's country;

(3) performing services outside the CFC's country for related parties;

(4) non-operating, insubstantial, or passive businesses.

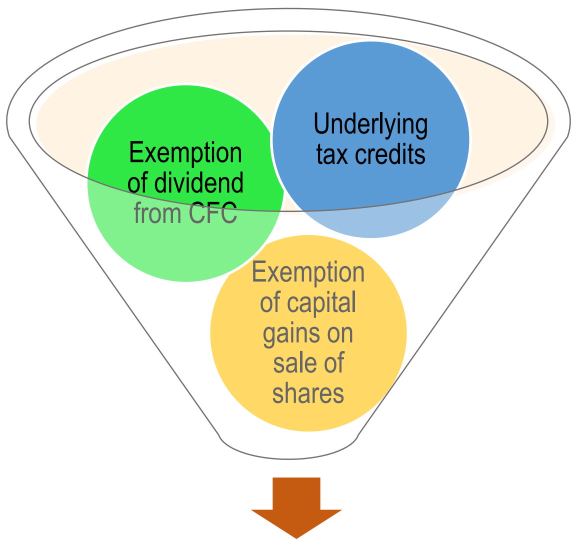


In addition, many CFC rules treat as a deemed dividend, earnings of the CFC loaned by the CFC to domestic related parties. Further, CFC rules also permit exclusion from taxable income of dividends paid by a CFC from earnings previously taxed to members under the CFC rules.

Participation exemptions & Tax credits : Mechanisms to mitigate the effect of CFC Provisions

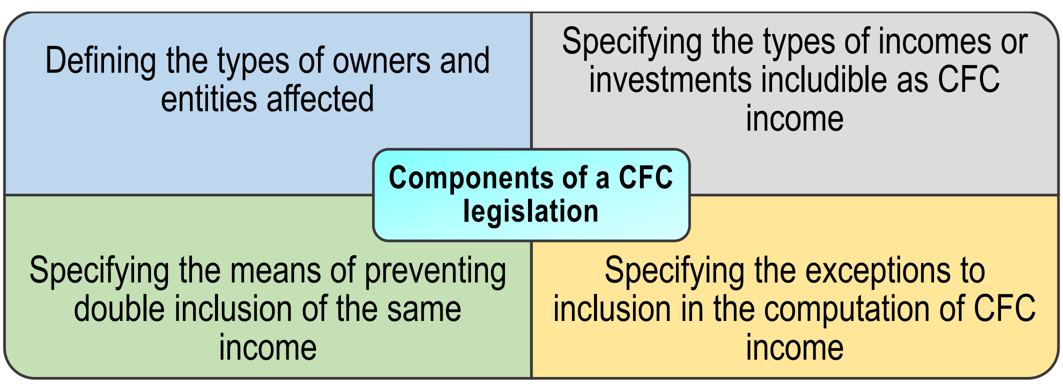
Irrespective of how the income is technically attributed/distributed to the domestic shareholder, this nature of mechanism has the inherent danger of taxing the foreign income abroad and the same income under CFC rules at home and potentially again on distribution back home again. Most countries with CFC rules have in place mechanisms such as participation exemptions or underlying tax credits to mitigate the effect of the CFC provisions. A participation exemption may typically provide that certain types of dividends are not taxed in the hands of shareholders. In addition, some participation exemption regimes may provide that capital gains on shares would not be taxed as long as a specified proportion of the company's share capital is held for a specified period.

Thus, in order to avoid double taxation, a credit is given with respect to the CFC income in the home country as regards foreign taxes paid and on distribution, again, a tax credit is given of the (entire CFC) income distributed from a CFC. Other jurisdictions exempt dividend from a CFC.



Mechanisms to mitigate the effect of CFC Provisions

Components of a CFC Regulation : In a nutshell



(4) APPROACHES IN TAXING CFC INCOME

(i) Categorization of countries based on their tax system, KYC norms and extent of co-operation accorded in sharing of information etc.

All countries have a right to tax their subjects according to their own wisdom and having regard to the economic situation of the country. Some countries, in spite of levying low tax or no tax at all may have sophisticated taxation system, sufficient KYC norms, and co-operative approach at the time of sharing of details of information of assets/investments made by residents/ citizens of the country making the requisition. Such countries must be considered as White listed category jurisdictions. However, there also exist such jurisdictions which must be black listed and CFC rules must be applied by using techniques such as substance over form, look through approach, business purpose rule, etc. Accordingly, it is important to classify countries into various categories. White-listed category jurisdictions which do not assist tax evasion / unacceptable tax avoidance must not be doubted subject to satisfying the substance over form principle, business purpose test and other Anti-Avoidance rules including Transfer pricing regulations.

(ii) Income specific CFC legislation

Under this approach, tax is levied on the specified income of a resident shareholder. The target is to tax certain passive income such as income from investment, income from properties owned by the foreign corporation of which the residents of a jurisdiction are shareholders. Here, on fulfilling certain conditions, CFC legislation presumes that shareholders are acting in a *malafide* manner by allocating profits to a low taxed jurisdiction and such income is deliberately intended to be parked outside the home country to avoid taxes thereon.

Certain active income may also be subject to taxation on satisfying certain conditions. For example, in some countries, residential status of a corporate entity is dependent upon the place of incorporation or its place of effective management (example – India). Therefore, if the place of effective management of a wholly owned subsidiary, say ABC Ltd. (incorporated in a low tax jurisdiction) of A Ltd (an Indian resident company) is found to be in India, the entire profits of ABC Ltd will be taxable in India. Further, being a resident, ABC Ltd. would be required to file its return of income, deduct tax at source on specified payments, furnish TDS statements, get its books of account audited from an accountant under section 44AB and further, also comply with Indian transfer pricing regulations.

(5) THE INDIAN SCENARIO

Indian resident companies are required to pay taxes on their global income including foreign source income. India is a developing country and it follows United Nations double taxation avoidance treaty model, and accordingly, taxes all the income earned from a foreign source and grants credit for the taxes paid abroad for avoidance of double taxation. A non-resident company is taxable in India in respect of income accruing or deeming to accrue or arise in India.

Accordingly, income derived by a foreign subsidiary (the holding company being an Indian company) is only taxed abroad, unless it gets distributed back to India. This non-taxation of foreign source income of an Indian company's foreign subsidiary provides a number of tax planning opportunities to Indian corporate groups enabling them:

- to reduce foreign taxes by choosing a jurisdiction with low / zero tax rates or beneficial regimes for certain types of income; and
- to defer or mitigate taxation in India on these (low) taxed overseas profits until distributed to India.

These strategies seek income being earned in a low tax regime (e.g. tax havens) and not repatriated to India. Such an activity is possible as there are no compulsions on India's foreign subsidiary under exchange control regime to repatriate such profits into India. Such strategies include but are not limited to setting up either foreign holding company or companies holding global intellectual property (rights) or a global operating company.

In past, the Income-tax Act, 1961 had sections 104 to 109 to levy additional tax on undistributed profits including that of residents. The Finance Act 1987 withdrew these provisions. Circular 495 dated 22 September 1987 explained this withdrawal as follows:

"10.1 Sections 104 to 109 relate to levy of additional tax on certain closely-held companies (other than those in which the public are substantially interested) if they fail to distribute a specified percentage of their distributable profits as dividends. These provisions had lost much of their relevance with the reduction of the maximum marginal rate of personal tax to 50 per cent which is lower than the rate for corporation tax on closely-held companies. Sections 104 to 109 have, therefore, been omitted by the Finance Act, 1987."

As a substitute, deemed dividend provisions in section 2(22)(e) of the Act were suitably amended to take care of the abuse. Circular 495 dated 22 September 1987 read as follows:

"10.2 With the deletion of sections 104 to 109 there was a likehood of closely-held companies not distributing their profits to shareholders by way of dividends but by way of loans or advances so that these are not taxed in the hands of the shareholders. To forestall his manipulation, sub-clause (e) of clause (22) of section 2 has been suitably amended."

India is essentially a capital importing country. Hence, earlier, there was not much of outbound investment from India. However, in the last couple of decades, India has witnessed a sharp rise in outbound investments, thereby necessitating regulations around taxation of foreign passive income in its tax legislation.

Taking a leaf out from the Vijay Mathur Committee reforms, the then Union Minister Shri Pranab Mukherjee introduced CFC Regulations in the Revised Direct Taxes Code Bill, 2010 ('DTC') for public suggestions. Along with the multiple objectives of eliminating distortions in the tax structure, rationalization of tax levies, enhanced tax compliance and reduction in tax litigations, the Government had set its sights high on broadcasting the sources from which it could generate revenue. This was evident in the proposals to bring in the regime of CFC regulations in final draft of DTC. The CFC Rules introduced in DTC provided that profits earned by a CFC, located in territory with a lower rate of taxation, would be included in the taxable profits of parent company located in India. As per the Budget Speech 2015-16 of Shri Arun Jaitley, Finance Minister, since most of the provisions of the DTC had already been included in the Income-tax Act, 1961, and the remaining were being addressed in that budget; and also considering that the jurisprudence under the Income-tax Act has been well evolved, there was no great merit in going ahead with the DTC. Therefore, the Income-tax Act, 1961 would continue with amendments being made every year through the Annual Finance Act. Certain significant proposals in the DTC have been incorporated in the Income-tax Act, 1961 in line with the expressed intent, the most important being General Anti Avoidance Rules (GAAR) which became effective from A.Y.2018-19, which is discussed at length later in this chapter. Further, the concept of Place of Effective Management ("POEM") has also been introduced in the Indian taxation regime to determine the residential status of a company, other than an Indian company. Simultaneously, adequate safeguard by way of transition provisions have been put in place to take care of the concerns of those companies becoming resident in India for the first time on account of their place of effective management being in India during the relevant previous year. The provisions relating to POEM have been discussed at length in Chapter 2 – Non-resident Taxation. Further, in order to encourage repatriation of profits, section 115BBD has been inserted in the Income-tax Act, 1961 which provides a concessional tax rate of 15% (gross basis) on dividends received from a specified foreign company i.e., a foreign company in which the Indian company holds 26% or more in the nominal value of the equity share capital of the company.

Strengthening CFC Rules is also a BEPS Action Plan (Action Plan 3) which has been detailed in the ensuing part of this chapter containing a discussion on Base Erosion and Profit Shifting.

8.2 BASE EROSION AND PROFIT SHIFTING

(1) BACKGROUND

Impact of Globalisation

Globalisation has benefited our domestic economies, boosted trade and increased foreign direct investments in many countries. The unrestricted movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. In this way, it accelerated growth, created jobs and fostered innovation. Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. It has a significant impact on a country's corporate income tax regimes.

Growth of E-Commerce and consequent aggressive tax planning

Way back in 1920s, the League of Nations recognised that the interaction of domestic tax systems can lead to double taxation with adverse effects on growth and global prosperity. Globally, countries concur on the need to eliminate double taxation and the need to achieve this on the basis of accepted international laws that are clear and predictable, giving certainty to both governments and businesses. International tax law is, therefore, a pillar in facilitating the development of the global economy. With the economy, the enterprises also became more globally integrated. Multi-national enterprises (MNE) now represent a significant proportion of global GDP. Further, intra-firm trade comprises of a growing proportion of overall trade. Also, the increasing significance of the service component of the economy, and of digital products which are deliverable over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been accompanied by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus, encouraging MNEs to minimise their tax burden by resorting to aggressive tax planning.

Adverse Effects of BEPS

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid. This has become a critical issue since governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth. Further, when tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden. This gives rise to tax fairness issues on account of individuals having to bear a higher tax burden. Also, enterprises that operate only in domestic markets, including family-owned businesses or new innovative businesses, may have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

Need for international collaboration to protect tax sovereignty of its countries

Taxation is at the core of countries' sovereignty, but the interaction of domestic tax laws in certain cases leads to gaps and frictions. While developing their domestic tax laws, sovereign states may not adequately take into consideration the effect of other countries' laws. The interaction of separate sets of laws enforced by sovereign countries causes frictions, including potential double taxation for corporations operating in many countries. It also causes gaps, in cases where corporate income is untaxed, both in the country of source and in the country of residence, or is taxed only at nominal rates. In the domestic context, coherence is generally achieved through a principle of matching – a payment that is deductible by the payer is usually taxable in the hands of the recipient, unless explicitly exempted. There is no similar principle of coherence at the international level, which leaves considerable scope for arbitrage by taxpayers, though sovereign states have united to ensure coherence in a narrow field, namely, to prevent double taxation. BEPS relates primarily to instances where the interaction of different tax rules leads to double non-taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. International standards have tried to reduce these frictions in a manner that respects tax sovereignty; however, gaps still remain. Therefore, there is a need for countries to collaborate on tax matters so that they are able to get their due share of taxes.

(2) OVERVIEW OF BEPS

In the background of the above repercussions, in February 2013, the OECD published a report on "Addressing Base Erosion and Profit Shifting" iterating the need for analyzing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing draft Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 which came to final fruition in October 2015. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions.

The Action Plans were structured around three fundamental pillars viz.:

(i) Introducing coherence in the domestic rules that affect cross-border activities.

(ii) Reinforcing of 'substance' requirements in existing international standards; Alignment of taxation with location of value creation and economic activity; and

(iii) Improving transparency and tax certainty.

A brief classification of the various action plans based on the fundamental pillars is as under:

BEPS Actions as per objectives

- **Coherence**
  - **Action 2** Neutralise the effects of hybrid mismatch arrangements
  - **Action 3** Strengthen CFC rules
  - **Action 4** Limit interest deductibility
- **Substance**
  - **Action 5 - 1st component** Preferential tax regimes
  - **Action 6** Prevent treaty abuse
  - **Action 7** Prevent the artificial avoidance of PE status
  - **Action 8-10** Aligning transfer pricing outcomes with value creation: Intangibles; Risk and capital; and Other high-risk transactions
- **Transparency**
  - **Action 5 - 2nd component** Exchange of information on tax rulings
  - **Action 11** Data analysis
  - **Action 12** Mandatory disclosure rules
  - **Action 13** Re-examine transfer pricing documentation
  - **Action 14** Dispute resolution
- **Horizontal**
  - **Action 1** Digital economy
  - **Action 15** Multilateral instrument

Coherence

Domestic tax systems are coherent – tax deductible payments by one person results in income inclusions by the recipient.

International coherence in corporate income taxation - A pre-requisite to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation

Substance

Present tax laws must be modified: To align tax with substance.

Domestic and international tax laws should ideally relate to both income and the economic activity that generates it. - since at times,tax treaty and transfer pricing facilitate the separation of taxable profits from value-creating activities, such as through shell companies that have little or no economic substance.

Concerns in the area of transfer pricing should be addressed within the prevalent system : These areas include returns related to over-capital-isation, risk and intangible assets. Specific rules, either within or beyond the arm's length principle, may be required for this purpose.

Transparency

Greater transparency and improved data: Pre-requisites to evaluate the impact and magnitude of BEPS.

Taxpayers to report their aggressive tax planning arrangements and rules about transfer pricing documentation, breaking down the information on a country-by-country basis: Assist governments identify risk areas and focus their audit strategies.

Making dispute resolution mechanisms more effective: To provide businesses with greater certainty and predictability

The BEPS measures range from new minimum standards to a revision of pre-existing international standards, and to common approaches which will facilitate the convergence of national rules and guidance drawing on best practices.

A brief classification of the various action plans based on the basis of outcomes is as under:

BEPS Actions as per Outcomes

- **Mimimum standards**
  - **Action 5 - 1st component** Preferential tax regimes
  - **Action 5 - 2nd component** Exchange of information on tax rulings
  - **Action 6** Prevent treaty abuse
  - **Action 13** Re-examine transfer pricing documentation
  - **Action 14** Dispute resolution
- **Reinforced international standards**
  - **Action 7** Prevent the artificial avoidance of PE status
  - **Action 8-10** Aligning transfer pricing outcomes with value creation: Intangibles; Risk and capital; and Other high-risk transactions
- **Common approaches and best practices**
  - **Action 2** Neutralise the effects of hybrid mismatch arrangements
  - **Action 3** Strengthen CFC rules
  - **Action 4** Limit interest deductibility
  - **Action 12** Mandatory disclosure rules
- **Horizontal work**
  - **Action 1** Digital economy
  - **Action 11** Data analysis
  - **Action 15** Multilateral instrument

An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards. The Inclusive Framework on BEPS works to ensure that the international tax framework for MNEs remains relevant for today and the future, thereby promoting economic efficiency and global welfare. It will also ensure that governments continue to efficiently raise revenues not only from traditional but also from digital businesses, both for direct tax and indirect tax purposes.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other States involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

New minimum standard - New minimum standard implies application of a new rule to be implemented by all states, since non-implementation may result in negative spill overs (including adverse impact of competitiveness) on other countries. Each of the four BEPS minimum standards [namely, Actions 5, 6, 13 and 14] is subject to peer review in order to ensure timely and accurate implementation and thus safeguard the level playing field. All members of the Inclusive Framework on BEPS commit to implementing the minimum standards, and commit to participating in the peer review.

Revision of a standard which already exists – Existing standards have been updated and will be implemented but with the caveat that all BEPS participants have not endorsed the underlying standards on tax treaties or transfer pricing; and

Best practice – A best practice is not a standard but optional recommendation for states to follow. Guidance based on best practices will support those countries proposing to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation.

(3) ACTION PLAN 1 – ADDRESSING THE CHALLENGES OF THE DIGITAL ECONOMY

Digital economy: Dissolving link between income-producing activity and physical location

At present, in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. Hence, business in digital domain doesn't actually occur in any physical location but instead takes place in "cyberspace." Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

Given the rise of e-commerce, an entire digital economy has emerged in the last decade. Since there is a concept of 'intangibility' attached to the digital model of business, tax authorities often faced challenges rightly bringing to tax the profits earned from a digital business. To address the same, the first action plan of the BEPS project was developed by the OECD which outlines the methods and principles based on which physical and digital economies can be taxed at par. Before the same, physical locations of the servers of such digital businesses were considered to establish the tax jurisdiction in which the profits of digital businesses could be taxed. However, it was observed that servers were therefore placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

Taxation issues in E-Commerce

These new business models have created new tax challenges. The typical taxation issues relating to e-commerce are:

(i) the difficulty in characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction,

(ii) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e., place of business, location, and permanency must be reconciled with the new digital reality.

OECD Recommendations under Action Plan 1 of the BEPS project

The OECD has recommended several options to tackle the direct tax challenges which include:

Modifying the existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digital presence in another country's economy.

A virtual fixed place of business PE in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website

Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or **imposition of a equalisation levy** on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

The Interim Report, 2018, on Tax Challenges arising from Digitalisation, considers an interim measure in the form of an excise tax on the supply of certain e-services within their jurisdiction that would apply to the gross consideration paid for the supply of such e-services by a registered e-services supplier.

After the delivery of the Interim Report in March 2018, the Inclusive Framework delivered a Policy Note in January 2019 including concrete proposals framed within two complementary pillars.

***Pillar 1 - Re-allocation of profit and revised nexus rules**: This pillar would explore potential solutions for determining where tax should be paid and on what basis ("nexus"), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located ("profit allocation").*

***Pillar 2 - Global anti-base erosion mechanism**: This pillar would explore the design of a system to ensure that multinational enterprises – in the digital economy and beyond – pay a minimum level of tax. This pillar is intended to address remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions which tax these profits at below the minimum rate.*

Indian Taxation Regime

Insertion of Chapter VIII in the Finance Act, 2016 on Equalisation Levy to address this challenge

In order to address the challenges of the digital economy, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

Meaning of "Specified Service"

(1) Online advertisement;

(2) Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

"Significant economic presence" to constitute "business connection"

The scope of provisions of section 9(1)(i), prior to amendment by the Finance Act, 2018, were restrictive as it essentially provided for physical presence based nexus rule for taxation of business income of the non-resident in India. *Explanation 2* to the said section which defines 'business connection' was also narrow in its scope since it limited the taxability of certain activities or transactions of non-resident to those carried out through a dependent agent. Therefore, emerging business models such as digitized businesses, which do not require physical presence of itself or any agent in India, were not covered within the scope of section 9(1)(i).

In view of the above, the Finance Act, 2018 has amended section 9(1)(i) to provide that 'significant economic presence' in India shall also constitute 'business connection'. For this purpose, "significant economic presence" means-

	Transaction/activity	Condition
(i)	any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India	the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed
(ii)	systematic and continuous soliciting of its business activities or engaging in interaction with users in India through digital means	The users would be of such number as may be prescribed.

Notes:

(i) Only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India.

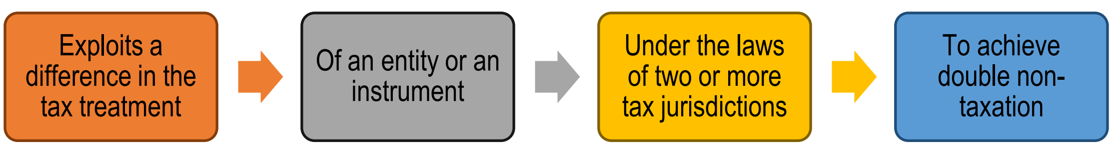
(ii) Such transactions or activities shall constitute significant economic presence in India, whether or not the agreement for such transactions or activities is entered in India or whether or not the non-resident has a residence or place of business in India or renders services in India.

(4) ACTION PLAN 2 - NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

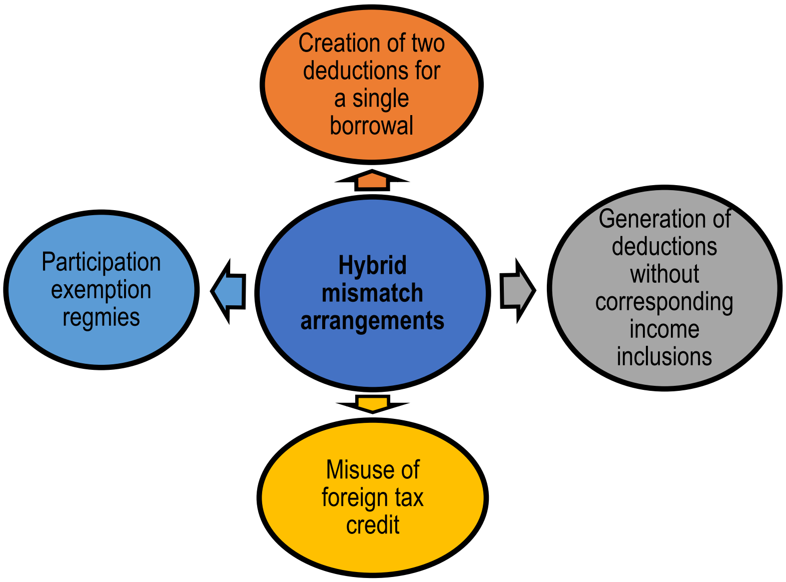
Before understanding what Action Plan 2 recommends, we must understand what a hybrid mismatch is.

Hybrid Mismatch Arrangement: Meaning

A hybrid mismatch is an arrangement that:



Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -



Specific country laws that allow taxpayers to opt for the tax treatment of certain domestic and foreign entities may aid hybrid mismatches. It may not be easy to find out which country has in fact lost tax revenue, since the laws of each country involved have been complied with; however, there is a reduction of the overall tax paid by all parties involved as a whole, which ultimately has an adverse effect on competition, economic efficiency, transparency and fairness.

The Final Report on Action Plan 2 is detailed providing examples on operational practicality of various proposals for amendments to domestic law. The Report provides recommendations for both general changes to domestic law followed by a set of dedicated anti-hybrid rules. Treaty changes are also recommended. A snap shot of the Action Plan 2 is as below:

Recommended general amendments are as follows:

- **A rule denying transparency to entities where the non-resident investors' resident country treats the entity as opaque;**

Example

Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.

With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies' income under the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries.

Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company's country, the double deduction can be avoided.

- **A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;**

Example

N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.

Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.

- **A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity**; and
- **Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.**

Treaty changes - Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a State can tax a resident entity generally unrestricted by treaty.

Anti-hybrid rules - The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either

(i) Those payments will not be included in the recipient's ordinary income, or

(ii) The same amount is being simultaneously deducted by another entity.

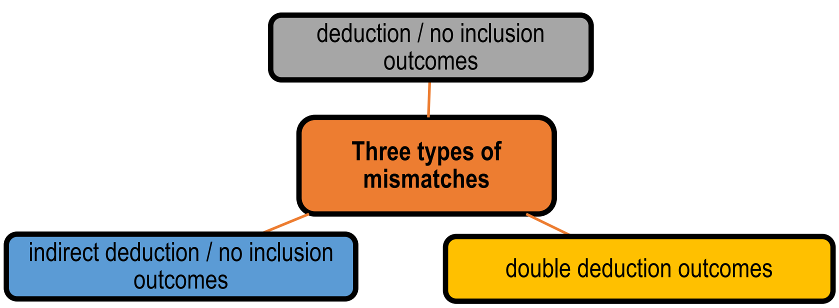
The examples in the 2015 Final Report demonstrate these outcomes (deduction and non-inclusion, or double deduction) arising from various hybrid financial instruments, financing transactions and under entity recognition and de-recognition rules.

The report also addresses banks and insurance companies wherein it recommends that there should be targeted rules addressing base erosion and profit shifting in such sectors. The basic rules might not work for them because they will typically have net interest income.

Treatment of Branch mismatches: 2017 Report

While the 2015 Report addresses mismatches that are a result of differences in the tax treatment or characterisation of hybrid entities, it did not directly consider similar issues that can arise through the use of branch structures. These branch mismatches occur where two jurisdictions take a different view as to the existence of, or the allocation of income or expenditure between, the branch in head office of the same taxpayer.

Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches:



The 2017 report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

(5) ACTION PLAN 3 - STRENGTHEN CONTROLLED FOREIGN COMPANY (CFC) RULES

Shifting investment income and passive income to subsidiaries in low tax or no tax jurisdictions: Deferral of home country taxation

Under the tax laws of several countries, a shareholder of a corporation is not taxed on the corporation's income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many countries (where global multi-nationals are based) have high tax rates as compared to certain other countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

Obviously, Governments were disturbed that multinationals based in their countries kept large amounts of profits offshore. In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These rules are generally referred to as Controlled Foreign Corporation (CFC) rules.

CFC Rules: Addressing BEPS

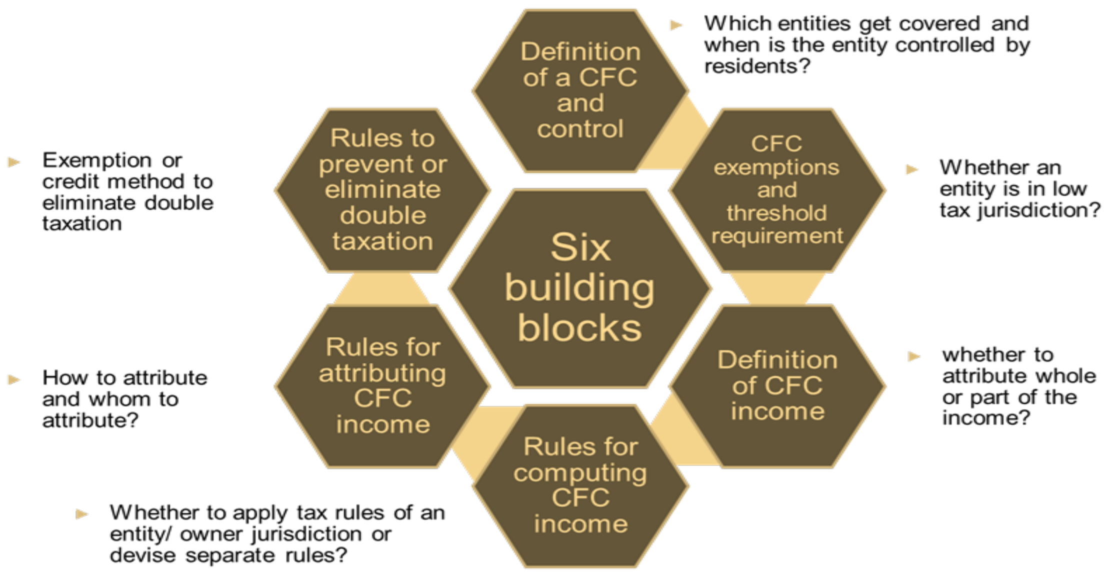
Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, OECD regards CFC rules as being important in tackling BEPS and has made a series of **best practice recommendations** in relation to the 'building blocks' of an effective CFC regime. The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states' tax bases from earnings stripping.

Building Blocks

The OECD recommended 'building blocks' are as follows.

- ***Computation and attribution of CFC income*** - CFC income should be calculated under a notional application of the parent jurisdiction's tax laws and attribution should be subject to a control threshold and based on proportionate ownership or influence.
- ***Prevention and elimination of double taxes*** - CFC rules should not result in double taxation. The specific measures suggested are to provide a credit for foreign tax paid on CFC income, provide relief where a dividend is paid out of attributed income or where taxpayers dispose of their interest in a CFC where there has been attribution.
- ***CFC definition*** - CFC rules apply to foreign subsidiaries controlled by shareholders in the parent jurisdiction. OECD recommends application of CFC rules to non-corporate entities, if those entities earn income that raises BEPS concerns and such concerns are not addressed.
- ***CFC exemptions and threshold requirements*** - Companies should be exempted from CFC rules where they are subject to an effective tax rate that is not below the applicable tax rate in the parent jurisdiction.
- ***Definition of CFC income*** - CFC rules should have a definition of income that ensures that BEPS concerns are addressed, but countries are free to choose their own definition.



Indian Taxation Regime

- At present, there are no CFC rules in the Income-tax Act, 1961;
- CFC rules formed part of the proposed Direct Tax Code.
- CFC regime has been debated over last many years in India and is one of the last remaining concepts from the DTC to be incorporated in the Income-tax Act, 1961.
- In order to encourage repatriation of profits, section 115BBD provides a concessional tax rate of 15% (gross basis) on dividends received from a specified foreign company i.e., a foreign company in which the Indian company holds 26% or more in the nominal value of the equity share capital of the company.

(6) ACTION PLAN 4 – INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

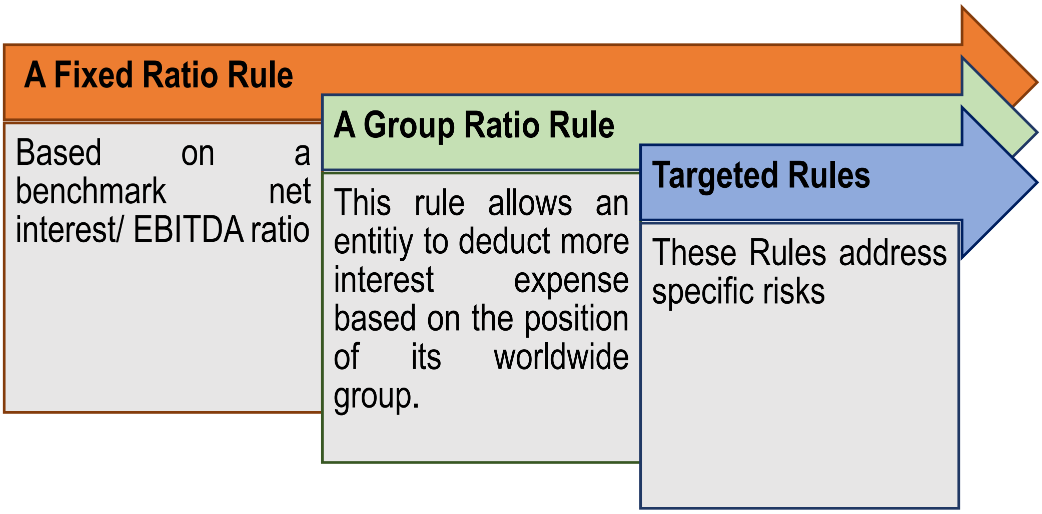
The OECD is concerned that multinational groups are able to erode their tax base (i.e., reduce their taxable profits) with interest expense, for example by:

- Locating third party debt in high tax countries;
- Using intra-group loans to achieve interest deductions in excess of the group's actual third party interest expense;
- Using related party or third party debt to finance the production of exempt or deferred income.

BEPS Action Plan 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

Common Approach: Linking an entity's net interest deduction to its level of economic activity

The mobility and fungibility of money enables multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. The 2015 Report established a common approach which directly links an entity's net interest deductions to its level of economic activity, based on taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:



Updation of BEPS Action 4 Report: Guidance on the design and operation of the group ratio rule and approaches to deal with risks posed by the banking and insurance sectors

In December 2016, the OECD released an updated version of the BEPS Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which includes further guidance on two areas: the design and operation of the group ratio rule, and approaches to deal with risks posed by the banking and insurance sectors.

- **The design and operation of the group ratio rule** - The 2015 Action 4 Report set out a common approach to address BEPS involving interest and payments economically equivalent to interest. This included a 'fixed ratio rule' which limits an entity's net interest deductions to a set percentage of its EBITDA and a 'group ratio rule' to allow an entity to claim higher net interest deductions, based on a relevant financial ratio of its worldwide group. The report included a detailed outline of a rule based on the net third party interest/EBITDA ratio of a consolidated financial reporting group, and provided that further work would be conducted in 2016 on elements of the design and operation of the rule. The updated report does not change any of the conclusions agreed in 2015, but provides a further layer of technical detail to assist countries in implementing the group ratio rule in line with the common approach**. This emphasises the importance of a consistent approach in providing protection for countries and reducing compliance costs for groups, while including some flexibility for a country to take into account particular features of its tax law and policy.**

- **Banking and insurance sectors** - The 2015 report also identified factors which suggest that the common approach may not be suitable to deal with risks posed by entities in the banking and insurance sectors**. The updated report examines regulatory and commercial requirements which constrain the ability of groups to use interest for BEPS purposes, and limits on these constraints.** Overall, a number of features reduce the risk of BEPS involving interest posed by banking and insurance groups, but differences exist between countries and sectors and in some countries risks remain. Each country should identify the risks it faces, distinguishing between those posed by banking groups and those posed by insurance groups. Where no material risks are identified, a country may reasonably exempt banking and/or insurance groups from the fixed ratio rule and group ratio rule without the need for additional tax rules. Where BEPS risks are identified, a country should introduce rules appropriate to address these risks, taking into account the regulatory regime and tax system in that country. The updated report considers how these rules may be designed, and includes a summary of selected rules currently applied by countries.

Progress in implementation

As at mid-2019, a number of OECD and Inclusive Framework members have adopted interest limitations rules or are in the process of aligning their domestic legislation with the recommendations of BEPS Action 4. From the commencement of 2019, the EU Member States apply an interest cap that restricts a taxpayer's deductible borrowing costs to generally 30% of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). Various other countries have also taken steps to limit interest deductibility (e.g., Argentina, India, Malaysia, Norway, South Korea) or are in the process of aligning their domestic legislation with the recommendations of Action 4 (e.g., Japan, Peru, Viet Nam).

Indian Taxation Regime

Section 94B of the Income-tax Act, 1961: Addressing Thin Capitalization

Debt financing of cross-border transactions is often favorable than equity financing for taxpayer. In view of the above, in line with the recommendations of OECD BEPS Action Plan 4, section 94B has been inserted in the Income-tax Act, 1961 by the Finance Act, 2017 to provide a cap on the interest expense that can be claimed by an entity to its associated enterprise. The total interest paid in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise for that previous year, whichever is less, shall not be deductible.

Applicability

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.

Carry forward of disallowed interest expenditure

The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

Threshold limit

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹ 1 crore in respect of any debt issued by a non-resident associated enterprise exceeding which the provision would be applicable. Banks and Insurance business are excluded from the ambit of the said provisions keeping in view of special nature of these businesses.

(7) ACTION PLAN 5 – COUNTER HARMFUL TAX PRACTICES

The Action 5 Report is one of the four BEPS minimum standards. The minimum standard of the Action 5 Report consists of two parts. One part relates to preferential tax regimes, where a peer review is undertaken to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. The second part includes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.

The Forum on Harmful Tax Practice (FHTP) has been conducting reviews of preferential regimes since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions. The current work of the Forum on Harmful Tax Practices (FHTP) comprises three key areas:

(1) the assessment of preferential tax regimes to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions.

(2) the peer review and monitoring of the Action 5 transparency framework through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns

(3) the review of substantial activities requirements in no or only nominal tax jurisdictions to ensure a level playing field.

Substantial activity in preferential regime: Basis for tax concession

The report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc. A minimum standard has been set up based on an agreed methodology to assess whether there is substantial activity in a preferential regime, such as IP regime. For instance, in case of R&D activities, a minimum standard has been advocated that establishes nexus test as the means of identifying the R&D activities which provide the substance justifying the tax concession including tracking of expense and income on a particular products/product line.

Transparency Framework

On 1 February 2017, the OECD released the Terms of Reference and Methodology for peer reviews on the Action 5 standard for the exchange of information on tax rulings (the "transparency framework"), approved by the Inclusive Framework on BEPS. The peer review and monitoring process will be conducted by the Forum on Harmful Tax Practices (FHTP) in accordance with the Terms of Reference and Methodology, with all members participating on an equal footing.

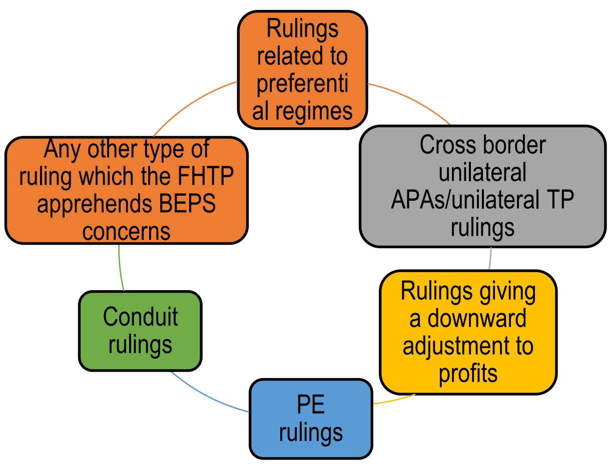
The Terms of Reference are broken down into four aspects, which capture the key elements of the transparency framework:

- Information gathering process;
- Exchange of information;
- Confidentiality of information received;
- Statistics.

The methodology sets out the procedural mechanisms by which jurisdictions will complete the peer review, including the process for collecting the relevant data, the preparation and approval of reports, the outputs of the review and the follow up process. The methodology contemplates collecting the data points relevant to the peer review by using standardised questionnaires, sent to the reviewed jurisdiction as well as the peers (i.e. the other members of the Inclusive Framework on BEPS).

Consensus on Framework: Six categories of rulings

As a key outcome of the work on BEPS Action 5, a framework covering all rulings that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange has been agreed, which covers six categories of rulings:



FHTP – Forum on Harmful Tax Practices

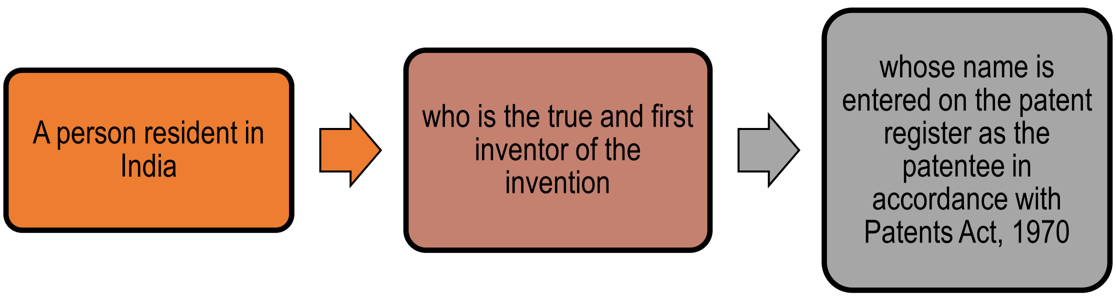
Indian Taxation Regime

In India, the Finance Act, 2016 has introduced a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

Section 115BBF of the Income-tax Act, 1961: In line with nexus approach of BEPS Action 5

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, section 115BBF of the Income-tax Act, 1961 provides that where the total income of the eligible assessee includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, developed means atleast 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

Meaning of Eligible Assessee



Eligible assessee **<u>includes</u>**

- every such person, being the true and the first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent.

(8) ACTION PLAN 6 – PREVENTING TREATY ABUSE

Protection against treaty shopping: Minimum Standard

Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). That commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

Countries will implement this common intention by including in their treaties:

(i) the combined approach of Limitation of Benefits (LOB) and Principal Purpose Test (PPT) rule,

(ii) the PPT rule alone, or

(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

Section A: Treaty Anti-abuse Rules

Section A of this report includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so. These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty, concluded by that State, grants to residents of that State, for example by establishing a letterbox company in that State.

Section A also includes new rules to be included in tax treaties in order to address other forms of treaty abuse. These rules address:

(i) certain dividend transfer transactions intended to lower artificially withholding taxes payable on dividends;

(ii) transactions that circumvent the application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property;

(iii) situations where an entity is resident of two Contracting States, and

(iv) situations where the State of residence exempts the income of permanent establishments situated in third States and where shares, debt-claims, rights or property are transferred to permanent establishments set up in countries that do not tax such income or offer preferential treatment to that income.

The report recognises that the adoption of anti-abuse rules in tax treaties is not adequate to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws; these must be addressed through domestic anti-abuse rules, including through rules that will result from the work on other parts of the Action Plan.

The report also addresses two specific issues related to the interaction between treaties and domestic anti-abuse rules. The first issue relates to the application of tax treaties to restrict a Contracting State's right to tax its own residents. A new rule will codify the principle that treaties do not restrict a State's right to tax its own residents (subject to certain exceptions). The second issue deals with so-called "departure" or "exit" taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State.

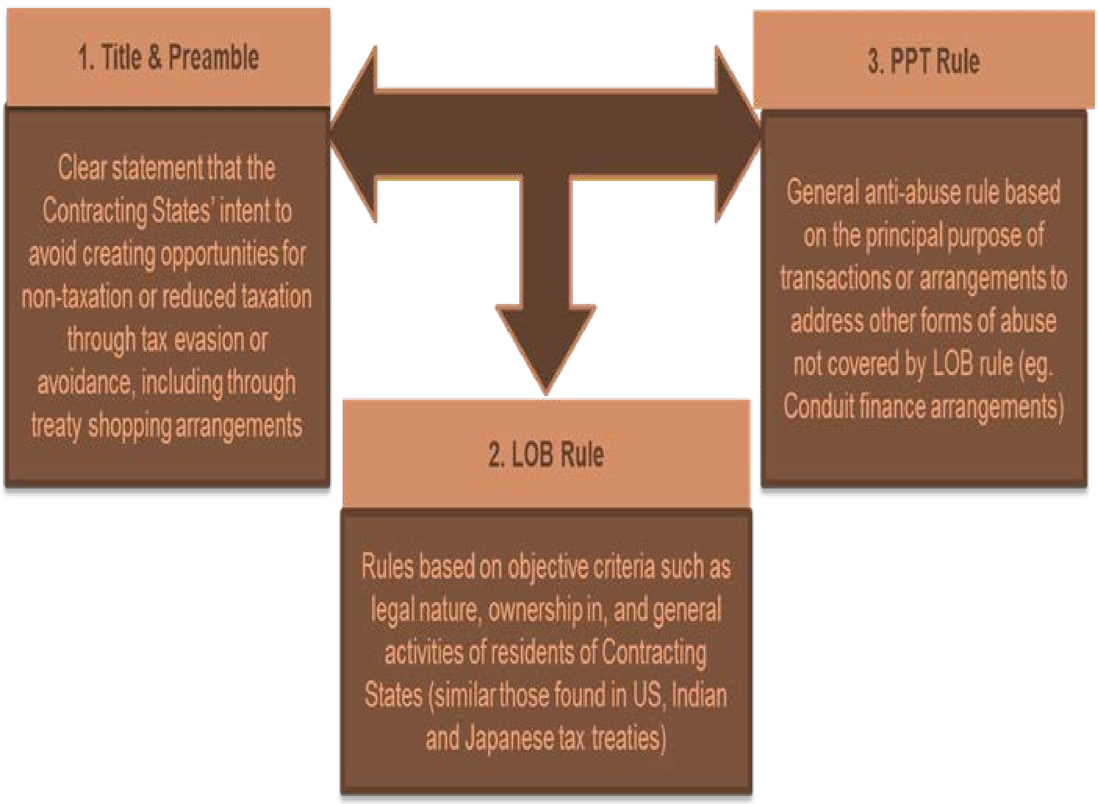
Section B: Clarity of intent to eliminate double taxation without creating opportunities for tax evasion and avoidance

Section B of the report addresses the part of Action seeking clarification "that tax treaties are not intended to be used to generate double non-taxation". This clarification is provided through a reformulation of the title and preamble of the Model Tax Convention that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular, through treaty shopping arrangements.

Section C: Identifying tax policy considerations before entering into a treaty

Section C of the report addresses the third part of the work mandated by Action 6, which was "to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country". The policy considerations described in that section should help countries explain their decisions not to enter into tax treaties with certain low or no-tax jurisdictions; these policy considerations will also be relevant for countries that need to consider whether they should modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty.

The three-pronged approach to address anti-treaty abuse is illustrated as under:



Implementation of Action 6 Minimum Standard

The first peer review on the implementation of the Action 6 minimum standard reveals that a large majority of Inclusive Framework members have begun to translate their commitment on treaty shopping into actions and are now in the process of modifying their treaty network. In total, on 30 June 2018, 82 jurisdictions had some treaties that were already compliant with the minimum standard or that were going to shortly comply.

The first peer review shows the efficiency of the Multilateral Instrument (MLI) [For detailed understanding of MLI, refer to discussion in Action Plan 15] in implementing the minimum standard and the other treaty-related BEPS measures. As per OECD, it is by far the preferred tool of Inclusive Framework members for implementing the minimum standard. The majority of the jurisdictions that have signed the MLI have listed almost all their treaties under the MLI.

As on 1st January, 2019, the provisions of the MLI started to take effect with respect to some treaties. For the treaties for which the MLI is effective, tax administration can now use effective treaty provisions to put an end to treaty-shopping.

Indian Tax Regime

LoB clause introduced in India-Mauritius Tax Treaty - On 10th May, 2016, India and Mauritius has signed a protocol amending the India-Mauritius tax treaty at Mauritius. In the said treaty, for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. The tax rate on such capital gains arising during the period from 1.4.2017-31.3.2019 should, however, not exceed 50% of the tax rate applicable on such capital gains in India. A Limitation of Benefit (LOB) Clause has been introduced which provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. Further, a shell or a conduit company claiming to be a resident of a Contracting State shall not be entitled to this benefit. A shell or conduit company has been defined as any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian rupee 15,00,000 or Indian ₹ 7,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

LoB clause in India-Singapore Tax Treaty - On similar lines, India and Singapore has signed a protocol amending the India-Singapore tax treaty. Capital gains on alienation of shares would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty. In respect of shares acquired after 1.4.2017 and sold before 1.4.2019, the expenditure test needs to be met for the 12 month period immediately preceding the date of transfer.

(9) ACTION PLAN 7 – PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS

This report includes changes to the definition of permanent establishment (PE) in the OECD Model Tax Convention that will address strategies used to avoid having a taxable presence in a country under tax treaties.

These changes will ensure that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.

Thus, the following steps have been advocated:

- ***Reworking exceptions to PE definition*** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are 'preparatory or auxiliary'.
- ***Analyzing arrangements entered through contractual agreements*** –A Commissionnaire arrangement may be broadly defined as an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Commissionnaire arrangements have been a major cause of concern for tax administrations in many countries.

  The 2017 update to OECD and UN MC on Article 5 paragraphs 5 and 7 addresses the artificial avoidance of PE status through commissionaire arrangements and similar strategies.

Article 5(5) of the OECD/UN/US Model refers to what is popularly known as "Agency PE". It contains a deemed inclusion clause and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in Source State even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in State of Source within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold of six or twelve months, as the case may be).

As per the 2017 update to OECD and UN MC, for paragraph 5 to apply, all the following conditions must be met: (i) a person acts in a Contracting State on behalf of an enterprise; (ii) in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and (iii) these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

Additional Guidance on attribution of profits to PEs under BEPS Action Plan 7

The March 2018 report contains additional guidance on the attribution of profits to permanent establishments resulting from the changes in the Report on BEPS Action Plan 7 to Article 5 of the OECD Model Tax Convention. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionnaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1).

Progress in implementation of BEPS Action Plan 7

The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the MLI (Articles 12 to 15). The Multilateral Instrument (MLI) is a flexible instrument that allows jurisdictions to adopt BEPS treaty-related measures to counter BEPS and strengthen their treaty network. The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes [For detailed understanding of MLI, refer to discussion under Action 15].

Indian Taxation Regime

The OECD, under BEPS Action Plan 7, reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities. In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended modifications to Article 5(5) to provide that an agent would include not only a person who habitually concludes contracts on behalf of the non-resident, but also a person who habitually plays a principal role leading to the conclusion of contracts. Similarly Action Plan 7 also recommends the introduction of an anti-fragmentation rule as per paragraph 4.1 of Article 5 of OECD Model tax conventions, 2017 so as to prevent the tax payer from resorting to fragmentation of functions which are otherwise a whole activity in order to avail the benefit of exemption under paragraph 4 of Article 5 of DTAAs.

Further, with a view to preventing base erosion and profit shifting, the recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to implement Tax Treaty Related Measures (MLI[1]), to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where treaty partner has also opted for Article 12. As a result, the DAPE provisions in Article 5(5) of India's tax treaties, as modified by MLI, became wider in scope than the erstwhile provisions in *Explanation 2* to section 9(1)(i). Similarly, the anti fragmentation rule introduced as per paragraph 4.1 of Article 5 of the OECD Model Tax Conventions, 2017 has narrowed the scope of the exception under Article 5(4), thereby expanding the scope of PE in DTAA *vis-a-vis* domestic provisions contained in *Explanation 2* to section 9(1)(i). In effect, the relevant provisions in the DTAAs became wider in scope than the domestic law.

However, section 90(2) of the Income-tax Act, 1961 provides that the provisions of the domestic law would prevail over corresponding provisions in the DTAAs, to the extent they are beneficial. Since, in the instant situations, the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAAs, as modified by MLI, such wider provisions in the DTAAs would become ineffective, unless the provisions of domestic law are appropriately amended.

In view of the above, section 9(1)(i) has been amended to align the same with the provisions in the DTAA as modified by MLI so as to make the provisions in the treaty effective. Accordingly, section 9(1)(i) has been amended by the Finance Act, 2018 to provide that "business connection" shall also include any business activities carried through a person who, acting on behalf of the non-resident, habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. Such contracts should be-

(i) in the name of the non-resident; or

(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that the non-resident has the right to use; or

(iii) for the provision of services by that non-resident.

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[1] Refer to discussion on MLI later on in this chapter under BEPS Action 15

(10) ACTION PLAN 8-10 - TRANSFER PRICING OUTCOMES IN LINE WITH VALUE CREATION/INTANGIBLES/RISK AND CAPITAL AND OTHER HIGH-RISK TRANSACTIONS

The aforesaid Action plans represent the OECD's work on transfer pricing which has been a core focus of the BEPS Action Plans. The specific Actions focus on Intangibles, Risks and capital and other high-risk transactions. These are the hard areas of transfer pricing and are summarized together in the Final Report 'Aligning Transfer Pricing Outcomes with Value Creation'.

Clarification and Strengthening of existing standards on transfer pricing

Transfer pricing rules, which are set out in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the ALP the conditions, including the price, for transactions within an MNE group. The existing standards in this area have been clarified and strengthened, including the guidance on the arm's length principle and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm's length principle. The work has focused on three key areas.

Action Plan	Details
8	Addresses transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are generally difficult-to-value. Misallocation of the profits generated by valuable intangibles is a significant cause of BEPS.
9	Contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks. Moreover, Action 9 addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
10	This action focuses on other high-risk areas, which include: - the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational, - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and - the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.

The combined 2015 report on these action plans contains revised guidance which responds to these issues and ensures that transfer pricing rules secure outcomes that better align operational profits with the economic activities which generate them. The report also contains guidance on transactions involving cross-border commodity transactions as well as on low value-adding intra-group services. As those two areas were identified as of critical importance by developing countries, the guidance will be supplemented with further work mandated by the G20 Development Working Group,

OECD Transfer Pricing Guidelines

In addition, the OECD Transfer Pricing Guidelines released in 2017 provide guidance on the application of the "arm's length principle", which represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between associated enterprises. In today's economy where multinational enterprises play an increasingly prominent role, transfer pricing continues to be high on the agenda of tax administrations and taxpayers alike. Governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein and taxpayers need clear guidance on the proper application of the arm's length principle.

Significant recommendations in the Final Report (2015)

- **Analysis of contractual relations between parties in combination with the conduct of the parties** -The OECD's view is that contractual allocation of functions, assets and risks between associated enterprises leaves the arm's length principle vulnerable to manipulation leading to outcomes which do not correspond to the value created through underlying economic activity. In order to deal with this, the revised transfer pricing guideline requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct.

- **Risks and returns to be allocated to the party exercising control and having financial capacity to assume the risks** - The Report determines that a party that cannot exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will not be allocated those risks and consequential returns. Rather, those risks and returns will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

- **Allocation of returns to MNE group members controlling economically significant risks and contributing assets** - The Report does not allocate the returns to the party which merely owns the assets rather, those returns are allocated to the MNE group members which perform important functions, control economically significant risks and contribute assets, as determined through the accurate delineation of the actual transaction. Similar considerations should apply to MNE group members who provide funding but perform few activities. Accordingly, the passive funder may only be entitled to a risk-free return, or less.

- **Actual nature of transaction to be determined for pricing, in a case where economic substance differs from form** - The OECD advocates that effort should be made to determine the actual nature of a transaction and then to price it, where the economic substance differs from form, or arrangements viewed in totality differ from those that would be made by independent enterprises.

- **Pricing methods to ensure that the profits are allocated to the most important economic activities** - Transactional profit split method is being analysed in order to provide additional guidance on the ways in which this method can be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains. Similarly, further guidance is expected on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm's length conditions. On low value adding intra group services, the guidance provides for an elective approach covering a wide category of services which command a very limited mark up on costs and which provide a consistent allocation key for all recipients for such services.

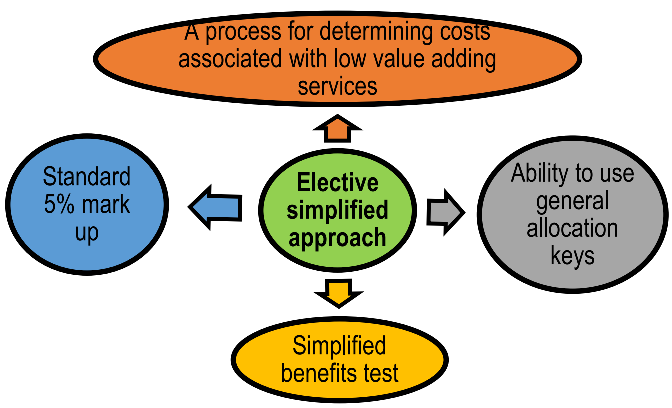
OECD's guidance on transfer pricing for low value-adding intra-group services under BEPS Actions 8-10

The guidance is intended to achieve a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payer countries.

Key features:

A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the Multinational Enterprise's (MNE) core business, not requiring or creating valuable intangibles and not involving significant risks.

- A list of services that would typically meet the definition. The services listed generally are back-office services.
- An elective simplified approach to determine arm's length charges for low value adding services, including:



- Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach
- The ability for tax administrations to include a threshold above which the simplified approach may be denied.

The Action Plan, thus, advocates a simplified approach to determination of arm's length price which would reduce the compliance effort of meeting the benefit test, provide greater certainty for MNEs that price charged would be accepted by tax authorities, provide tax authorities with targeted documentation enabling effective review of compliance risks.

(11) ACTION PLAN 11 – MEASURING AND MONITORING BEPS

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, The Addressing Base Erosion and Profit Shifting report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, the fiscal effects of BEPS are significant. BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

Indicators of BEPS activity

Six indicators of BEPS activity highlight BEPS behaviour using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

(i) **The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate.** For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.

(ii) **The effective tax rates paid by large MNE entities are estimated to be lower than similar enterprises with only domestic operations** - This tilts the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.

(iii) **Foreign direct investment (FDI) is increasingly concentrated** - FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

(iv) **The separation of taxable profits from the location of the value creating activity is**

particularly clear with respect to intangible assets, and the phenomenon has grown rapidly - For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.

(v) **Royalties received by entities located in these low-tax countries accounted for 3% of total royalties** - This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

(vi) **Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries**. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

Empirical Analysis: Confirming existence of BEPS and its adverse effects

The new empirical analysis of the fiscal and economic effects of BEPS alongwith the existing empirical studies that prove the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty abuse, these BEPS indicators confirm that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions. Also, empirical analysis indicates that BEPS adversely affects competition between businesses, levels and location of debt, the location of intangible investments, and causes fiscal spillovers between countries and wasteful and inefficient expenditure of resources on tax engineering. The empirical analysis in this report, along with several academic studies, confirms that strong anti-avoidance rules reduce profit shifting in countries that have implemented them.

Limitations

These indicators and all analyses of BEPS are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition to this, the analyses of profit shifting to date have found it difficult to separate the effects of BEPS from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure BEPS will be critical for measuring and monitoring BEPS in the future, as well as evaluating the impact of the countermeasures developed under the BEPS Action Plan.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, this report makes a number of recommendations that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report's recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS Project. The report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

(12) ACTION PLAN 12 – DISCLOSURE OF AGGRESSIVE TAX PLANNING ARRANGEMENTS

A significant challenge faced by tax authorities worldwide is the lack of timely, comprehensive and relevant information on aggressive tax planning strategies. Timely access to such information would facilitate quick response to tax risks through informed risk assessment, audits, or changes to legislation or regulations. BEPS Action Plan 12 recognises the advantages of tools designed to facilitate the information flow on tax risks to tax administrations and tax policy makers. The Report provides a modular framework for guidance drawn from best practices for use by countries without mandatory disclosure rules to design a regime that suits their requirement to get early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries can decide whether or not to introduce mandatory disclosure regimes. Where a country opts for mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

Design principles and significant objectives of a mandatory disclosure regime:

- Clarity and comprehensibility
- Ability to balance additional compliance costs to taxpayers with the benefits obtained by the tax administration
- Flexibility and dynamism : to allow the tax administration to adjust the system to respond to new risks (or carve-out obsolete risks
- Accurate identification of the schemes to be disclosed
- Effective achievement of objectives
- Ensuring effective use of information collected

The primary object of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may rethink about entering into a scheme if it has to be disclosed.

Key design features for an effective mandatory disclosure regime:

The final report suggests the use of different hallmarks to identify cross-border schemes, given that the tax benefit of a cross-border scheme may arise in a different country. Such hallmarks include use of hybrids arrangements that separate legal and tax ownership of depreciable assets and cross-border transfers of assets at other than market value.

Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures [March, 2018]

The purpose of these model mandatory disclosure rules is to provide tax administrations with information on CRS Avoidance Arrangements and Opaque Offshore Structures, including the users of those Arrangements and Structures and those involved with their supply. Information disclosed pursuant to the application of these model rules can be used both for compliance purposes and to inform future tax policy design. This information will provide tax administrations both with additional intelligence for their tax compliance activities as well as for designing future tax policy. These rules should also have a deterrent effect against the design, marketing and use of arrangements covered by the rules.

CRS Avoidance Arrangements are arrangements that are designed to circumvent, or are marketed as, or have the effect of, circumventing the Common Reporting Standard, as implemented in relevant domestic laws. An arrangement circumvents the Common Reporting

Standard where it avoids the reporting of CRS information to all jurisdictions of tax residence of the taxpayers in a way that undermines the policy intent of the CRS.

Opaque Offshore Structures are structures that involve the use of a passive entity in a jurisdiction other than the jurisdiction of tax residence of one or more of the beneficial owners and that are designed to, marketed as or have the effect of disguising the identity of the beneficial owner(s). Amongst others, this may include the use of nominee shareholders, the exercise of indirect control over entities or the use of jurisdictions with weak rules for the identification of beneficial owners. In order to minimise reporting in low-risk situations, there is a carve-out from the definition of Offshore Structure for Institutional Investors.

The model rules require an Intermediary or user of a CRS Avoidance Arrangement or Opaque Offshore Structure to disclose certain information to its tax administration. Where such information relates to users that are resident in another jurisdiction, it would be exchanged with the tax administration(s) of that jurisdiction in accordance with the terms of the applicable international legal instrument.

The mandatory disclosure rules provide tax administrations and policy makers with information on schemes, their users and suppliers, for use in compliance activities, exchange with treaty partners and tax policy design.

Progress in implementation

With the adoption of Council Directive (EU) 2018/822 by EU Member States, there has been a significant uptake in jurisdictions that now have mandatory disclosure rules. This directive will result in the reporting of cross-border aggressive tax planning, offshore structures and Common Reporting Standard avoidance schemes to EU tax authorities. The directive incorporates the model rules set out in the 2018 OECD report Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures.

(13) ACTION PLAN 13 – RE-EXAMINE TRANSFER PRICING DOCUMENTATION

This report contains revised standards for transfer pricing documentation incorporating a master file, local file, and a template for country-by-country reporting of revenues, profits, taxes paid and certain measures of economic activity. The revised standardised approach requires taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing and other BEPS risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. Country-by-country reports will be disseminated through an automatic government-to-government exchange mechanism. The implementation package included in this report sets out guidance to ensure that the reports are provided in a timely manner, that confidentiality is preserved and that the information is used appropriately, by incorporating model legislation and model Competent Authority Agreements forming the basis for government-to-government exchanges of the reports.

Requirements as per OECD report on Action 13 of BEPS Action Plan

The OECD report provides for:

(a) revised standards for transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

	Document	Information
(1)	Master File	Standardised information relevant for all multinational enterprises (MNE) group members. Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations.
(2)	Local file	Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to local tax administrations.
(3)	Country-by-country report	The BEPS Action 13 report provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by-Country (CbC) Report. To facilitate the implementation of the CbC Reporting standard, the BEPS Action 13 report includes a CbC Reporting Implementation Package which consists of (i) model legislation which could be used by countries to require the ultimate parent entity of an MNE group to file the CbC Report in its jurisdiction of residence including backup filing requirements and (ii) three model Competent Authority Agreements that could be used to facilitate implementation of the exchange of CbC Reports, respectively based on the:

		a) Multilateral Convention on Administrative Assistance in Tax Matters; b) Bilateral tax conventions; and c) Tax Information Exchange Agreements (TIEAs). **Following information are required in the CbC report**: Information relating to the global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group. CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism.

Advantages of the three-tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;

(b) Tax administrations would get useful information to assess transfer pricing risks;

(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

Country-by-country Report: Reporting Requirements of MNEs

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:

(1) the amount of revenue;

(2) profit before income tax; and

(3) income tax paid and accrued.

(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

(c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

Master File: Objective & Features

(a) The master file would provide an overview of the MNE groups business, including:

   (1) the nature of its global business operations,

   (2) its overall transfer pricing policies, and

   (3) its global allocation of income and economic activity

   in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

The BEPS Action 13 report (Transfer Pricing Documentation and Country-by-Country Reporting) provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by-Country (CbC) Report.

Peer Review Process for phased implementation of CbC Reporting

Under the Action 13 Minimum Standard, jurisdictions have committed to foster tax transparency by requesting the largest multinational enterprise groups (MNE Groups) to provide the global allocation of their income, taxes and other indicators of the location of economic activity. This unprecedented information on MNE Groups' operations across the world will boost tax authorities' risk-assessment capabilities. The Action 13 Minimum Standard has been translated into specific terms of reference and a methodology for the peer review process. The peer review of the Action 13 Minimum Standard is proceeding in stages with three annual reviews in 2017, 2018 and 2019. The phased review process follows the phased implementation of Country-by-Country (CbC) Reporting. Each annual peer review process will, therefore, focus on different aspects of the three key areas under review: the domestic legal and administrative framework, the exchange of information framework, and the confidentiality and appropriate use of CbC reports. The first annual peer review report (May, 2018) reflects the outcome of the first review which focused on the domestic legal and administrative framework. It contains the review of 95 jurisdictions which provided legislation or information pertaining to the implementation of CbC Reporting.

Indian Taxation Regime

Transfer Pricing provisions under the Income-tax Act, 1961

Chapter X of the Income-tax Act, 1961 comprising sections 92 to 92F contain provisions relating to transfer pricing regime.

Section 92D requires maintenance of prescribed information and document relating to the international transaction and specified domestic transaction by every person who has entered into an international transaction. ***Also, a constituent entity of an international group is required to keep and maintain the prescribed information and document in respect of the international group.***

Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [Section 286]

(a) **Threshold limit for applicability of CbC reporting [Sub-section (7)]:** The reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement (CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed i.e., ₹ 5,500 crore.

Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the calculation of the value in rupees of such total consolidated group revue shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year preceding the accounting year [Rule 10DB(7)].

(b) **Time limit for furnishing CbC report [Sub-section (2)]:** The parent entity of an international group or the alternate reporting entity, if it is resident in India shall be required to furnish the report in respect of the group to the Director General of Income-tax (Risk Assessment) for every reporting accounting year, within a period of twelve months from the end of the said reporting accounting year for which the report is being furnished, in the prescribed form and manner.

(c) **Meaning of "Parent entity"[Clause (h) to sub-section (9)]:** A constituent entity, of an international group holding, directly or indirectly, an interest in one or more of the other constituent entities of the international group, such that,—

(i) it is required to prepare a consolidated financial statement under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or

(ii) it would have been required to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange,

and, there is no other constituent entity of such group which, due to ownership of any interest, directly or indirectly, in the first mentioned constituent entity, is required to prepare a consolidated financial statement, under the circumstances referred to in sub clause (i) or sub clause (ii), that includes the separate financial statement of the first mentioned constituent entity.

(d) **Details to be furnished by constituent entity resident in India [Sub-section (1):** Every constituent entity resident in India, of an international group having parent entity that is not resident in India, shall notify the Director General of Income-tax (Risk Assessment) at least two months prior to the due date for furnishing CbC report –

(1) whether it is the alternate reporting entity of the international group; or

(2) the details of the parent entity or the alternate reporting entity, if any of the international group, and the country of territory of which the said entities are resident.

The report shall be furnished in prescribed manner and in the prescribed form.

(e) **Details/ information to be included in CbC report [Sub-section (3)]:** It should contain aggregate information in respect of:

(1) the amount of revenue,

(2) profit and loss before income-tax,

(3) amount of income-tax paid and accrued,

(4) details of stated capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent's incorporation country and residential status, nature and detail of main business activity of each constituent entity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13.

(f) **Furnishing of CbC report by resident constituent entity [Sub-section (4):** A constituent entity of an international group resident in India, other than the parent entity or the alternate reporting entity, shall be required to furnish CbC report within 12 months from the end of the reporting accounting year to the DGIT (Risk Assessment), if the parent entity of the group is resident -

(1) in a country or territory in which it is not obligated to file report of the nature of CbC report;

(2) in a country with which India does not have an arrangement for exchange of the CbC report; or

(3) there has been a systemic failure of the country or territory i.e., such country is not exchanging information with India even though there is an agreement and this fact has been intimated to the entity by the prescribed authority.

*In case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report shall be **six months** from the end of the month in which said systemic failure has been intimated.*

(g) **Nomination of one constituent entity for furnishing CbC report [Proviso to sub-section (4)]:** If there are more than one such constituent entity of the same group resident in India, other than the parent entity or the alternate reporting entity, then the group can nominate (under intimation in writing on behalf of the group to the prescribed authority), then, one constituent entity that shall furnish the report on behalf of the group. This entity would then furnish the report.

(h) **No obligation to furnish CbC report in certain cases [Sub-section (5)]:** If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident and such alternate entity has furnished such report on or before the date specified by that country or territory, then, the entities of such group operating in India would not be obliged to furnish report if the report can be obtained under the agreement of exchange of such reports by Indian tax authorities.

(i) **Entity to furnish documents and information called for [Sub-section (6)]:** The DGIT (Risk Assessment) may call for such document and information from the entity furnishing the report as it may specify in notice for the purpose of verifying the accuracy. The entity shall be required to make submission within 30 days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.

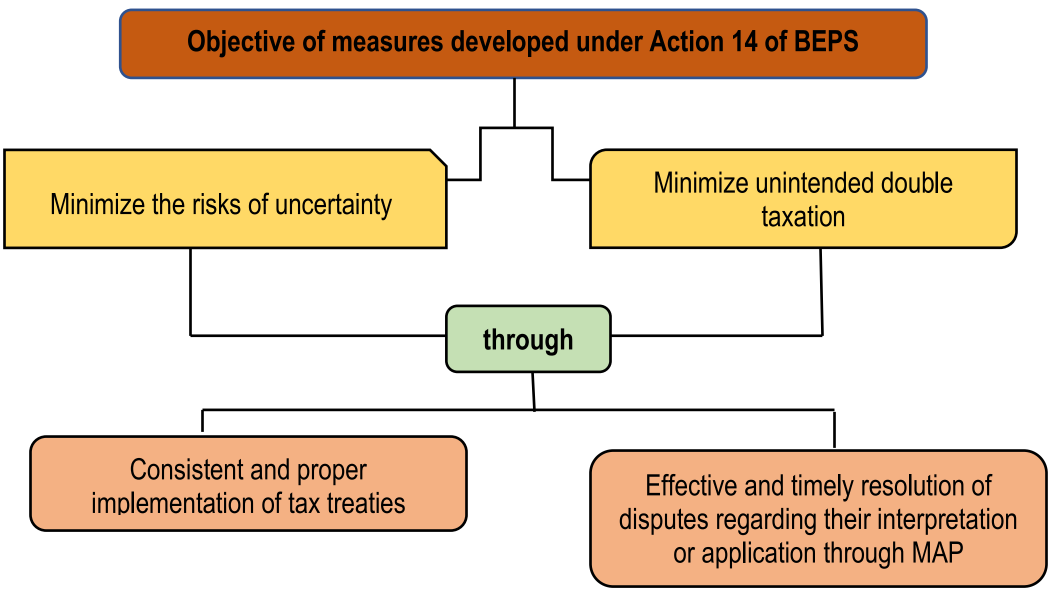
(j) **Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961**

	Section	Provision
(1)	*Section 92D(1)(ii)*	*A person being constituent of an international group has to keep and maintain the prescribed information and document in respect of the international group.* *The information and document as mandated for master file under OECD BEPS Action 13 report shall be prescribed by way of Rules.*
(2)	92D(4)	The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules

(k) **Threshold limit of consolidated group revenue for applicability of CbC reporting requirement**

The CbC reporting requirement for a reporting year does not apply unless the consolidated revenues of the preceding accounting year of the group, based on consolidated financial statement, exceeds a threshold to be prescribed. The threshold for total consolidated group revenue of the international group prescribed under section 286 of the Income-tax Act, 1961 read with Rule 10DB of the Income-tax Rules, 1962 is ₹ 5,500 crores.

(14) ACTION PLAN 14 – MAKING DISPUTE RESOLUTION MORE EFFECTIVE



Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are significant to developing an international tax system that facilitates economic growth and a buoyant global economy. Countries concur that the measures introduced to address BEPS pursuant to the BEPS Action Plans should not result in unnecessary uncertainty for compliant taxpayers and in unintended double taxation. Improving dispute resolution mechanisms is, therefore, a critical component of the work on BEPS issues.

MAP: Key to proper application and interpretation of tax treaties

Article 25 of the OECD Model Tax Convention provides a mechanism, distinct from the general legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties relating to interpretation or application of the Convention on a mutually-agreed basis. This mechanism, the mutual agreement procedure (MAP), is the key to the proper application and interpretation of tax treaties, particularly to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. Through the adoption of the Final Report of BEPS, countries have agreed to important changes in their approach to dispute resolution, in particular, by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.

Minimum Standard: Ensure effective implementation of MAP

The final report on Action 14: Making Dispute Resolution Mechanisms More Effective, which contains a BEPS minimum standard, was adopted in October 2015. The Action 14 Minimum Standard consists of 21 elements and 12 best practices, which assess a jurisdiction's legal and administrative framework in the following key areas:

a) preventing disputes;

b) availability and access to MAP;

c) resolution of MAP cases;

d) implementation of MAP agreements.

The minimum standard will, thus, ensure:

- that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner
- the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes;
- that taxpayers can access the MAP when eligible.

Along with the adoption of this minimum standard, the BEPS Inclusive Framework members agreed on:

- *a peer review process to evaluate the implementation of this standard and*
- *to report MAP statistics under a newly developed reporting framework*

Setting up FTA: Enabling Effective Monitoring of MAP Performance

The final report advocates setting up a Forum on Tax Administration (FTA), a subset of MAP Forum to deal with practical issues, as a minimum standard. The minimum standard is complemented by a set of best practices. States have agreed to join the FTA MAP Forum, report MAP statistics and agree to have their MAP performance monitored. In this way, a peer review mechanism has been set in place to ensure transparency in the area of exchange of information. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology.

(15) ACTION PLAN 15 – DEVELOPING A MULTILATERAL INSTRUMENT

Analysis of tax and public international law issues relating to development of multilateral instrument

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

Pursuant to this analysis, interested countries have to develop a multilateral instrument designed to provide an innovative approach to international tax matters, which reflect the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The aim of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a multilateral instrument exist in various other areas of public international law. Based on the public international law and the expertise of tax professionals, the 2014 Report, analysed the technical feasibility of a multilateral hard law approach and its consequences on the prevalent tax treaty system. The issues arising from the development of such an instrument were identified. The Report also provided an analysis of the international tax, public international law, and political issues arising from such an approach. The 2014 Report also concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly.

Formation of Adhoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS

Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS, was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015.

In line with Action 15 report, an ad-hoc group was formed with a pre-defined purpose of development of such Multilateral Instrument (MLI) and that adopted the text of the Convention and accompanying Explanatory Statement in November 2016.

India was part of the Ad Hoc Group of more than 100 countries and jurisdictions from G20, OECD, BEPS associates and other interested countries, which worked on an equal footing on the finalization of the text of the Multilateral Convention, starting May 2015. The text of the Convention and the accompanying Explanatory Statement was adopted by the Ad hoc Group on 24th November 2016.

Once drafted, the said document was thereafter kept open for signatures from 31 December 2016. At the time of signature, signatories submitted a list of their tax treaties in force that they would like to designate as Covered Tax Agreements (CTAs), i.e. to be amended through the MLI.

The Convention enables all signatories, *inter alia*, to meet treaty-related minimum standards that were agreed as part of the Final BEPS package, including the minimum standard for the prevention of treaty abuse under Action 6.

The Convention will operate to modify tax treaties between two or more Parties to the Convention. It will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the Covered Tax Agreement. Instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.

The Convention will modify India's treaties in order to curb revenue loss through treaty abuse and base erosion and profit shifting strategies by ensuring that profits are taxed where substantive economic activities generating the profits are carried out and where value is created.

MLI's role in BEPS

Abuse of tax treaties is an important source of BEPS. The MLI helps the fight against BEPS by implementing the tax treaty-related measures developed through the BEPS project in existing bilateral tax treaties in a synchronized and efficient manner. These measures will prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of permanent establishment status and neutralize the effects of hybrid mismatch arrangements.

Features of MLI

The Multilateral Convention is, thus, an outcome of the OECD / G20 Project to tackle Base Erosion and Profit Shifting (the "BEPS Project") i.e., tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.

The MLI modifies tax treaties that are "Covered Tax Agreements". A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.

The MLI is a flexible instrument which will modify tax treaties according to a jurisdiction's policy preferences with respect to the implementation of the tax treaty-related BEPS measures. The MLI provides for different types of flexibility:

(i) jurisdictions can choose amongst alternative provisions in certain MLI articles;

(ii) jurisdictions can choose to apply optional provisions (for instance, the provisions on mandatory binding arbitration);

(iii) jurisdictions may also choose to reserve the right not to apply MLI provisions (to opt out through a "reservation") with respect to all of their Covered Tax Agreements or with respect to a subset of their Covered Tax Agreements. Jurisdictions only have the possibility to opt out of provisions that do not reflect a BEPS minimum standard, with the possibility to withdraw their reservation (and opt in) later.

Coverage of the MLI

In the first signing ceremony of the MLI on 7th June, 2017, 67 countries have signed the MLI and 9 countries have expressed their intention to sign the instrument. As on 27th September, 2018, 84 countries have signed the MLI and 6 countries have expressed their intention to sign the instrument. Therefore, the MLI already has a significant impact on the worldwide network of tax treaties.

The provisional MLI position of each Signatory indicates the tax treaties it intends to cover, the options it has chosen and the reservations it has made. Signatories can amend their MLI position until ratification. Even after ratification, parties can choose to opt in with respect to optional provisions or to withdraw reservations.

Indian Taxation Regime

The Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS) was signed by India at Paris, France on 7th June, 2017. India had ratified the said Convention and had deposited the instrument of ratification along-with the list of Covered Tax Agreements, reservations and notifications (India's Position under the said Convention) to the Depositary on 25th June, 2019. The date of entry into force of the said Convention for India is 1st October, 2019, being the first day of the month following the expiry of a period of three calendar months beginning on 25th June, 2019, being the date of deposit by India of the instrument of ratification.

The provisions of the said Convention would have effect in India with respect to a Covered Tax Agreement in accordance with the provisions of Article 35 of the said Convention. Accordingly, in exercise of the powers conferred by section 90(1) of the Income-tax Act, 1961, the Central Government has, vide Notification No.57/2019 dated 9.8.2019 (available at https://www.incometaxindia.gov.in/communications/notification/notification57_2019.pdf), notified that the provisions of the said Convention shall be given effect to in the Union of India, in accordance with India's Position under the said Convention, as set out in the Annexure thereto.

As per Article 35 of the MLI, the provisions of this Convention shall have effect in each Contracting Jurisdiction with respect to a Covered Tax Agreement:

a) *with respect to taxes withheld at source on amounts paid or credited to non-residents, where the event giving rise to such taxes occurs* ***on or after the first day of the next calendar year*** *that begins on or after the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the Covered Tax Agreement; and*

b) *with respect to all other taxes levied by that Contracting Jurisdiction, for taxes levied with respect to taxable periods beginning* ***on or after* the expiration of a period of six calendar months** (or a shorter period, if all Contracting Jurisdictions notify the Depositary that they intend to apply such shorter period) from the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the Covered Tax Agreement.

Therefore, the earliest date when the provisions of this Convention can take effect in India is 1st April, 2020 (six months from 1st October, 2019, the date of entry into force for India)[2].

Resources: The discussion on BEPS Action Plans contained in this chapter is essentially based on the Action Plans developed in the context of the OECD/G20 BEPS Project and available at the website http://www.oecd.org/tax/beps/beps-actions.htm

[2] Since the provisions of this Convention takes effect only from F.Y.2020-21, the same have not been discussed in detail in this Study Material.

8.3 OTHER ANTI AVOIDANCE MEASURES

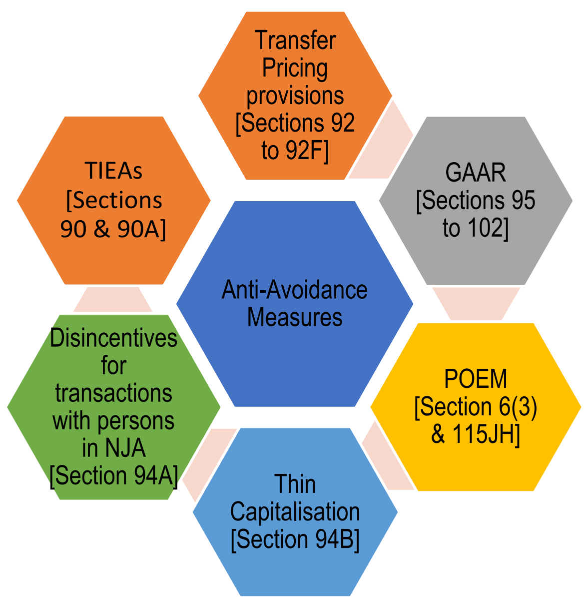
We have seen that there is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. We have also understood that the Base Erosion and Profits Shifting (BEPS) project of the Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

- Tax avoidance involves the legal exploitation of tax laws to one‘s own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways.

The significant anti-avoidance measures under the Indian tax laws in respect of international transactions are –



The Specific Anti-Avoidance Rules (SAARs) include transfer pricing, thin capitalisation, disincentives for transactions with persons in notified jurisdictional area (discussed in Chapter 1 – Transfer Pricing), Tax Information Exchange Agreements (discussed in Chapter 3 – Double Taxation Relief and Chapter 7 – Tax Treaties – Overview, Features, Application and Interpretation) and Place of Effective Management (discussed in Chapter 2 – Non-resident Taxation). The General Anti-Avoidance Rules (GAAR) are discussed in detail hereunder -

The General Anti-Avoidance Rules (GAAR) provisions aim at combating 'impermissible tax avoidance'. Many countries, like United Kingdom, China, South Africa, Australia, Canada, Brazil have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

The Indian GAAR

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals. The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.

The Shome Committee Report explains the need for and rationale of GAAR as under:

(i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.

(ii) Transactions have to be real and are not to be looked at in isolation.

(iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.

(iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.

(v) The GAAR provisions codify this 'substance over form' basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y.2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.

Prior to A.Y. 2018-19, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, inter alia, be considered specific examples of SAAR -

(i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible

(ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.

(iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions also made applicable to specified domestic transactions by the Finance Act, 2012.

(iv) Section 93 on avoidance of tax by transfer of income to non-residents through transfer of assets, rights or interest.

(v) Section 94 on avoidance of tax by certain transactions in securities.

(vi) Section 94A on transactions with persons located in notified jurisdictions.

(vii) Section 2(22)(e) on deemed dividend.

(viii) Section 40(a)(i) and (ia) on disallowance of expenses for non-deduction of tax at source.

(ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.

(x) *Explanations 1 to 13* to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.

Tax treaties also provide certain anti-avoidance rules for instance, Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

Applicability of General Anti-Avoidance Rule [Section 95]

(i) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.

(ii) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

(iii) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

(iv) The term arrangement referred to in section 95 of the Act, has been defined in section 102 under clause (1) and means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding;

The term 'Step' has been defined in section 102 under clause (9) to include a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement.

Example 1

Facts:

M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2016-17 for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit in F.Y. 2020 -21 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

Interpretation:

There is an arrangement of setting up of a unit in SEZ which results in a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Example 1A

Facts:

In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and shows the same as manufactured in the tax exempt SEZ unit, while doing only the process of packaging there. Is GAAR applicable in such a case?

Interpretation:

This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance.

Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

Example 1B

Facts:

In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

Interpretation:

As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The *company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through transfer pricing regulations that deny tax benefits. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.*

Example 1C

Facts:

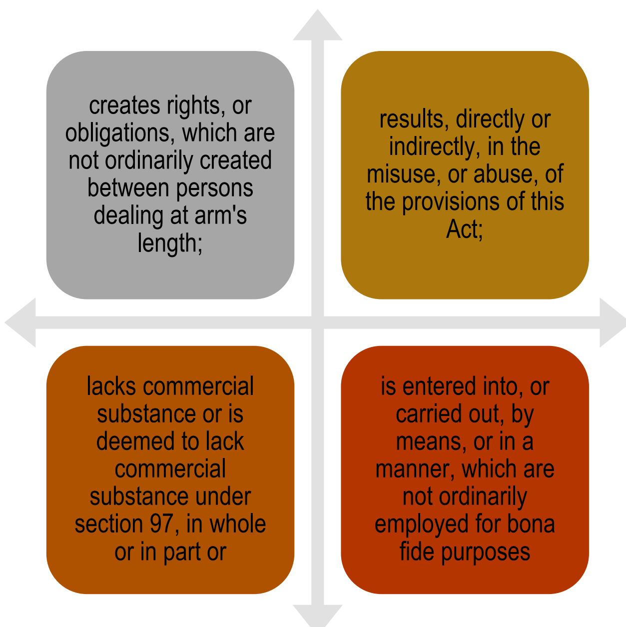
In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

Interpretation:

The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section 10AA of the Act. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.

Impermissible Avoidance Agreement [Section 96]

(1) An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:



(2) The **purpose test of obtaining tax benefit and tainted element test as under clauses (a) to (d)** above are **twin conditions** that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term "tax benefit" has been defined in section 102 clause (10) as under -

(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or

(b) an increase in a refund of tax or other amount under this Act; or

(c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or

(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or

(e) a reduction in total income or

(f) an increase in loss,

in the relevant previous year or any other previous year.

(3) **The first tainted element** refers to non-arm's length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

Example -2

Facts:

Y Tech Ltd. is a company resident of country C1. It enters into an agreement with Z Energy Ltd., an Indian company for setting up a power plant in India. It is a composite contract for an agreed price of US$ 100 million. The payment has been split in the following parts as per separate agreements

(i) US$ 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

(ii) US$ 70 million for offshore supplies of equipment etc (not taxable as no role is played by any PE in India. These are not subject to import duty)

(iii) US$ 20 million for local supplies and installation charges (taxable on net income basis)

It is found that the fair market value of offshore design is about USD 30 million; therefore, it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case? Reviewer

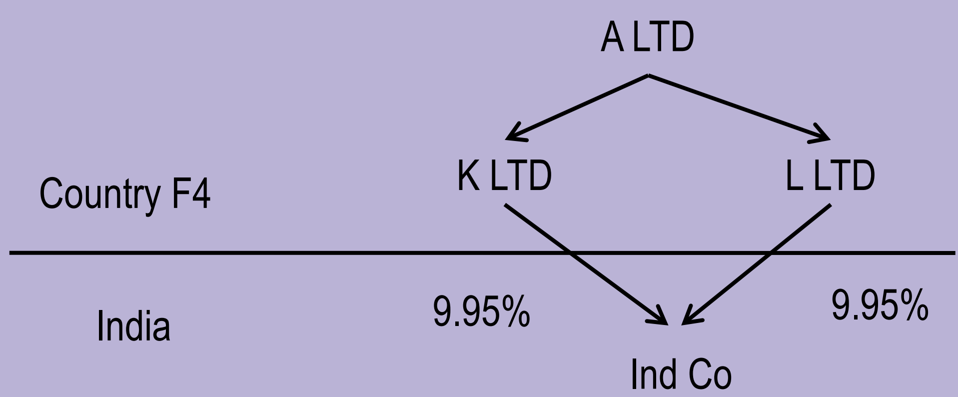
Interpretation:

The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied. (1) The main purpose of this arrangement is to obtain tax benefit; and (2) the transactions are not at arm's length. Consequently, GAAR may be invoked and prices would be reallocated. However, determination of arm's length price should be based on transfer pricing regulations under the Act.

(4) **The second tainted** element refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.

Example-3

Facts:



Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no *commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement can be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.*

(5) **The third tainted** element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance**. [Dealt with in detail below]**

(6) **The fourth element** refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.

Arrangement to lack commercial substance [Section 97]

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

(1) Under section 97, certain arrangements have been deemed to lack commercial substance as under –

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

(i) round trip financing;

(ii) an accommodating party;

(iii) elements that have effect of offsetting or cancelling each other; or

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter)

(2) Clause (a) is the codification of **substance v. form doctrine**. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed

based on the —substance of what took place. In other words, it reflects the inherent ability of the law to **remove the corporate veil and look beyond form**.

(3) Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

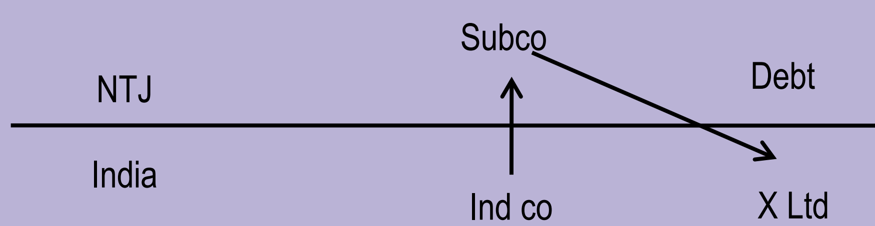
(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Example-4

Facts:

Indco incorporates a Subco in a NTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $ 100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?



Interpretation:

The arrangement appears to be to avoid payment of tax on interest income by Indco in case loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.

(4) Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase "accommodating party" has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

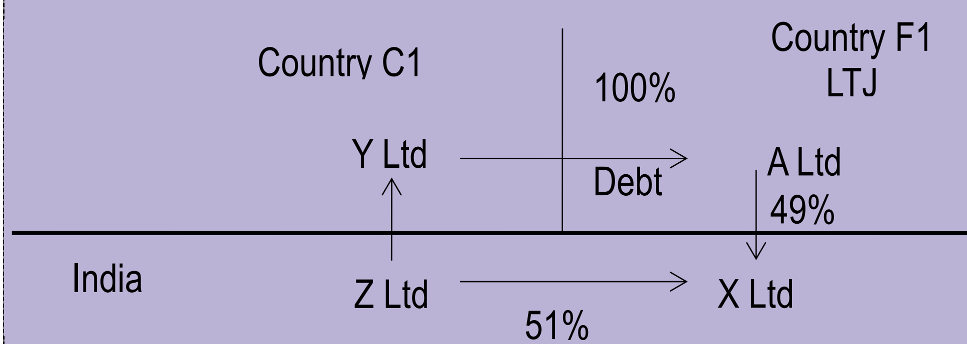
(5) Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(6) Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.

(7) Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

Example -5

Facts:



(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.

(ii) Z Ltd. is a company resident in India.

(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.

(iv) A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.

(v) The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.

(vi) A Ltd. is also designated as a permitted transferee of Y Ltd. Permitted transferee means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.

(vii) As per the joint venture agreement, 49% of X Ltd's equity is allotted to A Ltd. and 51% is allotted to Z Ltd..

(viii) Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. Can GAAR be invoked to deny the treaty benefit?

Interpretation:

The arrangement of routing investment through country F1 results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is a LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd. The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, it is possible to invoke GAAR, in this case.

(8) In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

Consequence of impermissible avoidance arrangement [Section 98]

(1) If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital or revenue nature; or

(ii) any expenditure, deduction, relief or rebate;

(f) treating—

(i) the place of residence of any party to the arrangement; or

(ii) the situs of an asset or of a transaction,

at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(2) It has also been provided that –

(i) any equity may be treated as debt or vice versa;

(ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or

(iii) any expenditure, deduction, relief or rebate may be recharacterised.

Treatment of connected persons and accommodating party [Section 99]

(1) As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—

(i) the parties who are connected persons in relation to each other may be treated as one and the same person;

(ii) any accommodating party may be disregarded;

(iii) such accommodating party and any other party may be treated as one and the same person;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

(2) The term 'connected person' is defined in section 102 clause (4). Connected person means any person who is connected directly or indirectly to another person and includes –

<table>
<tr><th colspan="4">If Connected Person is an</th><td rowspan="2">A Company/Firm /AOP/BOI/HUF having substantial interest in the business of the person or any director/partner/member or any relative of such director/partner/member</td><td rowspan="2">A Company/Firm /AOP/BOI/HUF whose director/partner/member has substantial interest in the business of the person or family or any relative of such director/partner/member</td><td rowspan="2">Any person who carries on business
– being an individual or any relative of such person has substantial interest in the business of that other person
– being a company/ Firm/AOP/BOI/HUF or any director /partner/member or any relative of such director/partner/ member has substantial interest in the business of that other person</td></tr>
<tr><td><u>Individual:</u>
any relative or who has substantial interest in the business of the person or any relative of such individual</td><td><u>Company:</u>
any director or relative of such director</td><td><u>Firm/ AOP/ BOI:</u>
any partner/ member or relative of such partner/ member</td><td><u>HUF:</u>
Any member or relative of such member</td></tr>
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Framing of guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA have to be applied in accordance with such guidelines and subject to such conditions as may be prescribed. These guidelines are contained in Rules 10U to 10UC.

(1) As per Rule 10U, the provisions of General Anti Avoidance Rule are not applicable to

(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crores.

(b) a Foreign Institutional Investor -

(i) who is an assessee under the Act;

(ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and

(iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments.

(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor.

(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.

However, the provisions of GAAR shall apply to any arrangement [other than specified in (d) above], irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017.

(2) Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only [Rule 10UA].

(3) The Assessing Officer shall, before making a reference to the Commissioner under section 144BA(1), issue a notice in writing to the assessee seeking objections, if any, to the applicability of provisions of GAAR in his case [Rule 10UB(1)].

Implementation of GAAR Provisions under the Income-tax Act, 1961

Clarifications on certain queries about implementation of GAAR [Circular No.7 of 2017 dated 27-1-2017]

The provisions of Chapter X-A of the Income-tax Act, 1961 relating to General Anti-Avoidance Rule will come into force from 1st April, 2017. Certain queries have been received by the Board about implementation of GAAR provisions. The Board constituted a Working Group in June, 2016 for this purpose. The Board has considered the comments of the Working Group and the following clarifications are issued:

Question no. 1: *Will GAAR be invoked if SAAR applies?*

Answer: *It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.*

Question no. 2: *Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?*

Answer: *Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR.*

Question no. 3: *Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?*

Answer: *GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.*

Question no. 4: *Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.*

Answer: *For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.*

Question no. 5: *Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?*

Answer: *Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income Tax Rules.*

Question no. 6: *The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, air craft leases) and loan arrangements, etc.*

Answer: *Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation.*

Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.

Question no. 7: *Will GAAR apply if arrangement held as permissible by Authority for Advance Ruling?*

Answer: *No. The AAR ruling is binding on the PCIT / CIT and the Income Tax Authorities subordinate to him in respect of the applicant.*

Question no. 8: *Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?*

Answer: *Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.*

Question no. 9: *Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.*

Answer: *GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.*

Question no. 10: *How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes and based on cogent evidence and not on the basis of interpretation difference?*

Answer: *The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.*

Question no. 11: *Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?*

Answer: *If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.*

Question no. 12: *A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4) of the IT Act.*

Answer: *Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.*

Question no. 13: *It may be ensured that in practice, the consequences of a transaction being treated as an 'impermissible avoidance arrangement' are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and* *fair manner. It should be clarified that if a particular consequence is applied in the hands of one of the participants, there would be corresponding adjustment in the hands of another participant.*

Answer: *Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.*

Question no. 14: *Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).*

Answer: *The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of the arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs. 3 crores cannot be read in respect of a single taxpayer only.*

Question no. 15: *Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?*

Answer: *If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.*

Question no. 16: *No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.*

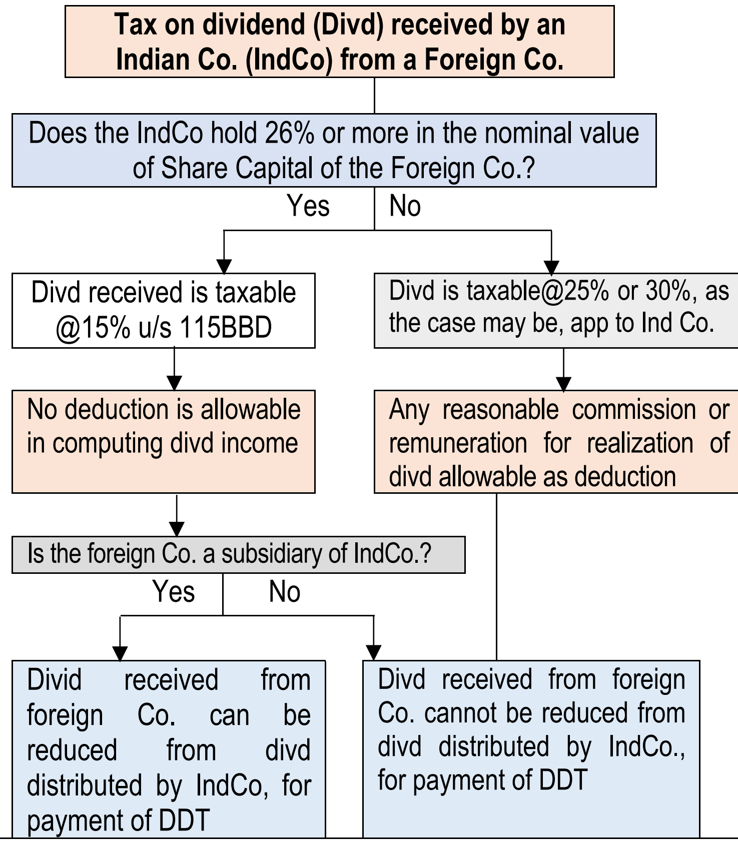
Answer: *Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.*

SUMMARY

<table>
<tr><th colspan="3">BEPS Action Plan 1 : Addressing the challenges of the digital economy</th></tr>
<tr><th colspan="2">OECD Recommendation</th><th>Provision incorporated in Indian Tax Laws</th></tr>
<tr><td>i</td><td>Modifying existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE if it maintained significant digital presence in another country's economy</td><td rowspan="2">"Significant economic presence" (SEP) to constitute "business connection"<table><tr><th>Upto A.Y.2018-19</th><th>From A.Y.2019-20</th></tr><tr><td>As per sec 9(1)(i) of the Income-tax Act, 1961, as it stood prior to amendment by the Finance Act, 2018, physical presence in India was necessary to fall within the scope of "business connection" to attract deemed accrual provisions for income of Non-resident to be subject to tax in India.</td><td>The Finance Act, 2018 has amended section 9(1)(i) to provide that significant economic presence would also constitute business connection from A.Y.2019-20. *</td></tr></table></td></tr>
<tr><td>ii</td><td>A virtual fixed place of business PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction & carries on business through that website.</td></tr>
<tr><td>iii</td><td>Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider</td><td rowspan="2">Equalisation Levy
Chapter VIII of the Finance Act, 2016 provides for Equalisation levy@6% of the amount of consideration for specified services received or receivable by a Non-resident not having PE in India or providing services not effectively connected with PE in India, from:
• a resident in India who carries on business or profession or
• from a Non-resident having PE in India.
The Resident or Non-resident having PE in India has to deduct Equalisation Levy@6% from consideration for specified services paid to Non-resident and remit the same to the Central Government within the prescribed time.</td></tr>
<tr><td>iv</td><td>Imposition of a Equalisation Levy on consideration for certain digital transactions received by a Non-resident from a resident or Non-resident having PE in the other contracting state</td></tr>
</table>

* Rules in this regard are yet to be notified

BEPS Action Plan 3: Strengthen CFC rules	
OECD Recommendation	**Provisions incorporated in the Income-tax Act, 1961**
CFCs are foreign subsidiaries in tax havens in which the taxpayer has controlling interest. Since tax is generally levied on distributed dividend, tax in parent country could be avoided until the tax haven country actually paid dividend to the shareholders. The OECD regards CFC Rules as important in tackling BEPS and has made a series of best practice recommendations in relation to the building blocks of an effective CFC regime.	There are no CFC Rules in the Income-tax Act, 1961. However, section 115BBD has been inserted in Income-tax Act, 1961 to encourage repatriation of profits by Indian companies which have significant voting power in foreign Companies.



BEPS Action Plan 4: Interest deductions and other financial payments

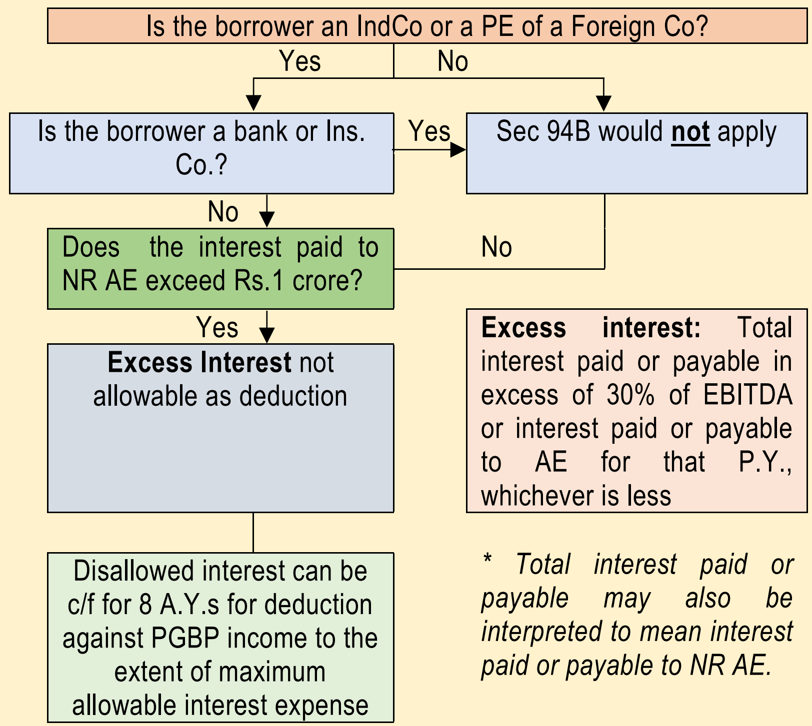
Common Approach in 2015 Report

The common approach which directly links an entity's net interest deductions to its level of economic activity, based on taxable EBITDA includes three elements:

	Rule	Basis
i	**Fixed Ratio Rule**	based on benchmark net interest/EBITDA Ratio
ii	**Group Ratio Rule**	allows an entity to deduct more interest expense based on the position of its world wide group
iii	**Targeted Rules**	address specific risks

Provisions incorporated in the Income-tax Act, 1961

Sec 94B – Limitation of interest deduction [based on Fixed Ratio Rule]



BEPS Action Plan 5: Counter harmful tax practices	
OECD BEPS Action 5 Report	**Provisions incorporated in the Income-tax Act, 1961**
Action 5 report identifies factors for determining a potential harmful tax practice that results in low or no effective tax rate, lack of transparency, negotiable tax rate or base etc. For instance, in case of R&D activities, the nexus approach recommended by the OECD under BEPS Action 5 requires attribution and taxation of income arising from exploitation of IP in the jurisdiction where substantial R & D activities are undertaken instead of the jurisdiction of legal ownership.	**Sec 115BBF of the Income-tax Act, 1961 – Tax on income from patent** Where the Total Income of the eligible assessee includes any income by way of royalty in respect of a patent developed & registered in India, then, such royalty is taxable@ 10% (plus applicable surcharge & cess). **Applicability of concessional rate of 10% u/s 115BBF** • Assessee should be a person **resident** in India, who is a **patentee** • Income must be from a patent **developed & registered in India** • Option for taxation of income u/s 115BBF to be exercised by assessee **on or before due date u/s 139(1) for filing ROI** **Meaning of developed** • The invention should be one for which patent is granted under the Patents Act, 1970 • At least 75% of the expenditure for such invention must be incurred in India

BEPS Action Plan 6: Preventing treaty abuse	
OECD Minimum Standard	**LoB clause incorporated in Indian Tax Treaties**
Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping by including in their treaties: (i) the combined approach of **Limitation of Benefits (LOB)** and **Principal Purpose Test (PPT)** rule, (ii) the **PPT rule** alone, or (iii) the **LOB rule** supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties	**LoB clause in India-Mauritius Tax Treaty** • On 10.5.2016, the India-Mauritius tax treaty was amended and for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. • The tax rate on such capital gains arising from 1.4.2017-31.3.2019 should, however, not exceed 50% of the applicable tax rate on capital gains in India. • LOB Clause provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. • A shell or a conduit Co. claiming to be a resident of a Contracting State shall not be entitled to this benefit. • A shell or conduit Co. is any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. **LoB clause in India-Singapore Tax Treaty** • The India-Singapore tax treaty has been amended to provide that capital gains on alienation of shares would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. • The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty.

BEPS Action Plan 7: Prevent the Artificial Avoidance of PE Status

OECD Recommendation

Review of definition of PE

To prevent tax avoidance

By way of **Commissionaire Arrangements**

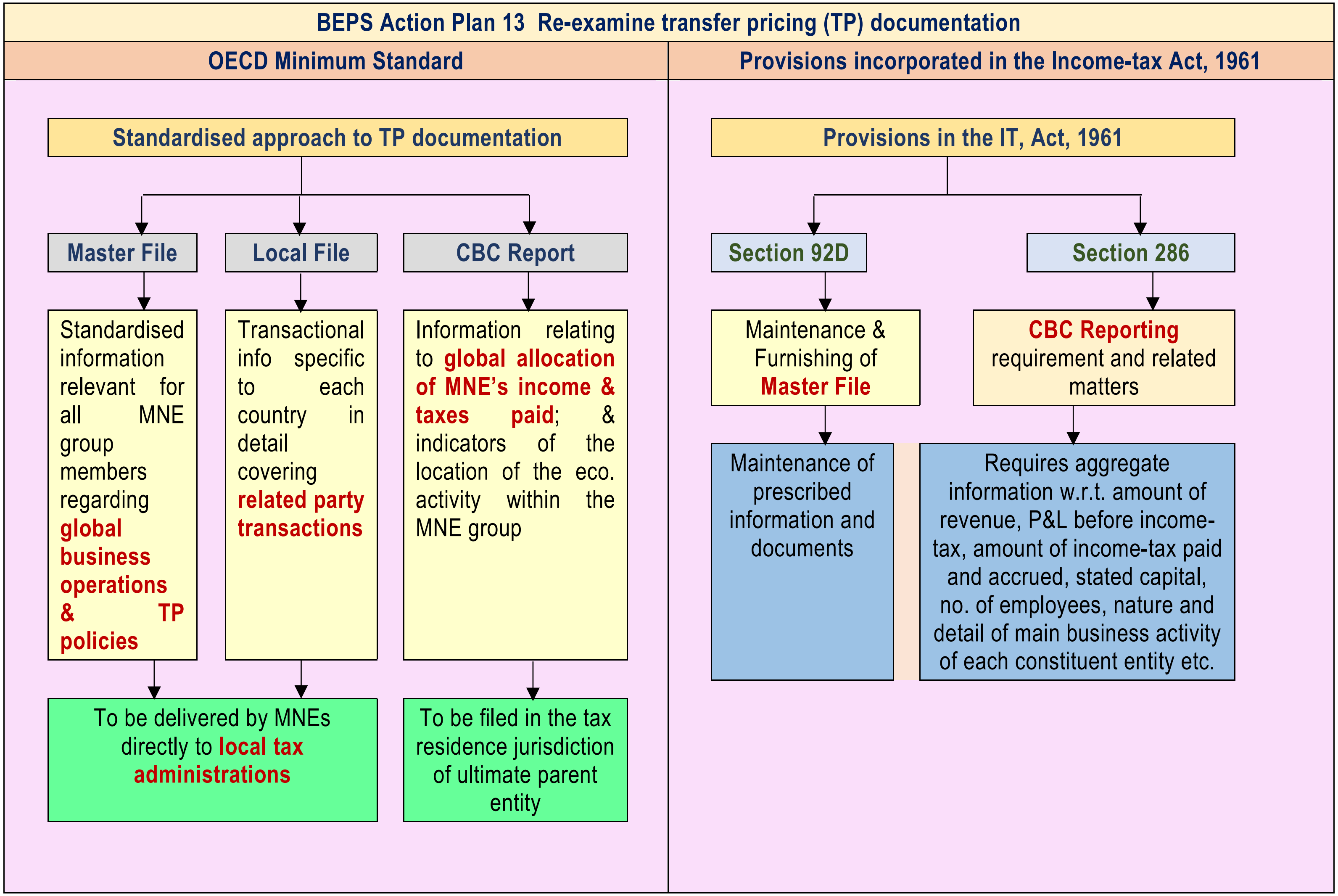
Modification of Article 5(5) to **include a person who habitually plays a principal role leading to conclusion of contracts** in the definition of agent

By way of **Fragmentation of business activities**

Introduction of anti-fragmentation Rule **to prevent fragmentation of functions** which are otherwise a whole activity to avail benefit of exemption

Provision incorporated in the Income-tax Act, 1961

Expanding the scope of business connection (BC) u/s 9(1)(i) of Income-tax Act, 1961	
Upto A.Y.2018-19	**From A.Y.2019-20**
BC is established, inter alia, where a person acting on behalf of NR has and habitually exercises the authority to conclude contracts on behalf of the NR.	BC also include any business activities carried through a person who, acting on behalf of the NR, habitually concludes contracts or **habitually plays the principal role leading to conclusion of contracts** by the NR. Such contracts should be- (i) in the name of the NR; or (ii) for transfer of ownership of, or for the granting of right to use, property owned by that NR or that the NR has the right to use; or (iii) for provision of services by that NR


BEPS Action Plan 13 Re-examine transfer pricing (TP) documentation
OECD Minimum Standard
Provisions incorporated in the Income-tax Act, 1961
Standardised approach to TP documentation
Master File
Local File
CBC Report
Standardised information relevant for all MNE group members regarding global business operations & TP policies
Transactional info specific to each country in detail covering related party transactions
Information relating to global allocation of MNE's income & taxes paid; & indicators of the location of the eco. activity within the MNE group
To be delivered by MNEs directly to local tax administrations
To be filed in the tax residence jurisdiction of ultimate parent entity
Provisions in the IT, Act, 1961
Section 92D
Section 286
Maintenance & Furnishing of Master File
CBC Reporting requirement and related matters
Maintenance of prescribed information and documents
Requires aggregate information w.r.t. amount of revenue, P&L before income-tax, amount of income-tax paid and accrued, stated capital, no. of employees, nature and detail of main business activity of each constituent entity etc.

<table>
<tr><th colspan="2">BEPS Action Plan 15 Developing a Multilateral Instrument (MLI)</th></tr>
<tr><th>BEPS Report</th><th>Entry into Force of MLI</th></tr>
<tr><td>The MLI helps fight against BEPS by implementing tax treaty-related measures developed through the BEPS Project in existing bilateral treaties in a synchronized and efficient manner to –
• prevent treaty abuse,
• improve dispute resolution
• prevent the artificial avoidance of PE status
• neutralize the effects of hybrid mismatch arrangements.
The MLI is flexible instrument which modifies tax treaties that are “Covered Tax Agreements”. A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.</td><td>➢ The Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS) was signed by India at Paris, France on 7th June, 2017.
➢ India had ratified the said Convention and had deposited the instrument of ratification along-with the list of Covered Tax Agreements, reservations and notifications (India’s Position under the said Convention) to the Depositary on 25th June, 2019.
➢ The date of entry into force of the said Convention for India is 1st October, 2019, being the first day of the month following the expiry of a period of three calendar months beginning on 25th June, 2019, being the date of deposit by India of the instrument of ratification.
➢ The earliest date when the provisions of this Convention can take effect in India is 1st April, 2020 (six months from 1st October, 2019, the date of entry into force for India)</td></tr>
</table>

CHAPTER 9

OVERVIEW OF MODEL TAX CONVENTIONS

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- **appreciate** the need for Model Tax Conventions;
- **appreciate** the key features of the OECD and UN Model Tax Conventions;
- **identify** the subject of the various articles of the OECD and UN Model Tax Conventions;
- **differentiate** between the principles enshrined in the Articles of the OECD Model Tax Convention *vis-à-vis* the corresponding Articles of the UN Model Tax Conventions;
- **analyse, integrate and apply** the above principles to make computations and address relevant issues.

9.1 INTRODUCTION

In order to enable various countries to enter into treaties, which are standardized to some extent, Organization for Economic Cooperation and Development (OECD) and the United Nations (UN) have developed certain Model Tax Treaties. These treaties can be used by various countries as a starting point in their negotiations with other countries. While these Models are not legally binding, they have been extensively used by various countries as a reference point while entering into Tax Treaties. In some cases, they have been incorporated verbatim or with minor changes. However, in other cases, countries have made suitable changes in the draft model according to their economic environment and commercial and tax considerations.

The significant model conventions have been briefly discussed hereunder:

→ **OECD Model** - The emergence of present form of OECD Model Convention can be traced back to 1927, when the Fiscal Committee of the League of Nations prepared the first draft of Model Form applicable to all countries. In 1946 the model convention was published in Geneva by the Fiscal Committee of U.N. Social & Economic Council and later by the Organisation for European Economic Co-operation (OEEC) in 1963. However, in 1961, the Organisation for Economic Co-operation and Development (OECD) was established, with developed countries as its members, to succeed the OEEC, and OECD approved the draft presented to the OEEC. In 1977, the final draft was prepared in the present form which has been revised several times; the latest being in the year 2017.

OECD Model Convention (OECD MC) is essentially a model treaty **between two developed nations.** This model advocates the residence based taxation, i.e., it lays emphasis on the right of state of residence to tax the income.

→ **UN Model** – In 1968, the United Nations set up an Adhoc Group of Experts from various developed and developing countries to prepare a draft model convention between developed and developing countries. In 1980, this Group finalised the UN Model Convention (UN MC) in its present form. It has further been revised a number of times, the latest being in the year 2017.

The UN MC is a compromise between the source principle and the residence principle. However, it gives more weight to the source principle as against the residence principle of the OECD MC. UN MC is designed to encourage flow of investments from the developed countries to developing countries. It takes into account sharing of tax-revenue with the country providing capital.

The United Nations MC seeks to be balanced in its approach. As a corollary to the principle of taxation at source, the Articles of the Convention are based on a recognition by the source country that

(a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis,

(b) taxation should not be so high as to discourage investment and

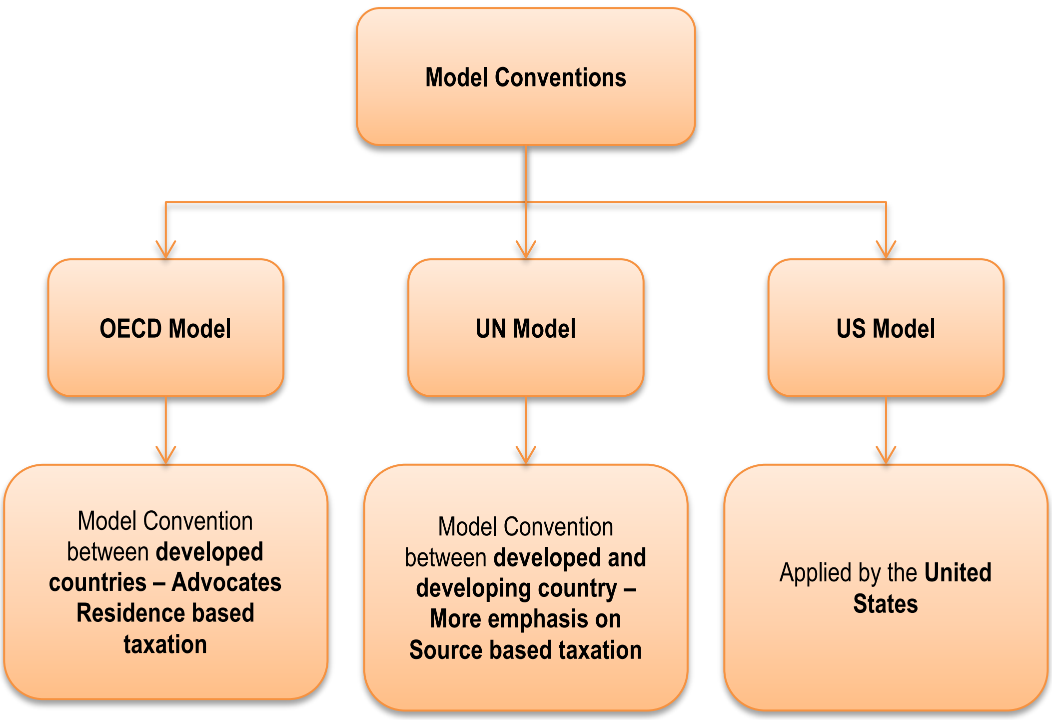
(c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital.

In addition, the United Nations MC embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either a foreign tax credit or an exemption, as is also the case with the OECD Model Convention.

→ **US Model** – This Model Convention is used by the United States while entering into tax treaties with various countries. The US Model Convention was last revised in 2016.

These Models have a significant influence on international treaty practice, and have important common provisions. The similarities between these Models highlight the areas of consistency. The areas of divergence indicate some critical differences in approach or emphasis which need special focus. These differences are mainly in relation to the taxing rights which would be available to a country under domestic law and the extent to which any country should forego, under a bilateral tax treaty, in order to avoid double taxation and encourage investment.

The above model conventions have been illustrated in the following diagram:



OECD Model contains VII chapters comprise of 32 articles and UN Model also contains VII chapters but comprise of 31 articles. List of articles of OECD MC and UN MC is given below:

Article	OECD Model Convention, 2017	UN Model Convention, 2017
	Chapter I : Scope of the Convention	
1	Persons covered	Persons covered
2	Taxes covered	Taxes covered
	Chapter II : Definitions	
3	General definitions	General definitions
4	Resident	Resident
5	Permanent establishment	Permanent establishment
	Chapter III : Taxation of Income	
6	Income from immovable property	Income from immovable property
7	Business profits	Business profits
8	International shipping and air transport	International shipping and air transport (Alternative A & B)
9	Associated enterprises	Associated enterprises
10	Dividends	Dividends
11	Interest	Interest
12	Royalties	Royalties
12A		Fees for technical services
13	Capital gains	Capital gains
14		Independent personal services
15	Income from employment	Dependent personal services
16	Directors' fees	Directors' fees and remuneration of top-level managerial officials
17	Entertainers and sportspersons	Artistes and sportspersons
18	Pensions	Pensions and social security payments (Alternative A & B)
19	Government service	Government service
20	Students	Students
21	Other income	Other income
	Chapter IV : Taxation of Capital	
22	Capital	Capital

	Chapter V : Methods for the Elimination of Double Taxation	
23A	Exemption method	Exemption method
23B	Credit method	Credit method
	Chapter VI : Special Provisions	
24	Non-discrimination	Non-discrimination
25	Mutual agreement procedure	Mutual agreement procedure (Alternative A & B)
26	Exchange of information	Exchange of information
27	Assistance in the collection of taxes	Assistance in the collection of taxes
28	Members of diplomatic missions and consular posts	Members of diplomatic missions and consular posts
29	Entitlement to benefits	Entitlement to benefits
30	Territorial extension	Entry into force
	Chapter VII : Final Provisions	
31	Entry into force	Termination
32	Termination	

Now, let us discuss the comparative analysis of some of the significant Model Tax conventions.

9.2 COMPARATIVE ANALYSIS OF SOME OF THE SIGNIFICANT ARTICLES OF OECD AND UN MODEL CONVENTIONS

For the purpose of this chapter, a comparative analysis of OECD and UN Model Conventions has been made in a tabular format. Such comparative analysis shall enable easy reference and identification of different words, phrases, sentences, clauses and paragraphs used/ omitted in the various articles of these Model Conventions.

The differences in the text of various articles of the Model Conventions have been indicated by appropriately using **Bold**, ***Bold and Italics*** and <u>***Bold, Italics and underline***</u> (as per the below key).

KEY FOR COMPARATIVE ANALYSIS
→ The Comparative analysis and article-wise/ para-wise chart has been prepared taking OECD Model Convention (OECD MC) as base.
→ The comparative differentiating words have been highlighted in **Bold** in OECD MC column, at appropriate places for ease of identification and reading.
→ Additional paras, phrases in UN MC as compared to OECD MC have been shown in ***Bold and Italics***.

→	Changes in Words, Phrases, Sentences etc. in UN MC as compared to OECD MC have been shown in ***Bold, Italics & Underlined*** at appropriate places in the comparative similar paragraphs.
→	As far as possible, articles, paras and clauses similar to those in OECD MC have been placed in parallel Columns in UN MC.

In cases where the articles prescribed in the OECD MC and UN MC are identical, only the text of the article has been mentioned and relevant summary have been provided. However, in other cases, necessary brief comments about the differences and other relevant observations have been provided in a summarised manner (after each clause/para of various articles for facilitating proper understanding of the comparative analysis).

Title and Preamble to the Model Conventions

The title of the OECD MC reads as follows:

"Convention between State A and State B for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance"

There is now a specific reference to "the prevention of tax evasion and avoidance" in the title to emphasize its significance in the Model Convention.

The Preamble of the OECD MC reads as follows:

"(State A) and (State B),

Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),"

The Title and Preamble to the UN MC is almost identical to that of OECD MC. The only minor difference is the reference to "tax avoidance and evasion" in the place of "tax evasion and avoidance" in the Title and Preamble.

The Preamble now clearly indicates that OECD and UN MCs do not intend to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion including through treaty shopping.

This language of the Preamble would help ensuring that the provisions of the Conventions are interpreted and applied to prevent abusive treaty shopping arrangements.

Significant Articles in the Model Conventions

Over the years, both Model Conventions have seen a lot of convergence and the language is identical in quite a few Articles. However, there are key differences in approach and language in some Articles which will be the focus of our discussion, in the section below.

The jurisdiction or country of residence of the taxpayer is referred to as the Residence State and the jurisdiction or country where the source of income is located is referred to as the Source State.

ART 1	PERSONS COVERED

This Article deals with persons, who shall be eligible to claim benefit under a particular Treaty. Since Tax Treaties are always agreed upon and signed between two countries ("Contracting States"), the benefits of the same shall be available only to persons who are residents of one or both of the Contracting States.

Para	OECD Model Convention 2017[1]	UN Model Convention 2017[2]
1	This Convention shall apply to persons who are residents of one or both of the Contracting States.	
Note - *Article 1(1) of the OECD MC and UN MC are identical. The OECD and UN Model Convention would apply to persons who are resident of one or both of the Contracting States.*		
2	For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.	
Note - *Article 1(2) of OECD and UN MCs are identical. It addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes, such as trusts and partnership firms.* *The concept of "fiscally transparent" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement.* *For the purposes of these Conventions, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State. However, the same would be treated as income only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.*		

[1] OECD Model Tax Convention on Income and on Capital 2017
[2] UN Model Double Taxation Convention between Developed and Developing Countries 2017

Para	OECD Model Convention 2017[1]	UN Model Convention 2017[2]
Example: *State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company, and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership, and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.*		
3	This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, **23 [A] [B]**, 24, **25** and 28.	This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, **23 A 23 [B]**, 24, **25A 25B** and 28.
Note - *Article 1(3) of UN and OECD MC provides that, with the exception of benefits granted under certain Articles of these conventions, these Conventions would not affect the taxation, by a Contracting State, of its resident. The intent of the saving clause is to put at rest the argument that some provisions aimed at the taxation of non-residents could be interpreted as limiting a Contracting State's right to tax its own residents.*		

ART 2	TAXES COVERED

This Article provides the details of taxes, which would be covered for the purpose of tax treaty. Any tax which is not provided in Article 2 is outside the purview of the tax treaty.

Para	OECD Model Convention 2017	UN Model Convention 2017
1	This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.	
Note - *Article 2(1) of the OECD MC and the UN MC are* ***identical****. Paragraph 1 provides the scope of application of the tax treaty. The tax treaty shall apply to taxes on income and on capital. It further elaborates that the taxes can be imposed by the Contracting States including its political sub-divisions and local authorities and it is immaterial if the taxes are levied through direct assessment or through deduction of tax at source, in the form of surtaxes or surcharges or as additional taxes. The tax treaty only intends to clarify the categories of taxes to which it would apply.*		

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td>2</td><td colspan="2">There 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.</td></tr>
<tr><td colspan="3">Note - Article 2(2) of the OECD MC and the UN MC are identical. It provides definition of the term ‘taxes on income and on capital’. It includes taxes on total income and on elements of total income, on total capital and elements of capital. Taxes on elements of total income/capital include tax on dividend, interest and capital gains[3]. Article 2(2) also includes taxes on alienation of movable and immovable property, on wages or salaries disbursed by enterprises and on capital appreciation. The provisions of the tax treaty do not apply to other charges such as social security charges where a direct nexus can be established towards the levy and individual benefits to be received.</td></tr>
<tr><td>3</td><td colspan="2">The existing taxes to which the Convention shall apply are in particular:
a) (in State A): ……………………..
b) (in State B): ……………………..</td></tr>
<tr><td colspan="3">Note - Article 2(3) of the OECD MC and the UN MC are identical. It creates a provision for the Contracting States to itemize the taxes in force at the time of signature of the Convention. The list of taxes in force shall not be exhaustive but only an illustrative list to support the preceding Paragraphs of the Article. However, in principle, the States shall enumerate all the taxes to which the tax treaty applies, which are in force at the time of signature of the Convention.</td></tr>
<tr><td>4</td><td>The Convention shall also apply to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.</td><td>The Convention shall also apply to any identical or substantially similar taxes <u>which</u> are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made <u>to</u> their <u>tax law</u>.</td></tr>
<tr><td colspan="3">Note – Article 2(4) is phrased to accommodate any subsequent changes in the taxation laws of the Contracting States. The tax treaty, in effect, would apply to all the taxes that are</td></tr>
</table>

[3] Cyril Eugene Pereira, In re (1999), 239 ITR 650

Para	OECD Model Convention 2017	UN Model Convention 2017
identical or substantially similar to the taxes in force at the time of entering into the tax treaty and this Paragraph is essentially included to avoid the necessity to conclude a new treaty every time the tax laws of the Contracting States are amended. In order to facilitate the same, each Contracting State is to notify the other of any significant changes made to its taxation laws by communicating to it, for example, details of new or substituted taxes. Member countries are encouraged to communicate other significant developments as well, such as new regulations or judicial decisions; many countries already follow this practice.		

ART 3	GENERAL DEFINITIONS

This Article provides the meaning of various terms used in the tax treaty. If a particular term is not defined in a tax treaty, Article 3 may provide that the meaning of such term should be construed as per the domestic tax laws.

Para	OECD Model Convention 2017	UN Model Convention 2017
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;	
Note - *Article 3(1)(a) of the OECD and UN MC are* ***identical****. The definition of 'person' is very significant because under Article 4, only a "person" can be a "resident" and, therefore, eligible for most benefits under the treaty. Also, it is only the "person" as defined in this paragraph of Article 3 who is eligible to claim relief under Article 25 (Mutual Agreement Procedure). The definition of person is not exhaustive and it should be read as indicating that the term "person" is used in a very wide sense.*		
(b)	the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;	
Note – *Article 3(1)(b) of the OECD/UN MC defines the term "company" to also include "any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons.*		
(c)	**the term "enterprise" applies to the carrying on of any business;**	-
(h)	**the term "business" includes the performance of professional services and of other activities of an independent character.**	-

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td colspan="3">Note - The UN Model Convention does not contain a definition of the term “enterprise” and “business”. In common parlance, enterprise means an economic activity carried on by a person capable of producing profits.
It would be important to note that, as per the OECD MC, the performance of professional services or other activities of an independent character would constitute an “enterprise” irrespective of the meaning of that term as per the domestic laws. This is due to the reason that enterprise is defined as carrying on of any business and the term “business” has been explicitly defined in Article 3(1)(h) of the OECD MC to include the “performance of professional services and of other activities of an independent character”. This definition was included to enable income from professional services or other activities of an independent character to be taxed under Article 7 of the OECD MC and not under Article 21 (Other Income).</td></tr>
<tr><td>(d)/ (c)</td><td colspan="2">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;</td></tr>
<tr><td colspan="3">Note - Article 3(1)(d) of the OECD MC is identical to Article 3(1)(c) of the UN MC. The above-mentioned sub-paragraph is self-explanatory. However, it may be noted that the residency of the enterprise depends on the residential status of the person carrying the enterprise and not the place from which the business is carried on.</td></tr>
<tr><td>(f)/(e)</td><td colspan="2">the term "competent authority" means:
(i) (in State A): ....
(ii) (in State B): ....</td></tr>
<tr><td colspan="3">Note - The competent authorities are those bodies of each Contracting State vested with the authority to determine issues relating to the convention in particular under the Mutual Agreement Procedures (Article 25) and the Exchange of Information (Article 26). The definition has regard to the fact that under certain treaties, execution does not exclusively fall within the jurisdiction of the highest tax authorities. Where the jurisdiction on some matters are reserved for or delegated to other authorities, this definition enables each country to designate one or more authorities as being competent to determine issues relating to the convention.
In India, the competent authority is the Ministry of Finance (Department of Revenue) of the Central Government or their authorised representative.</td></tr>
<tr><td>(g)/(f)</td><td>the term "national", in relation to a Contracting State, means:
(i) any individual possessing the nationality or citizenship of that Contracting State; and
(ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State;</td><td>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.</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
Note - *The definition of "national" is primarily relevant to Article 24 dealing with non-discrimination. The usage of the word "citizenship" has been particularly excluded in Article 3(1)(f) of the UN MC. The meaning of the term "national" depends on the sense in which the term is used and also on the rules pertaining to acquisition or loss of nationality adopted by each Contracting State.* *With respect to legal persons, partnerships or association, their nationality depends on the laws in force in that respective Contracting State. Further, the distinct mention of partnership is necessary to avoid confusion as some domestic laws may categorise an entity as a 'person' but not a 'legal person' for tax purposes.*		
2	As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires **or the competent authorities agree to a different meaning pursuant to the provisions of Article 25,** have the meaning **that** it has at that time under the law of that State for the purposes of the taxes to which the 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.	As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the 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.
Note – *Article 3(2) essentially contains a general rule concerning the meaning of terms used but not defined in the tax treaty. The general rule as embodied in the MC is that if any undefined term is used in the tax treaty, its meaning can be adopted from the meaning assigned to such a word under the domestic law of the Contracting State* ***at the time when the tax is being levied****.* *If, however, such a term is defined in both the tax and non-tax laws of a Contracting State, the definition provided in the tax law has to be considered. Moreover, where multiple definitions are provided, the definition used for purpose of the particular provision at issue, if any, should be used.* *The OECD and UN MC were identical until the 2017 update to the OECD MC which now provides that the domestic law meaning of an undefined term applies only if the context does not require an alternative interpretation and the competent authorities do not agree to a different meaning pursuant to Mutual Agreement Procedure under Article 25.* *OECD MC explains that the context is to be determined by the intention of the Contracting States when signing the tax treaty and the meaning given to the term in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which tax*		

Para	OECD Model Convention 2017	UN Model Convention 2017
treaties are based). This approach seeks to balance 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).		

ART 4	RESIDENT

Article 4 plays a significant role in determining the scope of application of the Convention and helps in avoiding juridical double taxation in many situations. Double taxation is, generally, by way of taxation of the same income in the hands of the same person in two different tax jurisdictions. A person whose income is subjected to such double taxation can mitigate it through access to the tax treaty between the two Contracting States. In this regard, the primary condition for accessing the tax treaty is residence of a person as per the fiscal laws and, hence, the concept of residence assumes tremendous importance.

A taxpayer has to demonstrate that he is a resident of one or both Contracting States to be able to gain access to a tax treaty and avail the benefits thereunder.

Article 4 of the OECD and UN Model Conventions provide the definition of the term 'resident of Contracting State'. It is an exhaustive definition, which determines the applicability or non-applicability of the tax treaty to a person.

In case the application of such criteria results in dual residency, the rules of determining the residential status of a person (tie breaker rule) are generally provided in the tax treaty.

The concept of 'resident of a Contracting State' has various functions and assumes significance in the following three scenarios:

- In determining a convention's scope of application;
- In solving cases where double taxation arises as a consequence of double residence;
- In solving cases where double taxation arises as a consequence of taxation in the Residence State and also in the Source State.

Para	OECD Model Convention 2017	UN Model Convention 2017
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,	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 incorporation,*** place of

Para	OECD Model Convention 2017	UN Model Convention 2017
	residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof **as well as a recognised pension fund of that State**. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.	management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

Note – *Article 4(1) of the OECD Model does not differ from Article 4(1) of the UN Model except that (a) the UN Model has added the criterion of "place of incorporation" to the list of criteria for residency and (b) OECD Model specifically mentions a recognized pension fund of the State.*

Coverage of only persons subject to comprehensive tax on total income - *As per this paragraph, a person is a resident of a Contracting State if he is liable to tax under the laws of that Contracting State as per the criterion mentioned therein, i.e., domicile, residence, place of management etc. The convention in this regard, intends to cover only the persons subject to comprehensive tax on their total income and thereby specifically excludes any person, who is paying tax only on income from sources in the State.*

Meaning of "liable to tax" - *A resident is a person who is 'liable to tax'. 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 are subject to tax law but may be exempt under domestic laws upon satisfying some conditions. Most States view such entities as 'liable to tax'. However, some States do not consider entities as being resident if they are exempt from tax under domestic tax laws.*

Coverage in case of a fiscally transparent entity - *"Liable to tax" is a precondition to consider a person as resident of a Contracting State, however, 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 a resident of that State.*

In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that 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 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.

For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

Consequently, Article 1(2) clarifies that the Convention will apply to the partnership's income to the extent that the income is treated, for purposes of taxation by that State, as the income of a

Para	OECD Model Convention 2017	UN Model Convention 2017
	partner who is a resident of that State. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State.	
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 only 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 only 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 only 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 only 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.	

Note - *The aforesaid Paragraphs of OECD and UN Model Convention relates to a case where, under provisions of Paragraph 1, an individual is a resident of both Contracting States. A series of tie-breaker rules are provided in the above Paragraph to determine single state of residence for an individual.*

(i) The first test is based on where the individual has a ***permanent home****. Permanent home would mean a dwelling place available to him at all times continuously and not occasionally and includes place taken on rent for a prolonged period of time. Any place taken for a short duration of stay or for temporary purpose, may be for reasons such as short business travel, educational purpose or a short holiday etc. is not regarded as a permanent home.*

(ii) If that test is inconclusive for the reason that the individual has permanent home available to him in both Contracting States, he will be considered a resident of the Contracting State where his ***personal and economic relations are closer****, in other words, the place where lies his centre of vital interests. Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the individual.*

(iii) Sub-paragraph (b) establishes a secondary criterion for two quite distinct and different situations:

- *The case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;*
- *The case where the individual has a permanent home available to him in neither Contracting State.*

In the aforesaid scenarios, preference is given to the Contracting State where the

Para	OECD Model Convention 2017	UN Model Convention 2017
	individual has a ***habitual abode****.* *Habitual abode refers to the frequency, duration, regularity of stays that are part of settled routine of an individual life and are therefore more than transient. In this case, all stays made in a State must be considered without it being necessary to ascertain the reasons for them.*	
(iv)	*If the individual has habitual abode in both Contracting States or in neither of them, he shall be treated as a resident of the Contracting State of which he is* ***a national****.*	
(v)	*If the individual is a national of both or neither of the Contracting States, the matter is left* ***to be considered by the competent authorities*** *of the respective Contracting States under the Mutual Agreement Procedure (Article 25).*	
3	Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.	

Note – *Paragraph 3 of the OECD and UN MC concerns companies and other bodies of persons, other than individuals. The situation of dual residence may arise in case of companies and other non-corporate bodies in case where one Contracting State attaches importance to the place of incorporation and the other State to the place of effective management.*

Case by Case approach - *Until 2017, the sole tie-breaker rule for resolving double taxation disputes was place of effective management. In 2017, the Committee on Fiscal Affairs recommended a change to case by case approach considering the number of tax avoidance cases involving dual resident companies. Determination under the case by case approach will be requested by the concerned taxpayer through Article 25 (Mutual Agreement Procedure).*

Factors to be taken into account during the MAP proceedings - *Competent authorities would be expected to take account of various factors, such as, where the meetings of the person's board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc.*

Entitlement to treaty relief in case of a dual resident person - *The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the*

Para	OECD Model Convention 2017	UN Model Convention 2017
	dual-resident person shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person.	

ART 5	PERMANENT ESTABLISHMENT

The Concept of "Permanent Establishment" (PE) is defined in Article 5 of tax treaties. This expression is invariably used in all tax treaties. It has considerable importance as Article 7 mandates that business profits of an enterprise cannot be taxed by a Source State unless it proves the existence of a PE. If the existence of a PE is proven in Source State, then, that State can only tax such profits of the enterprise to the extent that the profits are attributable to the PE.

In this Article, the jurisdiction or country of residence of the person is referred to as the Resident State (or State R) and the jurisdiction or country where the PE is located is referred to as the Source State (or State S).

The definition of PE is significant for several Articles. The term "Fixed base" in Article 14 (Independent Personal Services) of UN Model Convention can be understood by reference to the term "permanent establishment". Articles 10, 11, 12 (in both OECD and UN MC) and Article 12A (in UN MC) dealing with dividends, interest, royalties and fees for technical services, respectively, provide for reduced rates of tax at sources on payments of these items of income to a resident of the Residence State when income is **not** effectively connected to a PE in Source State. The concept of PE is also relevant in determining which Contracting State may tax certain gain under Article 13 (Capital gains) and certain "Other Income" under Article 21.

In order to decide whether a PE is constituted, one has to undertake a functional and factual analysis of each of the activities undertaken by the establishment. Further, while deciding whether a PE exists or not, Article 5 has to be read as a whole.

PE under Income-tax Act, 1961

As per Section 92F(iiia), "Permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

The comparable term to PE under the Indian tax law is "business connection" [Section 9(1)(i)]. There exists a distinction between a "business connection" and a PE. Generally speaking, the concept of "business connection" is wider than PE and hence, a business connection may exist even without a PE, but the absence of a "business connection" may indicate absence of a PE.

Para	OECD Model Convention 2017	UN Model Convention 2017
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.	

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td colspan="3">Note - Article 5(1) states the "basic rule" for a PE and expresses the primary meaning of PE. The definition of PE in Article 5 does not use the qualifying words "unless the context otherwise requires". As such, the definition needs to be followed in all cases unless specifically excluded.
Paraphrasing Article 5(1), a PE exists if the following conditions are satisfied cumulatively:
• There is an "enterprise";
• Such enterprise is carrying on a "business";
• There is a "place of business";
• Such place of business is at the disposal of the enterprise (may be owned / rented but must be one which the enterprise has the effective power to use);
• The place of business is "fixed", that is, it must be established at a distinct place with a certain degree of permanence.
The business of the enterprise is carried on wholly or partially through this fixed place of business.
A PE does not exist unless all the aforesaid conditions are satisfied.</td></tr>
<tr><td>2</td><td colspan="2">The term "permanent establishment" includes especially:
a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.</td></tr>
<tr><td colspan="3">Note - Article 5(2) provides a list of specific inclusions which may constitute a PE e.g. an office, workshop, place of management.
The common thread in all these examples is that an enterprise can carry on business in Source State through these establishments. Since Article 5(2) only provides a list of inclusions, accordingly, what is not included in Article 5(2) is not automatically excluded from Article 5(1).</td></tr>
<tr><td>3</td><td>A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.</td><td>The term "permanent establishment" also encompasses:
(a) A building site, <u>a</u> construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than <u>six months;</u>
(b) The furnishing of services, including consultancy services, by an</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
		enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

Note - *Article 5(3) of the OECD MC differs from Article 5(3)(a) of the UN MC on the following points:*

- *The OECD MC does not specifically mention "assembly projects" and "supervisory activities" in connection with building sites, construction, assembly or installation projects. Further, the threshold time in OECD Model is 12 months vis-à-vis 6 months in the UN MC.*
- *Article 5(3)(b) of the UN Model makes a specific reference to the Service PE which is absent in the OECD MC.*

Article 5(3)(b) of the UN MC deals with the furnishing of services, including consultancy services, the performance of which does not, by itself, create a PE in the OECD MC. In the absence of provision for Service PE in OECD MC, the presence has to be ascertained in accordance with the principles of Article 5(1). Article 5(3)(b) of UN MC provides that if a non-resident provides services in a country for more than 183 days, the non-resident's involvement in the commercial life of that country clearly justifies the country taxing the income from those services whether the services are provided for one project or multiple projects. The degree of the non-resident's involvement in the source country's economy is the same, regardless of the number of projects involved.

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, display or delivery** of goods or merchandise belonging to the enterprise;	The use of facilities solely for the purpose of ***storage or display*** of goods or merchandise belonging to the enterprise;

Note – *This paragraph lists a number of business activities which are treated as exceptions to the general definition of PE laid down in paragraph 1 and which are not sufficient to constitute a PE. The final part of the paragraph [i.e., after sub-clause (f)] provides that* ***these exceptions only apply if the listed activities have a preparatory or auxiliary character.***

Article 5(4)(a) of the UN MC, applies to the use of facilities by an enterprise for storage or display of goods or merchandise belonging to it.

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td colspan="3">Unlike the OECD Model, Article 5(4)(a) of the UN Model does not include “delivery” and restricts sub-paragraph (a) to “storage” or “display”. The word “delivery” is absent in the UN Model because stocking of goods in State S for ensuring quick delivery to the customers facilitates sales of the products and thereby earning of profit in State S. Consequently, a warehouse used for “delivery” could be a PE under the UN Model. However, income attributable to such activity may not be significant.</td></tr>
<tr><td>(b)</td><td>The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;</td><td>The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;</td></tr>
<tr><td colspan="3">Note – Article 5(4)(b) of the UN MC, relates to the stock of goods or merchandise and provides that maintenance of such stock shall not be treated as a PE if it is maintained solely for the purpose of storage or display for the enterprise. Unlike the OECD MC, sub-para (b) of Article 5(4) of the UN MC does not include “delivery” and restricts the maintenance of stock of goods or merchandise for the purpose of “storage” or “display”, to qualify as an exception to the definition of PE. Hence, again the definition of PE under UN MC is wider than under OECD MC displaying a preference to Source State jurisdiction.</td></tr>
<tr><td>(c)</td><td colspan="2">The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</td></tr>
<tr><td colspan="3">Note – This paragraph provides that a PE is not constituted when a stock of goods or merchandise belonging to a foreign enterprise is maintained solely for processing by another enterprise in Source State.</td></tr>
<tr><td>(d)</td><td colspan="2">The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;</td></tr>
<tr><td colspan="3">Note – The first part of sub-paragraph (d) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise and the second part of sub-paragraph (d) relates to a fixed place of business that is used solely to collect information for the enterprise. An enterprise will frequently need to collect information before deciding whether and how to carry on its core business activities in a State. If a fixed place of business is maintained solely for that purpose, a PE is not constituted.</td></tr>
<tr><td>(e)</td><td colspan="2">The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;</td></tr>
<tr><td colspan="3">Note – “Any other activity” referred to in sub-clause (e) should be of preparatory or auxiliary character, if the maintenance of a fixed place of business solely for the purpose of carrying on such activity is to be excluded from the definition of PE.</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017

Fixed place of business

In a recent Supreme Court case[4] the Court relied on renowned international tax expert Philip Baker's views to explain that a PE must have three characteristics: stability, productivity and dependence. In order to ascertain whether an establishment has a fixed place of business, such physically located premises has to be "at the disposal" of the enterprise. The Supreme Court used these tests to hold that the formula one racing circuit which was at the disposal of a non-resident, FOWC, was a fixed place of business from where FOWC's economic activity was carried out. The number of days for which FOWC had access would not make any difference.

Project Office

There is a view that a project office set up by a non-resident in India primarily as a support office for the purpose of facilitating the performance of a contract, falls within the purview of Article 5(4)(e). In National Petroleum Construction Company v DIT (2016) 383 ITR 648 (AAR) (Delhi-HC), the AAR held that a project office only used as a communication channel and not for execution of contracts by an assessee engaged in fabrication and installation of petroleum platforms, would qualify as an auxiliary activity not constituting a PE. The determination, thus, depends on the overall facts of each case.

Liaison office

There is a divergence of views regarding liaison offices constituting a PE:

- *In UAE Exchange Centre LLC, In re, the AAR[5] held that an Indian liaison office of a foreign enterprise engaged in remittance services, performs an essential activity and thus, falls outside Article 5(4)(e) when such liaison office downloads information (such as names and addresses of beneficiaries, amount to be remitted, etc), prints cheques/ draft and dispatches them to the addresses of beneficiaries through courier. In certain other cases[6] it was held that the liaison/ representative office was not a PE. Where no violation was reported by the RBI, the activities of the liaison office were presumed to be of preparatory and auxiliary character[7].*
- *Identifying new customers, marketing activities, price negotiation, discussion of commercial issues, securing and processing orders have led to the liaison office forming a PE[8]. Courts have observed that merely because the Head Office received orders and payments directly from the buyers and also sent goods to them directly, would not mean that only liaison work was done by the liaison office. However, receiving information, enquiries and feedback for passing it on to the Head Office and co-ordination activities*

[4] *Formula One World Championship Ltd. v. Commissioner of Income-tax (International Taxation) [2017] 394 ITR 80 (SC)*
[5] *(2004) 268 ITR 9 AAR.*
[6] *Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP HC), Motorola Inc. (2005) 95 ITD 269 (Del ITAT)SB)*
[7] *Metal One Corpn (2012) 52 SOT 304 (Del ITAT)*
[8] Jebon Corporation India v CIT (2012) 206 Taxman 7 (Kar HC), Brown And Sharpe Inc v CIT (2014) 369 ITR 704 (All HC),

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have been held as preparatory in nature.

- *In the case of GE Energy Parts Inc[9], the Delhi Tribunal held that as the activities carried out were substantial and core, the liaison office of one of the group entity was a fixed place PE of the assessee as well as of other overseas entities in the group for which such activities were carried out.*

The fact whether a liaison office constitutes a PE will, thus, have to be examined based on facts and circumstances of each case and it cannot be presumed that a liaison office will always be excluded from the purview of Article 5.

Advertising activity

There is no PE in Source State when a fixed place of business engages solely in promotional advertising for the goods manufactured by the foreign enterprise.

(f)	The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

Note – *This paragraph provides that where a fixed place of business combines any of the activities mentioned in sub-paragraphs (a) to (e) that, by itself, does not lead to a conclusion that a PE exists. As long as the combined effect of the overall activity of such fixed place of business is preparatory or auxiliary, a PE should not be deemed to exist.*

The terms "preparatory" and "auxiliary" have not been defined in the Convention. The OECD MC mentions that it is often difficult to distinguish between the activities which are "preparatory or auxiliary" in character and those which are not. The facts of each case have to be individually examined. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a

[9](2017) 184 TTJ 570 (Del ITAT)

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whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character. *Whether an activity has preparatory or auxiliary character should not be interpreted rigidly and ought to be considered in light of the facts and circumstances. However, enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each part is merely engaged in a preparatory or auxiliary activity.*		
4.1	Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and: (a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or (b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.	
Note - *Paragraph 4.1 is an anti-fragmentation rule. The purpose of this new paragraph 4.1 is to prevent an enterprise from fragmenting its activities (either within the enterprise or between closely related enterprises) in order to qualify for the specific activity exemptions in paragraph 4 of Article 5.* ***Example:*** *RCO, a bank resident of State R, has a number of branches in State S which constitute PEs. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications. The verifications done by the employees are forwarded to the headquarters in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a PE of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S).*		
5	Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph **6**, where a person is acting in a Contracting State on behalf of an enterprise **and, in doing so,** habitually concludes	Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph **7**, where a person is acting in a Contracting State on behalf of an enterprise, that enterprise shall be deemed to have a permanent

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td></td><td>contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
a) in the name of the enterprise, or
b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
c) for the provision of services by that enterprise,
that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for 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 (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</td><td>establishment in that State in respect of any activities which that person undertakes for the enterprise, if such a person:
(a) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
(i) in the name of the enterprise, or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
(iii) for the provision of services by that enterprise,
unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or
(b) the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise.</td></tr>
<tr><td>- / 6</td><td></td><td>Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, 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.</td></tr>
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Para	OECD Model Convention 2017	UN Model Convention 2017
Note - *The UN MC has additional Article 5(6) relating to insurance which is absent in OECD MC. As per this paragraph, insurance companies of a State (except with regard to re-insurance) are deemed to have a PE in the other State if they collect premiums in that other State through an agent established there (other than an agent who already constitutes a PE by virtue of paragraph 5) or insure risks situated in that territory through such an agent.* *However, if an insurance agent is independent, then, the enterprise would not be deemed to have a PE and the profits of the insurance company attributable to his activities would not taxable in the Source State.* *In the absence of similar Article in the OECD MC, a PE of an insurance Enterprise has to be determined in accordance with provisions of Article 5(1) or 5(2) of the OECD MC.*		
6 / 7	Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.	Paragraphs 5 ***and 6*** shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.
Note - ***Agency PE : Dependent agent PE*** *Article 5(5) of the OECD/UN Model refers to what is popularly known as "Agency PE". It contains a deemed inclusion clause and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in Source State even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in State of Source within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold of six or twelve months, as the case may be).* *Article 5(5) and Article 5(6)/(7) address the artificial avoidance of PE status through commissionaire arrangements and similar strategies.* *Articles 5(5) and 5(6) of the OECD MC and Articles 5(5), 5(6) and 5(7) of the UN MC must be read together. On such combined reading, the following two principles emerge:* • *Article 5(5) applies only to a case where the person, who acts on behalf of a non-resident, is not an agent of independent status within the meaning of Article 5(6) of OECD Model or*		

Para	OECD Model Convention 2017	UN Model Convention 2017

Article 5(7) of UN Model.

- *Even when an agent fails to come up to the standard of independence mentioned in Article 5(6)/(7), the issue regarding PE is not closed but has to be resolved in terms of Article 5(5). In other words, a dependent agent does not automatically constitute a PE for its principal unless it (agent) satisfies the requirements of Article 5(5).*

For paragraph 5 of Article 5 to apply, all the following conditions must be met:

(i) a person acts in a Contracting State on behalf of an enterprise;

(ii) in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and

(iii) these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

(iv) the person is not be an independent agent to whom Article 5(6)/(7) applies',

(v) activities performed by such person are not limited to those mentioned in Article 5(4)

UN MC has an additional subparagraph (b) in Article 5(5), relating to the maintenance of a stock of goods which is broader in scope than the OECD MC. It is interpreted that if sales-related activities (for example, advertising or promotion) including delivery are conducted in Source State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, then a PE may exist.

Test to determine Agent's Independence

Article 5(6) of the OECD and 5(7) of the UN MC are identical.

- *An agent is independent if it acts for the enterprise in its ordinary course of business.*
- *A person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related.*

Article 5(5) and 5(1) & (2)

If a dependent agent works at the fixed place of business of its non-resident principal in State of Source, a PE of the principal may exist under Article 5(1) and (2), even if the agent is not authorised to conclude contracts. In other words, if the principal has a PE within the meaning of Article 5(1) and (2) from where the agent works, it is not necessary to show that the agent would fall under Article 5(5).

7 / 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.	

Note - *Article 5(7) of the OECD MC is identical to Article 5(8) of the UN MC. This paragraph of Article 5 clarifies that a company of Residence State is not deemed to have a PE in Source State merely because it controls, or is controlled by, a company that is a resident of Source*

Para	OECD Model Convention 2017	UN Model Convention 2017
	State. The determination of whether a company is a PE of a related company or not is to be made solely on the basis of the requirements under the other paragraphs of Article 5 and the mere existence or possibility of existence of close relationships is not sufficient to constitute a PE[10]. Hence, the existence of a subsidiary does not, by itself, make that subsidiary company a PE of its parent nor is a PE constituted on account of identical shareholding. *Likewise, since each company constitutes an independent legal entity, the mere fact that the subsidiary company is managed by its parent or that the parent exercises strict control over activities of its subsidiary and desires stringent financial reporting, does not make the subsidiary a PE of the parent.*	
8 / 9	For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.	
	Note – *Paragraph 8 of the OECD MC is identical to Paragraph 9 of the UN MC. This para explains the meaning of the concept of a "person closely related to an enterprise" for the purpose of the Article. That concept is to be distinguished from the concept of "associated enterprises" used for Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.* *This paragraph is divided into two parts. The first part includes the general definition. It provides that a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises; and the second part provides certain circumstances in which the definition of "person closely related to an enterprise" is automatically satisfied.*	

ART 7 BUSINESS PROFITS

This Article provides for the situation when business profits of a non-resident would be taxable in the Source State and also lay down the criteria and extent of deduction of expenses. The business profits would be taxable only when the non-resident has a PE as per Article 5 in the Source State.

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[10] *DIT v E-Funds IT Solution (2014) 364 ITR 256 (Del HC), Adobe Systems Incorporated v ADIT (2017) 292 CTR 407 (Del HC)*

Para	OECD Model Convention 2017	UN Model Convention 2017
1	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 **that are attributable to the permanent establishment in accordance with the provision of paragraph 2** may be taxed in that other state**.**	***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.***

Note - *Article 7(1) of the OECD Model does not incorporate the "Force of Attraction" rule, which is incorporated in UN Model.*

Article 7(1) of the UN Model provides as follows:

- *Source State can tax the profits of an enterprise of State of Residence only if:*
  - *the enterprise carries on business in Source State; and*
  - *such business is carried on through a PE in that Source State.*
- *If the above conditions are not fulfilled, the profits can be taxed only in State of Residence. However, if both the conditions are fulfilled, State of Source can tax only so much of the profits of the enterprise as are attributable to:*
  - *the PE [Article 7(1)(a)];*
  - *sales in Source State of same or similar goods or merchandise as those sold through that PE [Force of Attraction (FOA) Rule, Article 7(1)(b)]; or*
  - *other business activities carried on in Source State of the same or similar kind as those effected through that PE. [FOA Rule, Article 7(1)(c)].*

Under the OECD MC, only profits attributable to the PE may be taxed in the Source State. The UN MC amplifies this attribution principle by a limited FOA rule, which permits Source State taxation of the enterprise, not only in respect of the business carried on by it through a PE in the Source State, but also on business profits arising from certain other transactions by the enterprise in the Source State, which are not through the PE.

The aforesaid FOA is limited to business profits covered by Article 7 and do not apply to income from capital i.e., Article 10 (Dividends), 11 (Interest) or 12 (royalties) which can be taxed under these articles even in the absence of a PE.

Para	OECD Model Convention 2017	UN Model Convention 2017
Business profits not attributable to a PE cannot be taxed in Source State except under FOA rule in Article 7(1)(b) and (c) as per UN Model. ***Force of Attraction (FOA) Rule*** *The FOA rule implies that when a foreign enterprise sets up a PE in the Source State, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that all profits that the enterprise derives from Source State, whether through the PE or not, can be taxed by it (Source State).* ***Example:*** *To illustrate, consider the case of a sale of jeeps in Source State through a showroom in that State. If the enterprise also sells jeeps directly to some customers, i.e. not through the showroom, by way of, say, direct exports from outside the State of Source to a bulk customer in the Source State, then, the profits arising on such bulk sale would also be attributed to the PE and would be treated as profits arising from the PE, under the FOA principle.* *Further, due to deletion of Article 14 in the OECD [which continues to remain in UN MC], income derived from furnishing of independent personnel services falls under Article 7 of the OECD MC.*		
2	**For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise,** if it were a separate and **independent** enterprise engaged in the same or similar activities under the same or similar conditions, **taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.**	***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.***
Note - *Article 7(2) of OECD and UN Models advocate a distinct and separate entity approach for attribution of profits to a PE with difference in language. It is a machinery provision, which provides the methodology for computation of profits of the PE.* *In addition, Article 7(2) of the OECD Model makes a reference to FAR Analysis [Functions, Assets and Risks] in attributing profits, which is absent in Article 7(2) of the UN Model.* *In simple words, the Article 7(2) of the UN Model provides that profits attributable to PE should*		

Para	OECD Model Convention 2017	UN Model Convention 2017
be computed after making the following assumptions: • The PE is a separate and distinct enterprise. • It is engaged in the "same or similar" activities as that of the foreign enterprise of which it is a PE. • It is operating under the same or similar conditions as that of the foreign enterprise of which it is a PE. • It was dealing wholly and independently with the foreign enterprise of which it is a PE.		
- / 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***

Para	OECD Model Convention 2017	UN Model Convention 2017
		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.

Note – *Article 7(3) of the UN MC relating to deduction of expenses, is absent in OECD MC.*

The basic principle behind paragraph 3 is that profits and gains of the business would be worked out by deducting all expenses related to the business activity, other than capital expenditures which are currently not deductible or expenses of a personal or non-business nature which cannot be attributed to the business of the enterprise. The objective is to ensure that the expenditure claimed as a deduction in determining the taxable profits is relevant, referable and necessary for carrying out the business operations.

Paraphrasing Article 7(3) of the UN MC:

(i) Expenses

a. *All expenses incurred for the purposes of the business of the PE shall be allowed as a deduction, in determining profits of a PE.*
b. *Such expenses include executive and general administrative expenses.*
c. *Such expenses could be incurred within or outside the State in which the PE is situated (Source State).*
d. *In case of a banking enterprise, such expenses would include interest on moneys lent by the head office or other offices to the PE.*
e. *Such expenses would include reimbursement by the PE of actual expenses incurred by the head office or other offices.*
f. *Subject to (d) and (e) above, no deduction shall be allowed in respect of amounts paid by the PE to the head office or other offices by way of:*
   - *royalties, fees or similar payments in return for use of patents and use of other rights;*
   - *commission for specific services performed or for management;*
   - *interest on moneys lent to the PE (in case of non-banking enterprise).*

(ii) Receipts

a. *In case of a banking enterprise, receipts of PE would include interest on moneys lent by the PE to the head office or other offices.*
b. *Receipts of the business shall include reimbursement to a PE by the head office or other offices.*
c. *Subject to (a) and (b) above, receipts of PE would not include amounts paid to the PE by the head office or other offices by way of:*
   - *royalties, fees or similar payments in return for use of patents and use of other rights;*
   - *commission for specific services performed or for management;*
   - *interest on moneys lent to the head office or other offices (in case of non-banking enterprise).*

Para	OECD Model Convention 2017	UN Model Convention 2017
3 / -	Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.	-

Note - *Article 7(3) of the OECD Model is absent in UN MC which provides for adjustment in the tax charged on the profits attributable to the PE in other Contracting State to eliminate double taxation on such profits, where one State makes an adjustment in conformity with Article 7(2).*

Example*: A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a PE of the enterprise situated in State S. For the purpose of determining the profits attributable to the PE under Article 7(2), a notional arm's length price must be determined for that dealing. The enterprise's documentation shows a notional price of Rs.90 has been used to determine the profits attributable to the PE. State S accepts the price used by the enterprise but State R considers that the amount is low and the arm's length price that should have been Rs.110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of exemption or the credit claimed with respect to the profits attributable to the PE.*

In that situation, since the price of the same dealing will have been determined as Rs.90 in State S and Rs.110 in State R, profits of Rs.20 may be subject to double taxation. Paragraph 3 requires State S to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States, to the extent that there is indeed double taxation and that the adjustment made by State R is in conformity with Article 7(2).

If State S does not agree that the adjustment made by State R was warranted by Article 7(2), it will not make the adjustment and the issue will be solved under a mutual agreement procedure under Article 25.

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td>- / 4</td><td>-</td><td>In so far 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.</td></tr>
<tr><td colspan="3">Note - Article 7(4) of the UN MC relating to determination of the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, is absent in the OECD MC .

Paraphrasing, profits can be attributed to the PE by apportionment of the total profits of the enterprise to its various parts, provided:

• it is customary in Source State to determine the profits in such a manner;

• the method of apportionment adopted is such that the result is in accordance with the principles in Article 7.

Article 7(4) determines the profits to be attributed to a PE by apportioning the total profits of the enterprise on the basis of various formulae. It is a machinery provision and not a charging provision. The underlying principle of Article 7(4) is that all parts of an enterprise contribute to its profitability and such contribution can be determined on the basis of the adopted criteria.

Article 7(4) prescribes a method different from that in Article 7(2), since, unlike Article 7(2), it does not contemplate an attribution of profits on a separate enterprise footing. It is not as scientific a method as under Article 7(2). Hence, Article 7(4) might produce a result which is different from that produced by applying Article 7(2) and hence, should be used only where it has been customarily used in the past and accepted both by the tax authorities and taxpayers as being satisfactory.</td></tr>
<tr><td>- / 5</td><td>-</td><td>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.</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
Note - *Article 7(5) of the UN Model relating to use of same method for attribution of profits to a PE year by year unless there is good and sufficient reason to the contrary, is absent in OECD Model.*		
4 / 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 - *Article 7(4) of OECD Model is identical to the Article 7(6) of UN Model, which provides that the articles dealing with specific categories of income (e.g., dividends, interest, royalties, etc.) override the provisions of Article 7, unless such articles state otherwise. Even otherwise, it is a well-settled principle that a specific provision overrides a general one. Hence, dividends, interest, royalties, etc. are taxable under Article 10 to 12 even if they are earned in the course of business. Thus, Article 7 applies to industrial and commercial income which does not belong to categories of income covered by the special articles.*		

ART 11	INTEREST

This Article provides the right to both the countries in respect of taxation of interest. Generally, interest is taxed in the Source State at a given rate on gross basis. Thereafter, such income may be taxable in the Residence State with credit for taxes paid in the Source State.

Para	OECD Model Convention 2017	UN Model Convention 2017
1	Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.	
Note - *Article 11(1) of the OECD and UN MC provides that the Residence State can always tax the income unless a tax treaty prohibits it. Even without this clause, the Residence State could tax interest. The two important phrases used in this article are "paid" and "may be taxed".* *The term "paid" should not be restricted to physical payment in cash as it might include performance in kind or set off amounts. The term "may be taxed" gives right to the Residence State to tax the interest income. In doing so, it does not stipulate an exclusive right to tax in favour of the Residence State.*		
2	However, **interest arising in a Contracting State** may also be taxed in **that State** according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not	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 beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent ***(the percentage is to be established***

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td></td><td>exceed 10 per cent 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.</td><td>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.</td></tr>
<tr><td colspan="3">Note - Article 11(2) of the OECD MC differs from Article 11(2) of the UN MC to the extent that it provides that the tax in Source State “shall not exceed 10% of the gross amount of interest”, whereas the UN MC leaves this percentage to be established through bilateral negotiations. Article 11(2) provides to the Source State, a limited right to tax interest as per its domestic laws at concessional rate.
Thus, it may be seen that interest is taxed in both the States, the Source State as well as the Residence State. The benefit of concessional tax rate is given subject to fulfilment of certain conditions. Accordingly, the recipient of interest should be:
a) the beneficial owner of interest; and
b) a resident of other country.</td></tr>
<tr><td>3</td><td colspan="2">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.</td></tr>
<tr><td colspan="3">Note – Article 11(3) provides for an exhaustive definition of interest. It nevertheless remains understood that, in a bilateral convention, two Contracting States may widen the formula employed so as to include in it, any income which is taxed as interest under either of their domestic laws but which is not covered by the definition.
The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of non-traditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a “substance over form” rule, an “abuse of rights” principle, or any similar doctrine.
The second sentence of Paragraph 3, excludes from the definition of interest, penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral convention.</td></tr>
<tr><td>4</td><td>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</td><td>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</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
	Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	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 in (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.
Note – *Article 11(4) of OECD MC is similar to provisions of UN MC, with two modifications. First, the UN MC refers to a fixed base as well as a PE. Second, since UN Model, unlike OECD Model, adopts a limited force of attraction rule (FOA), it applies if the debt-claim, on which the interest is paid, is effectively connected with the PE or fixed base or with business activities in the Source State of the same or similar kind as those effected through the PE.* *Article 11(4) states that Article 11 (1) & (2) will not apply if the beneficial owner of the interest i.e. the lender has a PE in the interest source state which carries on business and debt claim is effectively connected with that Source State PE. In such a case, Article 7 – Business Profits or Article 14 - Independent Personal Services (in case of UN Model) will apply.* ***Example:*** *Citibank, USA has a branch in India. A Ltd, an Indian Co., has taken a loan from Citibank, India branch and is paying interest to it. This interest shall be taxable as business profits as per Article 7 in the hands of Citibank, USA in India as it is effectively connected with the PE in India.*		
5	Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.	Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment ***or a fixed base*** in connection 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.

Para	OECD Model Convention 2017	UN Model Convention 2017

Note - *Article 11(5) of the OECD MC does not differ from Article 11(5) of the UN MC, except that the OECD MC does not refer to a 'fixed base'.*

Article 11(5) lays down the principle that the Source State of interest is the State of which the payer of the interest is a resident. However, it also provides an exception to this rule in the case of interest-bearing loans which have an economic link with the PE owned in the other Contracting States, by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, then, the source of interest is in the Contracting State in which the PE or fixed base (in case of UN Model) is situated irrespective of the place of residence of the owner of the PE/fixed base even when he resides in neither of the Contracting States. The existence of the nexus between the indebtedness and the needs of the PE/fixed base is the essential requirement for holding the state of location of PE/fixed base as the source of interest. The absence of the nexus will render this rule inapplicable.

Example: *There is a UK Co. which has taken loan from a US Co. The UK Co. has a branch (which constitutes a PE) in India. The loan taken from US Co. is for the branch in India. Interest is paid by the UK Co. to the US Co. which is ultimately borne by the branch in India. Therefore, in such a case, the interest arises in the State in which the PE is located i.e. India and hence India-US tax treaty will apply.*

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.

Note - *This rule will operate where a special relationship prevails between the payer of interest and beneficial owner of the interest and the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. Therefore, benefit of Article 11 for lower tax rates applies only to the arms' length interest.*

Examples of special relationship

a) *an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him*

b) *relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of interest.*

ART 12	**ROYALTIES**

This Article provides the right to Contracting States to tax income from royalty. Generally, the right to tax are shared by both the countries. However, OECD MC lays down the principle of exclusive taxation of royalties in the State of beneficial owner's residence with some exception. UN MC provides a separate Article to cover income from fees for technical services. However, in some treaties, Article 12 also covers fees from technical services. In case these are not covered under Article 12, they may be taxable as business profits under Article 7 or as other income under Article 21.

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td>1</td><td>Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.</td><td>Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.</td></tr>
<tr><td>- / 2</td><td>-</td><td>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 beneficial owner of the royalties is a resident of the other Contracting State, 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.</td></tr>
<tr><td colspan="3">Note - As per Article 12(1) of the OECD MC, royalties arising in Source State and beneficially owned by resident of the Residence State are taxable only in Residence State. However, the UN MC omits the word "only" and provides that royalties may be taxed in the Residence State. Article 12(2) of UN MC is an addition flowing logically from the premise underlying Article 12(1), which is that royalties may be taxable in the Source State as well as Residence State. Hence, the UN MC departs from the principle of exclusive right to tax provided to Residence State in the OECD MC. However, the benefit of concessional tax rate in Source State in UN MC is given subject to fulfilment of certain conditions. Accordingly, the recipient of royalty should be:
a) the beneficial owner of royalty; and
b) a resident of other Country.
A provision corresponding to Article 12(2) of the UN MC is absent in the OECD MC, since the OECD MC does not allow sharing of taxing rights by Contracting States. However, the OECD MC requires that the royalties should be beneficially owned by a resident of the Residence State.</td></tr>
<tr><td>2 / 3</td><td>The term "royalties" as used in this Article means payments of any kind received as a</td><td>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,</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
	consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.	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.
Note - *Article 12(2) of the OECD MC is identical to Article 12(3) of the UN MC except that the OECD MC does not include the following within the definition of "royalties":* → *Rentals for "films or tapes used for radio or television broadcasting";* → *Equipment rentals like rentals for industrial, commercial or scientific equipment.* *Such rentals would, therefore, be taxable under Article 7 (Business Profits) or 21 (Other Income) of the OECD MC.*		
3 / 4	The provisions of paragraph 1 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 and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	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 in (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.
Note - *Article 12(3) of the OECD Model differs from Article 12(4) of the UN Model in the following two respects:* → *OECD MC does not provision reference of independent personnel services from a fixed base since OECD MC, now, does not have separate Article on Independent Personal Services ; and* → *It does not include reference to Article 7(1)(c) (Force of Attraction rule) since such a provision is present only in the UN MC.* *Article 12(3) of both the MCs states that the income will not be taxable as royalty under*		

Para	OECD Model Convention 2017	UN Model Convention 2017
paragraph 1 or 1 & 2, if the beneficial owner of the royalties has a PE in the Source State which carries on business and right or property is effectively connected with that PE in the Source State or with business activities in the Source State of the same or similar kind as those effected through the PE (in case of UN Model). In such a case, Article 7 – Business Profits or Article 14 - Independent Personal Services (in case of UN Model) will apply.		
- / 5	-	***Royalties shall be deemed to arise in a Contracting State when the payer is 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.***
Note - *A provision corresponding to Article 12(5) of the UN MC is not present in Article 12 of the OECD MC since the latter does not confer right to tax to the Source State.* *Article 12(5) of the UN MC lays down the principle that the Source State in case of royalty is the State in which the payer of the royalty is a resident. However, an exception to this rule is provided in cases where the payer of royalty incurs a liability* ***in connection with*** *the PE/fixed base owned in other Contracting States. If the right or property was contracted for the requirements of PE/fixed base and the royalty is borne by such PE/fixed base, then, the source of royalty is in the Contracting State in which the PE/fixed base is situated irrespective of the place of residence of the owner of the PE/fixed base even when he resides in neither of the Contracting States. The existence of the nexus between the usage of property or right and the needs of the PE/fixed base is the essential requirement for holding the state of location of PE/fixed base as the source of royalty. The absence of the nexus will render this rule inapplicable.* ***Example****: There is an Australian Co. which has obtained right to manufacture cellular mobiles from a UN Co. The Australian Co. has a branch (which constitutes a PE) in India. The right obtained from UN Co. is for the branch in India. Royalty is paid by the Australian Co. to the UN Co. which is ultimately borne by the branch in India. Therefore, in such a case, the royalty shall be deemed to arise in the State in which the PE is located i.e., India and hence India-UN tax treaty will apply.*		
4 / 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,	

Para	OECD Model Convention 2017	UN Model Convention 2017
	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.	

***Note** – This paragraph provides for adjustment of an amount which is in excess of what would be allowed under the arm's length principle. The purpose is to restrict the operation of the provisions concerning the taxation of royalties in cases 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 paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. The excess part of the royalty shall remain taxable according to the laws of the two Contracting States due regard being had to the other provisions of the Convention.*

Examples of special relationship

a) an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him

b) relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty.

ART 12A FEES FOR TECHNICAL SERVICES (UN MODEL CONVENTION)

Fees for Technical Services: In its 2017 update the UN MC has inserted a specific article (Article 12A) pertaining to FTS. In its absence, taxability of FTS has to be considered either under Article 7 or Article 14 or Article 21, depending upon the facts.

However, most Indian tax treaties have a specific provision for taxing FTS with common operating provisions, as for 'royalties'.

The newly inserted Article 12A in UN MC reads as follows:

Para	UN Model Convention 2017
1	Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

***Note** – Until the addition of Article 12A, income from services derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a PE (Article 7) or provided professional or independent personal services through a fixed base (Article 14) in the Source State. With the rapid changes in technology, it is now possible to operate in countries without a substantial physical presence. This*

Para	UN Model Convention 2017
	led to issues of tax avoidance, especially for developing countries who are disproportionately importers of services. *Article 12A(1) provides that the FTS may be taxed in the Residence State but does not provide that the FTS is exclusively taxable in the Residence State.*
2	However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].
	Note – *Article 12A(2) lays down the principle that the Contracting State in which FTS arises may tax those payments in accordance with the provisions of its domestic law. However, if the beneficial owner of the fees is a resident of the other Contracting State, the amount of tax imposed by the State in which the FTS arises should not exceed a maximum percentage, to be established through bilateral negotiations, of the gross amount of the payments*
3	The term "fees for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made: (a) to an employee of the person making the payment; (b) for teaching in an educational institution or for teaching by an educational institution; or (c) by an individual for services for the personal use of an individual.
	Note - *The definition of "fees for technical services" in Article 12A(3) is exhaustive. "Fees for technical services" are limited to the payments described in Article 12A(3); other payments for services are not included in the definition and are not dealt with in Article 12A.* ***Definition -*** *Article 12A(3) defines FTS as payments for managerial, technical or consultancy services. It also sets out specific exceptions such as payment for teaching in an educational institution, payments for services for personal use.* ***Meaning and scope of "Management" –*** *It involves application of knowledge, skill or expertise in the control or administration of the conduct of a commercial enterprise or organization. Payments made to a consultant for advice related to the management of an enterprise (or of the business of an enterprise) would be fees for technical services.* ***Meaning and scope of "Technical" –*** *It involves the application of specialized knowledge, skill or expertise with respect to a particular art, science, profession or occupation. Therefore, fees received for services provided by regulated professions such as law, accounting, architecture, medicine, engineering would constitute FTS.*

Para	UN Model Convention 2017
Meaning and scope of "Consultancy" - *The ordinary meaning of "consultancy" involves the provision of advice or services of a specialized nature. Professionals usually provide advice or services that fit within the general meaning of consultancy services although; they may also constitute management or technical services.* *The terms "management," "technical" and "consultancy" do not have precise meanings and may overlap. Thus, for example, services of a technical nature may also be services of a consultancy nature and management services may also be considered to be services of a consultancy nature.*	
4	The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with: (a) such permanent establishment or fixed base, or (b) business activities referred to in (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
Note - *Article 12A(4) is similar to the paragraph 4 of Articles 11 and 12; it provides that income will not be taxable as FTS under paragraphs 1 and 2 if beneficial owner of FTS has a PE or fixed base in the State in which the fees arise and the services rendered are effectively connected with such PE in Source State or with business activities in the Source State of the same or similar kind as those effected through the PE. In such a case, Article 7 – Business Profits or Article 14 - Independent Personal Services (in case of UN Model) will apply.*	
5	For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person 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 obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.
6	For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.
Note - *Article 12A(5) lays down the principle that the State in which FTS arises is the State of which the payer of the fees is a resident or the State in which the payer has a PE or fixed base, if the FTS are borne by the PE or fixed base. The existence of the nexus between the technical services being*	

Para	UN Model Convention 2017
	provided and the PE/fixed base is the essential requirement for holding the State of location of PE/fixed base as the source of FTS. The absence of the nexus will render this rule inapplicable. *Article 12A(5) is subject to Article 12A(6). Article 12A(6) deems FTS paid by a resident of a Contracting State not to arise in that State, in a case where that resident/the payer carries on business through a PE in the other Contracting State or performs independent personal services through a fixed base in the other Contracting State or in a third State and the FTS is borne by that PE or fixed base.*
7	Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services 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 fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.
	Note - *The purpose of Article 12A(7) is to restrict the operation of the provisions in cases where, by reason of a special relationship, the amount of the fees paid exceeds the amount that would have been agreed upon by the payer and the beneficial owner if they had stipulated at arm's length.* ***Examples of special relationship*** *a) an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him* *b) relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty*

ART 13 CAPITAL GAINS

This is the most commonly used Article and it provides for the taxation of income arising from transfer of a capital asset, including transfer of shares. The right to tax income from capital gains may be exclusively with the Residence State, or shared between the Residence and Source States.

Para	OECD Model Convention 2017	UN Model Convention 2017
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.	
	Note - *On account of use of the word 'may', both the countries i.e. the Source State and the Residence State, have the right to tax the aforesaid income. The country of source is the*	

Para	OECD Model Convention 2017	UN Model Convention 2017
country in which the immovable property is physically located. If such income is taxed in the Source State, the State of Residence will either grant credit for taxes paid in Source State or exempt such income in accordance with Article 23 of the tax treaty. ***Meaning of "immovable property" -*** *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 [Article 6(2) of the UN and OECD Model].* ***Coverage of the phrase "alienation of property" -*** *This Article does not give a detailed definition of capital gains. The words "alienation of property" is used to cover, in particular, capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation (compulsory acquisition by the Government), the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.* ***Manner of computation of capital gain not specified -*** *This Article does not specify how to compute a capital gain, this being left to the domestic law applicable.*		
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, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.	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 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.
Note - *Article 13(2) of the OECD MC and UN MC are similar, except that the OECD MC does not refer to provision of independent personnel services from a fixed base. The said reference is absent on account of deletion of Article 14 from OECD MC i.e. Provision of Independent Personnel Services.* ***Taxation of gains from alienation of movable property -*** *Article 13(2) deals with movable property forming part of the business property of a permanent establishment of an enterprise (both OECD and UN MC) or pertaining to a fixed base (in the case of UN MC) used for performing independent personal services. Gains from the alienation of such assets may be*		

Para	OECD Model Convention 2017	UN Model Convention 2017
taxed in the State in which the PE (both OECD and UN MC) or fixed base (in case of UN MC) is situated. ***Meaning of "movable property" -****The term "movable property" means all property other than immovable property which is dealt with in Article 13(1). It includes also incorporeal property, such as goodwill, licences, etc.* ***Taxability when PE or fixed based is alienated*** *- The paragraph makes clear that its rules apply when movable property of a PE or fixed base is alienated as well as when the PE as such (alone or with the whole enterprise) or the fixed base as such is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the PE.* *The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in Article 13(6).*		
3	Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.	
Note – *Article 13(3) of the OECD and UN MC are identical. As per this para, gains from the alienation of ships or aircraft, or of movable property pertaining to the operation of ships or aircraft are taxable only in the State of the enterprise operating such ships and aircraft.*		
4	Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.	
Note - *Article 13(4) of the OECD MC is identical to Article 13(4) in the UN MC.* ***Interpretation of the phrase "may be taxed" -*** *By providing that gains from the alienation of shares or comparable interests which, at any time during the 365 days preceding the alienation, deriving more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State* **may** *be taxed in that State, paragraph 4 provides that gains from the alienation of such shares or comparable interests and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in both States.* ***Method of computation of value of interest or shares derived from immovable property situated in other Contracting State -*** *Paragraph 4 allows the taxation of the entire gain attributable to the shares or comparable interests to which it applies even where part of the value of these shares or comparable interests is derived from property other than immovable property located in the Source State. The determination of whether shares of a company or comparable interests derive, at any time during the 365 days preceding the alienation, more*		

Para	OECD Model Convention 2017	UN Model Convention 2017
than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company, entity or arrangement without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).		
-/ 5	-	***Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least __ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.***
Note - *This paragraph provides for taxation of a gain from the alienation of shares and comparable interests as contemplated in the Article 13(5) but excludes gains from the alienation of shares to which Article 13(4) of the UN MC applies.* *The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 365 days preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations.*		
5/6	Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 **and 4**, shall be taxable only in the Contracting State of which the alienator is a resident.	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.
Note – *The aforesaid paragraph is a residuary clause and accordingly, seeks to cover within its ambit, gains arising on alienation of all the properties which are otherwise not covered in the earlier paragraphs.* *This paragraph allows the country of residence of the alienator to tax the income in the nature of capital gains sourced from other countries. Thus, all the movable properties, other than those specifically set out in the earlier paragraphs, shall be subject to taxes only in the Residence State of the alienator.*		

ART 14	INDEPENDENT PERSONAL SERVICES (UN MODEL)

This Article deals with the taxation of income derived by a person for professional or specified services which are offered in the Source State through some presence. Currently, this article on Independent Personal Services is only present in the UN MC which reads as under:

Para	UN Model Convention 2017
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.

Note - *Article 14 was deleted from the OECD Model on 29-4-2000 on the basis of OECD Report (2000) on "Issues Related to Article 14 of the OECD Model Tax Convention". The Effect of deletion of Article 14 is that income derived from Professional Services etc., is now dealt with as 'Business Profits' (Article 7) under the OECD MC.*

Meaning of "professional services" - *This Article of UN MC covers independent activities involving professional skills. The meaning of the term "professional services" is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive.*

It normally covers services rendered by individuals. However, in case of Double Tax Avoidance Agreements ('DTAAs'/ 'tax treaty') with Australia, UK, USA, etc., partnership firms are also covered.

It suggests 'Principal to Principal relationship'.

Activities excluded from the scope of Article 14 – *(1) It excludes industrial and commercial activities that are covered under the Article 7 Business Profits. (2) It also excludes professional services performed in employment which are covered under the Article on Dependent Personal Services, e.g. a physician serving as a medical officer in a factory. (3) Independent activities of artists and sportsmen, etc. are also not covered by this Article.*

Para	UN Model Convention 2017
	Sub-paragraph (a) of Article 14(1) provides that the income may be taxed if the individual has a fixed base regularly available to him for performing his activities. Though the presence of a fixed base gives the right to tax, the amount of income that is subject to tax is limited to that which is attributable to the fixed base. *Sub-paragraph (b) extends the source country's right to tax by providing that the source country may tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base. Only income derived from activities exercised in that country, however, may be taxed.* ***Definition of "fixed base" -*** *The provisions of this Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. Even if Articles 7 and 14 are based on the same principles, since the concept of permanent establishment is reserved for commercial and industrial activities, the term "fixed base" has been used. The term "fixed base" would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. However, if there is, in another State, a centre of activity of a fixed or a permanent character, then, that State would be entitled to tax the person's activities.*

ART 21 OTHER INCOME

This Article deals with taxation of items of income which are not specifically taxable under any other specific Article.

Para	OECD Model Convention 2017	UN Model Convention 2017
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.	
	Note – *Article 21(1) envisages that other income 'shall be taxable only' in the Residence State, hence, providing for an exclusive right to the Residence State to tax such income. In the UN MC, however, Article 21(3) gives right to the Source State to tax income not covered in any of the foregoing articles (i.e., upto Article 20)*	
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,	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

Para	OECD Model Convention 2017	UN Model Convention 2017
	carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	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.
Note – *Article 21(2) provides an exception to the general rule in Article 21(1) for income that is effectively connected with a PE maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Article 7(Business Profits).* *In addition, the UN MC provides that if the aforesaid income is effectively connected with a fixed base situated in a Contracting State by a resident of the other Contracting State, the taxation of such income would be governed by the provisions of Article 14 (Independent Personal Services).* *Article 21(2) includes income from third States. In such a case, a right to tax is given to the Contracting State in which the PE or the fixed base is situated.* ***Example:*** *Income arising outside Country A that is effectively connected with a PE maintained in Country A by a resident of Country B generally would be taxable by Country A under the provisions of Article 7 (Business Profits).* ***Non-applicability of this paragraph to immovable property –*** *Article 21(2) does not apply to immovable property for which, according to Article 6(4), the State of situs has a primary right to tax. Therefore, immovable property situated in a Contracting State and forming part of the business property of a PE 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.*		
- / 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.***
Note - *Article 21(3) of UN MC is absent in the OECD MC. Article 21(1) of the OECD and UN MC provides for an exclusive right to the Residence State to tax other income. However, Article 21(3) of the UN MC provides right to tax such income to Source State as well. In such case, income would be taxable in both the States i.e. the State of Residence and State of Source. Under such scenario, the State of Residence will either grant credit for taxes paid in*		

Para	OECD Model Convention 2017	UN Model Convention 2017
	Source State or exempt such income in accordance with Article 23 of DTAA.	

ART 23	METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

In many cases, the application of tax treaty may result into double taxation for tax payers. In such a case, in order to provide relief to such tax payers, Article 23 which contains provisions relating to elimination of double taxation is applied. Article 23 provides for the mechanism through which tax credit/exemption may be available in the Residence State for taxes deducted in the Source State.

The OECD MC and UN MC specify two approaches- Exemption method (Article 23A) and Credit method (Article 23B). These methods are not mutually exclusive and there may be cases where a treaty may adopt exemption method for certain types of income and credit method for other incomes.

The double taxation referred to here, is juridical double taxation, meaning the same income or capital is taxable in the hands of the same person by more than one State. It does not thus, encompass situations of economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

Articles 23A and 23B apply to the situation in which a resident of State R, the Residence State, derives income from, or owns capital in, the other Contracting State E (where the non-resident person has a PE or fixed base) or State S (State of Source or situs), not being the State of residence within the meaning of the Convention and that such income or capital, in accordance with the Convention, may be taxed in such other State E or State S. The Articles, therefore, apply only to the State of residence and do not prescribe how the other Contracting State E or S has to proceed.

ART 23A	EXEMPTION METHOD

Article 23A sets out the exemption method to eliminate double taxation.

Para	OECD Model Convention 2017	UN Model Convention 2017
1	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.	

Para	OECD Model Convention 2017	UN Model Convention 2017

Note – *This Article lays down that the Residence State must exempt from tax, income and capital which may be taxed by the other State E or S in accordance with the Convention, whether or not the right to tax is, in effect, exercised by that other State. This method is known as full exemption method and regarded as the most practical one since it relieves the Residence State from undertaking investigations of the actual taxation position in the other State. Indian tax treaties, generally, do not follow full exemption method.*

Example illustrating "Full Exemption" Method - *For easy understanding, an illustration for computation of relief under 'full exemption' method for A.Y.2020-21 has been tabulated below:*

Sl. No.	***Particulars***	***Amount (in ₹)***
1	*Income earned in Residence State*	*10,00,000*
2	*Income earned in Source State*	*3,00,000*
3	*Total income earned by the individual [1+2] in case there is* ***no exemption***	*13,00,000*
4	*Tax liability on (3) above based on income-tax slab (including health and education cess@4%)*	*2,10,600*
5	*Total income to be considered under* ***full exemption method*** *[only (1) above can be included]*	*10,00,000*
6	*Tax liability on (5) above based on income-tax slab (including health and education cess@4%)*	*1,17,000*

Para	OECD Model Convention 2017	UN Model Convention 2017
2	Where a resident of a Contracting State derives items of income which may be taxed in the other Contracting State in accordance with the provisions of **Articles 10 and 11 (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that 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.	Where a resident of a Contracting State derives items of income which, in accordance with the provisions of ***Articles 10 11, 12 and 12A***, 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 which may be taxed in that other State.

Note - *Article 23A(2) of the OECD MC differs from Article 23A(2) in the UN MC, to the extent that OECD Model does not refer to Article 12 (Royalties) and Article 12A (Fees for Technical*

Para	OECD Model Convention 2017	UN Model Convention 2017

Services). This is on account of the fact that as per the OECD MC, royalties are taxable only in the Residence State and there is no separate article for Fees for Technical Services.

In Articles 10 and 11 (both OECD and UN MC) and 12 and 12A (in the case of UN MC), the right to tax dividends and interest is divided between the Residence State and the Source State. In these cases, the Residence State is left free not to tax if it wants to do so and to apply the exemption method also to the above-mentioned items of income. However, where the Residence State prefers to make use of its right to tax such items of income, it cannot apply the exemption method to eliminate the double taxation since it would, thus, give up fully its right to tax the income concerned. Hence, for the Residence State, application of the credit method would normally give a satisfactory solution.

Para	
3	Where in accordance with any provision of the 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.

Note -.*Under exemption with progression method, income earned in the Source State, though considered as exempt, is included in total income in the Residence State only for the purpose of determining effective tax rate.*

To make it simple, Residence State does not impose tax on such foreign income but includes such exempt income for the purpose of computing the tax rate applicable on the remaining income.

This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23A as well as to income or capital which under any other provision of the Convention "shall be taxable only" in the other Contracting State.

Example illustrating "Exemption with Progression" Method - *For easy understanding, an illustration of computation of relief under 'exemption with progression' method for A.Y. 2020-21 has been tabulated below:*

Sl. No.	*Particulars*	*Amount (in ₹)*
1	*Income earned in Residence State*	10,00,000
2	*Income earned in Source State*	3,00,000
3	*Total income earned by the individual [1+2]*	13,00,000
4	*Tax liability on (3) above based on income-tax slab (including health and education cess@4%)*	2,10,600
5	*Effective tax rate [i.e. (4)/ (3) * 100]*	16.20%
6	*Total income to be considered under* ***exemption with progression method*** *[only (1) above can be included]*	10,00,000
7	*Tax liability on (6) above based on the effective rate as computed in (5)*	1,62,000

Para	OECD Model Convention 2017	UN Model Convention 2017
4	The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of the Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of **Article 10 or 11** to such income.	The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of the Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of ***Article 10, 11, 12 or 12A*** to such income; ***in the latter case, the first mentioned State shall allow the deduction of tax provided for by paragraph 2.***

Note - *The purpose of this paragraph is to avoid double non-taxation as a result of disagreements between the Residence State and Source State on the facts of a case or on the interpretation of the provisions of the Convention.*

Article 23A(4) applies where the Source State interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that does not allow the Source State to tax the item while the Residence State adopts a different interpretation under which the item falls under a provision of the Convention that allows the Source State to tax the item.

In such a case, the Residence State cannot exempt an income which is not taxed by the Source State (on account of different interpretation of the convention) whereas it has the right to tax such income or capital in accordance with the provisions of the Convention.

However, Residence State must exempt that item of income where Source State has the right to tax an item of income or capital in accordance with the provisions of the Convention but it had not imposed such tax since no tax is actually payable on such income or capital under its domestic laws. Residence State must exempt such income because the exemption in the Source State does not result from the application of the provisions of the Convention but, rather, from the domestic law of the Source State.

ART 23B CREDIT METHOD

As mentioned for Article 23A above, the application of tax treaty may result in double taxation for tax payers. In such a case, in order to provide relief to such tax payers, Article 23B provides for the mechanism through which tax credit may be available in the Residence State for taxes deducted in the Source State.

Para	OECD Model Convention 2017	UN Model Convention 2017
1	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall allow: a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State; b) 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 either 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.	
Note – *Article 23B(1) of the OECD and UN MC incorporates the principle contained in Article 23A(2) of the OECD and UN MC. Article 23B, based on the credit principle, follows the ordinary credit method: the Residence State allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other Contracting State on the income derived from, or capital owned in that other Contracting State, but the deduction is restricted to the appropriate proportion of its own tax.* *Under the principle of credit, the Residence State would determine the resident's worldwide income (including the foreign sourced income) and compute the tax liability thereon. From the tax liability so computed, the Residence State would grant a deduction in respect of foreign tax paid on the foreign sourced income in the Source State.* *If the tax payable in the Residence State is more than the taxes paid in the Source State, then, the resident would be liable to pay the differential tax in the Residence State. If the foreign tax exceeds the Residence State tax on the same income, the excess tax credit may be carried forward or forfeited.* *The main feature of the credit method is that the Residence State retains the right to tax the foreign income but it allows credit for the taxes paid in the Source State.* *Most of the tax treaties relieve double taxation only through credit method. For a Residence State, the loss of revenue is lower in credit method. Hence, generally, most countries prefer the credit method. It may be noted that India follows credit method for most of the incomes.*		
2	Where in accordance with any provision of the 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.	
Note – *Article 23B(2) enables the Residence State to retain the right to take the amount of income or capital exempted in that State into consideration when determining the tax to be imposed on the rest of the income or capital. The right so retained extends to income or capital which "shall be*		

Para	OECD Model Convention 2017	UN Model Convention 2017
taxable only" in the other State. The principle of progression is thus safeguarded for the Residence State, not only in relation to income or capital which "may be taxed" in the other State, but also for income or capital which "shall be taxable only" in that other State.		

ART 24	NON-DISCRIMINATION

In order to provide equality in terms of tax treatment, this Article provides that the tax provision cannot be discriminatory merely because one person is a non-resident.

Para	OECD Model Convention 2017	UN Model Convention 2017
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, in particular with respect to residence, 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.	
Note – *Article 24(1) establishes the principle that for purposes of taxation, discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.* ***Parity in tax treatment of residents, whether of the same or different nationality*** *- In applying Article 24(1), the underlying question is whether two persons who are residents of the same State are being treated differently solely by reason of having a different nationality. Article 24(1) provides that the nationals of the other State must be treated on par with the nationals of the Contracting State for tax purpose.* ***Parity not required to be maintained in certain cases, where circumstances are different*** *- Consequently, 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, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its nationals who reside in the other State. Similarly, Article 24(1) does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) as the two persons are not in the same circumstances with respect to their residence.* ***Non-applicability of provisions of this Article to special taxation privileges accorded to own public bodies*** *- Likewise, the provisions of Article 24(1) are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State. Neither are they to*		

Para	OECD Model Convention 2017	UN Model Convention 2017
be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.		
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, in particular with respect to residence, are or may be subjected.	
Note - *A Stateless Person is a person who is not considered as a national by any State under the operation of its law. The purpose of Article 24(2) is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to Stateless persons who are residents of that or of the other Contracting State. By thus excluding Stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.*		
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.	
Note – ***Addresses discrimination based on actual situs of an enterprise -*** *The type of discrimination which Article 24(3) is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It, therefore, affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a PE in the other Contracting State.* *By the terms of the first sentence of Article 24(3), the taxation of a PE shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of PEs as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits.* ***Conditions under which principle of equal treatment would apply -*** *However, the second sentence of Article 24(3) specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a PE in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are resident, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment.*		

<table>
<tr><th>Para</th><th>OECD Model Convention 2017</th><th>UN Model Convention 2017</th></tr>
<tr><td colspan="3">For purposes of Article 24(3), the tax treatment in one Contracting State of the PE of an enterprise of the other Contracting State should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the PE belongs. However, Article 24(3) does not require a State to apply to the profits of the PE of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

Regulated and unregulated activities do not tantamount to same activities -Similarly, regulated and unregulated activities would generally not constitute the "same activities" for the purposes of Article 24(3). Thus, for instance, Article 24(3) would not require that the taxation on a PE whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the PE does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which, since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a PE.</td></tr>
<tr><td>4</td><td>Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 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.</td><td>Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, paragraph 6 of Article 12, or paragraph 6 of Article 12A apply, interest, royalties, fees for technical services, 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.</td></tr>
<tr><td colspan="3">Note – Article 24(4) is designed to end a particular form of discrimination resulting from the fact that, in certain countries, the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is, however, open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.</td></tr>
</table>

Para	OECD Model Convention 2017	UN Model Convention 2017
Application of thin capitalization rules - *Article 24(4) does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with the relevant Articles of this Convention. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by Article 24(4).* ***Additional information requirements with respect to payments to non-residents permitted -*** *Also, Article 24(4) does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.*		
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.	
Note – *Article 24(5) forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital.*		
6	The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.	
Note – *Article 24(6) states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.*		

ART 25 MUTUAL AGREEMENT PROCEDURE

There may be a situation wherein a tax payer may believe that the treatment accorded by either or both Contracting States is not in accordance with the provisions of the tax treaty. In such a case, there is a need for dispute resolution which is addressed by this Article.

The UN Model Convention provides two alternatives - Alternative A and Alternative B, for the article on Mutual Agreement Procedure which was introduced in 2011.

Para	OECD Model Convention 2017	UN Model Convention 2017
		Alternatives A & B
1	Where a person considers that the actions of one or both of the	Where a person considers that the actions of one or both of the Contracting States result or

Para	OECD Model Convention 2017	UN Model Convention 2017
	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 **either Contracting State.** 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.	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.
Note - *Article 25 provides recourse to a taxpayer who feels he has not been or will not be taxed as per the provisions of the tax treaty. Under OECD MC the taxpayer may make a request to either Contracting State while UN MC contemplates taxpayer going to Residence State or the country of his nationality. The remedy under Article 25 is irrespective of those under domestic law and must be invoked within three years from the first notification of the action that gives rise to the grievance.*		
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 the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.	
Note - *When a request is received from a taxpayer, the competent authority shall try to resolve unilaterally at the first stage. If it is not possible then the competent authority of the other Contracting State shall be approached for resolution through mutual agreement. Any decision arrived through such process shall be implemented irrespective of any time limits set by domestic laws.*		
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.	
Note - *The first sentence of this paragraph invites and authorises the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case.* ***Nature of difficulties which can be resolved by mutual agreement -*** *This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not*		

Para	OECD Model Convention 2017	UN Model Convention 2017
only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or impede the normal operation of the clauses of the 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. ***Examples of difficulties which can be resolved by mutual agreement -*** *Under this provision the competent authorities can, in particular:* *(i) where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;* *(ii) where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes;* *(iii) 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).* *(iv) conclude bilateral advance pricing arrangements (APAs) as well as conclude multilateral APAs with competent authorities of third States with which each of the Contracting States has concluded a bilateral tax convention in cases where difficulties or doubts exist as to the interpretation or application of the conventions.* *The second sentence of Article 25(3) enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention*.		
4	The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.	The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. ***The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedures provided for in this article.***
Note - *Article 25(4) of the UN MC consists of two sentences, the first of which reproduces the first sentence of the Article 25(4) of the OECD MC while the second sentence in UN MC, which is not contained in the OECD MC, relates to development of procedures and other matters relating to smooth implementation of MAP.*		

Para	OECD Model Convention 2017	UN Model Convention 2017
Manner of consultation between Competent Authorities – *Article 25(4) determines how the competent authorities may consult together for the resolution by mutual agreement, either of an individual case coming under the procedure defined in Article 25(1)/(2) or of general problems relating in particular to the interpretation or application of the Convention, and which are referred to in Article 25(3).* ***Manner and Mode of communication between Competent Authorities*** *The first sentence of Article 25(4) provides that the competent authorities may communicate with each other directly. It would, therefore, not be necessary to go through diplomatic channels. The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meetings, or any other convenient means. They may, if they wish, formally establish a joint commission for this purpose. As to this joint commission, Article 25(4) leaves it to the competent authorities of the Contracting States to determine the number of members and the rules of procedure of this body.* *The second sentence of Article 25(4) in the UN MC allows the competent authorities to develop bilateral procedures for the implementation of the MAP.*		
5/ 5 (Alt B)	Where, a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within **two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities**, any unresolved issues arising from the case shall be submitted to arbitration if **the person so requests in writing**. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State.	**[Only in Alternative B]** Where, (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within ***three years from the presentation of the case to the competent authority of the other Contracting State***, any unresolved issues arising from the case shall be submitted to arbitration if ***either competent authority so requests. The person who has presented the case shall be notified of the request.*** These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be

Para	OECD Model Convention 2017	UN Model Convention 2017
	Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.	implemented notwithstanding any time limits in the domestic laws of these States ***unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or*** unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

Note - *Paragraph 5, which is only found in Alternative B of the Article of UN MC, provides for mandatory arbitration under which the competent authorities are obliged to submit unresolved issues to arbitration if one of them so requests after they were unable to resolve these issues within a given period of time.*

Paragraph 5 of the UN MC reproduces paragraph 5 of Article 25 of the OECD MC with four differences:

(1) ***Period within which arbitration is to be initiated –*** *Para 5 of UN MC provides that arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within* ***three years*** *from the presentation of that case rather than within* ***two years*** *as provided in the OECD MC.*

(2) ***Person entitled to make a request for arbitration*** *- While the OECD MC provides that arbitration must be requested by* ***the person who initiated the case****, paragraph 5 of Alternative B provides that arbitration must be requested by* ***the competent authority of one of the Contracting States*** *(this means that a case shall not be submitted to arbitration if the competent authorities of both Contracting States consider that such a case is not suitable for arbitration and neither of them make a request).*

(3) ***Departure from the arbitration decision*** *- Paragraph 5 of Alternative B of UN MC, unlike the corresponding provision of the OECD MC, allows the competent authorities to depart from the arbitration decision if they agree on a different solution* ***within six months after the decision has been communicated to them****.*

(4) ***Point of time from which period for initiation of arbitration is to be reckoned*** *- While the OECD MC provides that the two-year period begins* ***when all the information required by the competent authorities in order to address the MAP case has been provided****, paragraph 5 of alternative B of UN MC provides that the three-year period begins with the* ***presentation of the MAP case to the competent authority*** *of the State that did not initially relate it.*

ART 26	EXCHANGE OF INFORMATION

In order to complete tax cases, a country may require certain information which may be available with the treaty partner. Article 26 provides for the information which may be exchanged and the manner in which such a request has to be made. The purpose of Article 26 is to facilitate effective exchange of information between Contracting States.

Para	OECD Model Convention 2017	UN Model Convention 2017
1	The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.	The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws ***of the Contracting States*** concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. ***In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes.*** The exchange of information is not restricted by Articles 1 and 2.

Note - *Article 26 embodies rules under which information may be exchanged to the widest possible extent, both to facilitate proper application of the treaty and to assist the Contracting States in the enforcement of their domestic tax laws. Consequently, the obligation to exchange information under this Article should be interpreted broadly, and the limitations on that obligation should not be extended by analogy beyond their specific meaning.*

Objective - *In particular, the Article should be understood to require the Contracting States to promote an effective exchange of information. From the perspective of many developing countries, Article 26 is particularly important not only for curtailing cross-border tax evasion and avoidance, but also to curtail the capital flight that is often accomplished through such evasion and avoidance.*

Meaning and scope of "Foreseeably relevant" *- The first sentence of Article 26(1) sets forth the basic obligation of the Contracting States concerning the exchange of information. It requires, subject to the limitations of Article 26(3), that the competent authorities exchange such information as is "foreseeably relevant" for the proper application of the Convention or for the administration or enforcement of their domestic tax laws, as long as taxation under those laws is not inconsistent*

Para	OECD Model Convention 2017	UN Model Convention 2017
with the Convention. *The standard of "foreseeably relevant" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information about a particular taxpayer that is highly unlikely to be relevant to the tax affairs of that taxpayer.* ***Scope of information to be exchanged*** *- The information covered by Article 26(1) is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement; for example, they might provide information about risk analysis techniques or tax avoidance or evasion schemes. They may also share information they have obtained about aggressive or abusive tax avoidance schemes. In addition, the competent authorities may exchange information relating to a whole economic sector (e.g. the oil, fishing or pharmaceutical industry, the banking sector, etc.) and not to particular taxpayers.* *The scope of the obligation to exchange information is not limited by Articles 1 or 2. That is, the obligation applies not only with respect to information relevant to the proper application of the Convention or to the administration or enforcement of domestic taxes mentioned in Article 2, but also to all other domestic taxes, including subnational taxes. In this respect, the UN MC and the OECD MC are identical.*		
2	Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.	Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and ***it*** shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes

Para	OECD Model Convention 2017	UN Model Convention 2017
		under the laws of both States and the competent authority of the supplying State authorizes such use.

Note *- A Contracting State cannot be expected to provide confidential financial information to another Contracting State unless it has confidence that the information will not be disclosed to unauthorized persons. The confidentiality rules apply to information provided in a request and information transmitted in response to a request.*

Information to be used only for specified purposes *- In general, the information received by a Contracting State may be used only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for purposes other than those referred to in that paragraph, that State may not use the information for such other purposes without the authorization of the competent authority of the supplying State. That authorization should not be unreasonably withheld.*

Non-disclosure of information to a third country *- Similarly, the information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.*

Conditions for sharing of information received for tax purposes - *The last sentence of paragraph 2, therefore, allows the Contracting States to share information received for tax purposes provided two conditions are met: first, the information may be used for other purposes under the laws of both States and, second, the competent authority of the supplying State authorizes such use.*

It allows the sharing of tax information by the tax authorities of the receiving State with other law enforcement agencies and judicial authorities in that State on certain high priority matters (e.g., to combat money laundering, corruption, terrorism financing). When a receiving State desires to use the information for an additional purpose (i.e. non-tax purpose), the receiving State should specify to the supplying State the other purpose for which it wishes to use the information and confirm that the receiving State can use the information for such other purpose under its laws.

Sharing of information with oversight bodies - *The OECD and UN MCs include a provision that would allow the sharing of information obtained under Article 26 with persons charged with the oversight of the persons allowed to obtain such information. The disclosure should be limited to information necessary for those bodies to fulfil their oversight duties. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. Such sharing is permitted only if the persons engaged in oversight activities are subject to confidentiality requirements at least as strict as those applicable to tax administration and enforcement officials. The competent authorities may want to agree as to the bodies that constitute an oversight body within the meaning of this paragraph.*

3	In no case shall the provisions of paragraphs **1 and 2** 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

Para	OECD Model Convention 2017	UN Model Convention 2017
	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 (*ordre public*).	

Note *- Paragraph 3 of Article 26 contains provisions that limit the obligation of the requested State under paragraph 1. The limitations provided in paragraph 3, however, may be superseded by the provisions contained in paragraphs 4 and 5. The provisions of paragraph 3, read in conjunction with the provisions of paragraphs 4 and 5, should not be read in a way that would prevent an effective exchange of information between the Contracting States. In addition, a Contracting State should disclose to the other Contracting State before it enters into a convention any specific provisions of its laws and administrative practice that it believes entitle it to avoid an obligation otherwise imposed by paragraph 1.*

Effect of restriction placed by internal laws - *Paragraph 3(a), subject to the limitations provided in paragraphs 4 and 5, contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. For example, if a requested State is not permitted under its laws or administrative practice to seize private papers from a taxpayer without court authorization, it is not required to make such a seizure without court authorization on behalf of a requesting State even if the requesting State could make such a seizure without court authorization under its own laws or administrative practice. The purpose of this rule is to prevent Article 26 from creating an unintentional conflict between a Contracting State's obligation under Article 26 and its obligations under domestic law.*

Decline of request to disclose confidential communication and secret information - *In general, a requested State may decline, under paragraph 3(c), to disclose information that constitutes a confidential communication between an attorney, solicitor, or other admitted legal representative in his role as such and his client to the extent that the communication is protected from disclosure under domestic law. However, in no event may a requested State decline to disclose communications between attorneys, solicitors or other admitted legal representatives and their clients, if those persons have themselves participated with their clients in a plan to commit tax evasion or avoidance.*

A trade or business secret or trade process is generally understood to mean information which has considerable economic importance and which can be exploited practically and the unauthorized use of which may lead to serious damage (e.g. may lead to severe financial hardship). The purpose of the secrecy exception is to prevent an exchange of information from imposing unfair hardship on taxpayers by revealing to their competitors or potential competitors valuable secret information and thereby significantly diminishing the commercial value of that information. Secret information that once had substantial commercial value may be disclosed, if that information does not have substantial commercial value at the time the information is requested.

Para	OECD Model Convention 2017	UN Model Convention 2017
4	If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.	
	Note - *According to Article 26(4), a requested State must use its information gathering measures to obtain requested information even though those measures are invoked solely to provide information to the other Contracting State and irrespective of whether the information could still be gathered or used for domestic tax purposes in the requested Contracting State. Thus, for instance, any restrictions on the ability of a requested Contracting State to obtain information from a person for domestic tax purposes at the time of a request (for example, because of the expiration of a statute of limitations under the requested State's domestic law or the prior completion of an audit) must not restrict its ability to use its information gathering measures for information exchange purposes.* ***Meaning of "information gathering measures" -****The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. That is, a requested State does not need to have a domestic tax interest in obtaining the requested information for the obligation to supply information under paragraph 1 to apply.*	
5	In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.	
	Note - *Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries, as well as ownership information.* ***Overriding effect of Paragraph 5*** - *Paragraph 5 states that a requested State shall not decline to supply information to a requesting State solely because the information requested is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of domestic bank secrecy laws. Access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access bank information.* ***Supply of information held by persons acting in fiduciary capacity*** - *Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the*	

Para	OECD Model Convention 2017	UN Model Convention 2017
information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State has a law under which all information held by a fiduciary is treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information held by the fiduciary to the other Contracting State. ***Supply of information relating to ownership interest*** *- Paragraph 5 states that a Contracting State shall not decline to supply information solely because the requested information relates to an ownership interest in a person, which includes companies and partnerships, foundations or similar organizational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.*		
- / 6	-	***The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.***
Note – *Paragraph 6 of UN MC specifically grants to the competent authorities the authority to establish procedures for an effective exchange of information. The OECD MC does not contain paragraph 6 or an equivalent. The position taken in the OECD Commentary is that this authority is implicit in Article 26.* ***Modes of exchanges of information by competent authorities*** *- This language of paragraph 6 of UN MC authorize the competent authorities to exchange information in at least three modes: exchange by specific request, automatic exchange, and other exchanges, understood to include spontaneous exchanges.*		

Resources: The discussion on Model Tax Conventions in the above chapter is essentially based on the text and commentaries of the OECD and UN Model Tax Conventions, 2017 available at the websites http://www.oecd.org/tax/treaties/ and http://www.un.org, respectively.

SUMMARY

	Article	OECD MC *vis-à-vis* UN MC Common paras & Significant differences
		Chapter I : Scope of the Convention
1	**Persons covered**	**Resident of CS -** For application of treaty, a person has to be a resident of one or both of the Contracting States (CSs). **Fiscally transparent entity** - Income derived by or through a fiscally transparent entity under the tax law of either CS to be considered to be income of a resident of a CS, to the extent such income is treated, for purposes of taxation by that State, as the income of a resident of that State.

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<td>Taxes covered</td>
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- **Taxes on income and capital** - The MCs apply to taxes on income and on capital imposed on behalf of a CS or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
- **Coverage of taxes** - Taxes on income and on capital covers:

<table>
<tr><th>Taxes imposed</th><th>Taxes included</th></tr>
<tr>
<td>• On total income
• on total capital
• on elements of income or of capital</td>
<td>• taxes on gains from alienation of movable or immovable property
• taxes on total amounts of wages or salaries paid by enterprises
• taxes on capital appreciation</td>
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<td colspan="2">Chapter II : Definitions</td>
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<td>Resident</td>
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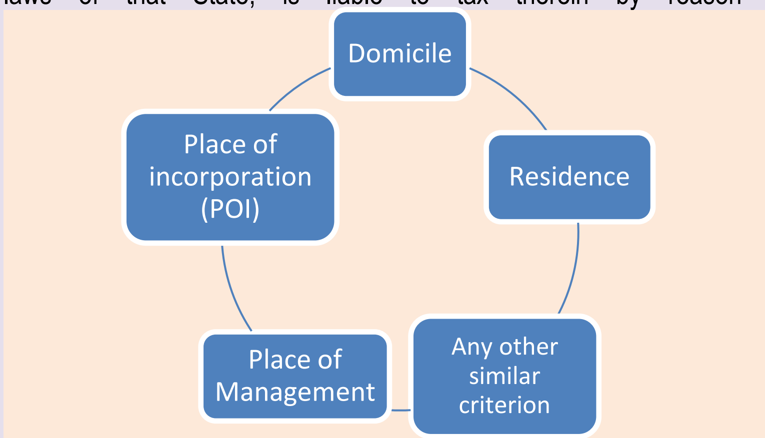
- **Resident of either CS** - A taxpayer has to demonstrate that he is a resident of one or both CSs to be able to gain access to a tax treaty and avail benefits thereunder.
- **Meaning of "Resident of a Contracting State"**- Any person who, under the laws of that State, is liable to tax therein by reason of his:



This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

Note *- OECD MC does not contain reference to place of incorporation*

- **Tie-breaker Rule**

<u>In case of individuals</u>

Where an individual is a resident of both CSs as per domestic tax laws of that CS, then, his residential status shall be determined by applying the tie-breaker rule in the following sequence:

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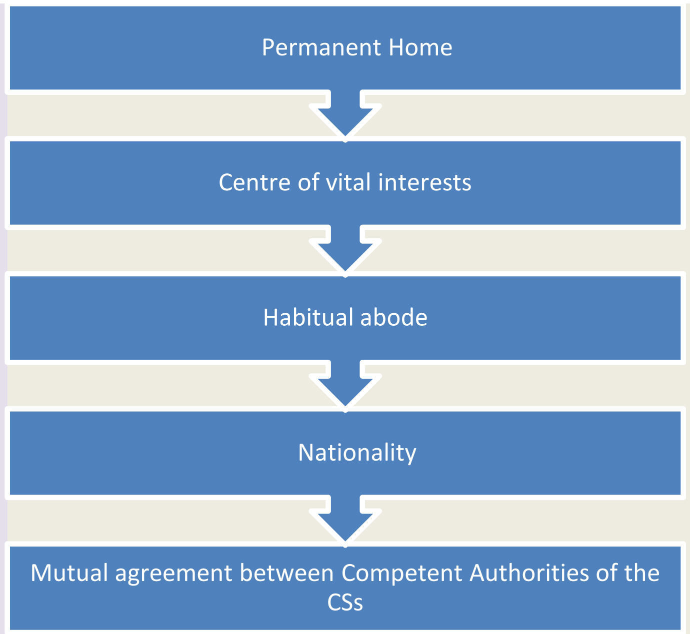
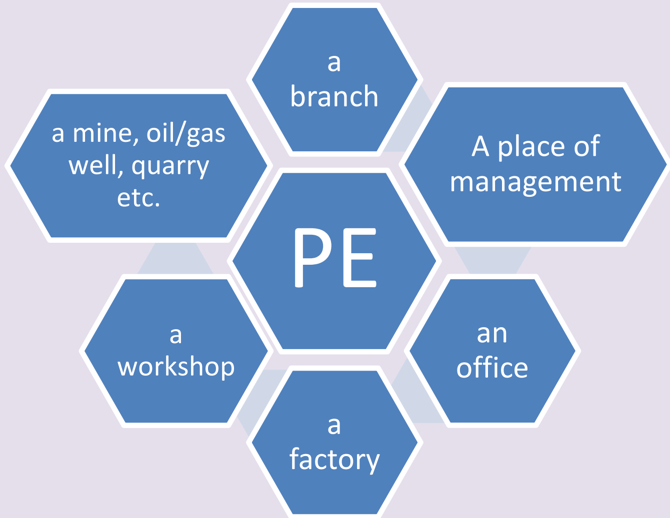
		 **<u>In case of companies</u>** • Dual residence arises where one CS attaches importance to POI and the other CS to the POEM. • The tie-breaker test involves a case by case approach considering the no. of tax avoidance cases involving dual resident Cos. • Request has to be made by the tax payer through Article 25 (MAP). • Competent Authorities will rely on range of factors to resolve the question of dual residency.
5	**Permanent establish-ment (PE)**	**Meaning of PE [Article 5(1)]** • There should be an "**enterprise**" (Entr). • Such Entr should be carrying on a "**business**"; • There should be a "**place of business** (POB)"; • Such place of business (POB) should be at the **disposal of the Entr** (may be owned / rented but must be one which the Entr has the effective power to use); • The POB should be "fixed", i.e., it must be established at a distinct place with a certain **degree of permanence** • The business of the enterprise is carried on wholly or partially through this fixed POB.

A PE does not exist unless all the aforesaid conditions are satisfied.

- **Specific inclusions in the meaning of PE [Article 5(2)]**



- **Expansion of scope of Agency PE**
- Agency PE targets activities done by a dependent agent (DA) of the Entr in the Source State (SS).
- DAPE now includes instances when an agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts routinely concluded without material modification by the enterprise.
- **PE of an Insurance Enterprise**

UN MC	OECD MC
UN MC has an additional Article 5(6) relating to insurance. An insurance Entr of a CS is deemed to have a PE in the other CS if it collects premiums in the territory of that other CS or insures risks situated therein through a person.	In the absence of similar Article in the OECD MC, a PE of an insurance Entr is to be determined in accord with Article 5(1) or 5(2).

Chapter III : Taxation of Income

7 Business profits

- **Right of CS to tax business profits (BPs)**

OECD MC	UN MC
BPs of an Entr can only be taxed by the Residence State **(RS)**. Right of Source State **(SS)** to tax BPs of an enterprise only exists if a PE exists in its jurisdiction.	
Once a PE is proven, the **SS** can tax only such profits	- The attribution principle is amplified by a **<u>limited</u>** Force of Attraction rule (FOA). - The FOA rule implies that when a foreign enterprise sets up a PE in SS, it brings itself within the fiscal jurisdiction of that State to such a degree that profits that the Entr

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<td>as are attributable to the PE</td>
<td>derives therefrom, whether through the PE or not, can be taxed by it (i.e., the SS).
- Accordingly, if the Entr carries on business in the other CS through a PE, the profits of the Entr may be taxed in the other CS but only so much of them as is attributable to:
(a) that PE;
(b) sales in that other CS of goods or merchandise of the same or similar kind as those sold through that PE; or
(c) other business activities carried on in that other State of the same or similar kind as those effected through that PE.</td>
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<td>Interest</td>
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- Right of CSs to tax interest
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<tr><th>Para of Article</th><th>Right of CS to tax interest</th></tr>
<tr><td>1</td><td>Confers the right to RS to tax interest</td></tr>
<tr><td>2</td><td>Confers right to the SS to tax interest.
Generally, interest is taxed in the SS at a given rate on gross basis.
However, if the beneficial owner of the interest is a resident of the other CS, the tax so charged ≤ specified % of the gross interest.
The specified % as per OECD MC is 10%, but the UN MC leaves this % to be established through bilateral negotiations.</td></tr>
</table>
- Definition of interest in OECD & UN MCs - Interest means income from debt claims of every kind,
• whether or not secured by mortgage and
• whether or not carrying a right to participate in the debtor's profits.
- Specific inclusions in the definition of interest as per OECD & UN MCs
• income from govt securities
• income from bonds or debentures
• premiums and prizes attaching to such securities, bonds or debentures.
Note - Interest does not include penalty charges for late payment.
</td>
</tr>
<tr>
<td>12</td>
<td>Royalties
(Roy)</td>
<td>
<table>
<tr><th></th><th>OECD MC</th><th>UN MC</th></tr>
<tr><td>Right of CS to tax Roy. income</td><td>Roy. arising in SS and beneficially owned by resident of the RS is taxable only in RS. Thus, RS has exclusive right to tax royalty income.</td><td>Roy may also be taxed in the SS. However, if the beneficial owner is a resident of the RS, the tax charged by SS ≤ the specified %, (to be established through bilateral negotiations) of gross royalty.</td></tr>
</table>
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</tr>
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<td>
<table>
<tr>
<td>Definition of Roy</td>
<td>Definition of Royalty does not include:
(a) rentals for films/tapes used for radio/ TV broadcasting; and
(b) rentals for industrial, commercial or scientific equipment.</td>
<td>Royalty includes:
(a) rentals for films or tapes used for radio or TV broadcasting and
(b) equipment rentals like rentals for industrial, commercial or scientific equipment.</td>
</tr>
</table>
</td>
</tr>
<tr>
<td>12A</td>
<td>FTS</td>
<td>
In its 2017 update, the UN MC has inserted a specific article pertaining to Fees for Technical Services (FTS). There is no specific reference to FTS in OECD MC.

Right of CS to tax FTS [UN Model]
<table>
<tr><th>Para of Article</th><th>Right of CS to tax FTS</th></tr>
<tr><td>1</td><td>Confers right to the RS to tax FTS. However, does not state that FTS is exclusively taxable in the RS.</td></tr>
<tr><td>2</td><td>Establishes the right of the SS to tax FTS in accordance with its domestic law, subject to limitation on the max. rate of tax, to be established through bilateral negotiations, if the beneficial owner is a resident of the other CS.</td></tr>
</table>
Meaning of FTS [UN Model]
<table>
<tr><td colspan="2">FTS means payments for managerial, technical or consultancy services</td></tr>
<tr><td colspan="2"><u>Exclusions from the meaning of FTS</u>:</td></tr>
<tr><td>i</td><td>payment to an employee</td></tr>
<tr><td>ii</td><td>payment for teaching in an or by an educational institution</td></tr>
<tr><td>iii</td><td>payment by an individual for services for personal use</td></tr>
</table>
</td>
</tr>
<tr>
<td>13</td>
<td>Capital gains</td>
<td>
This Article provides for the taxation of income arising from transfer of a capital asset, including transfer of shares.

Right of CS to tax income from Capital Gains

The right to tax capital gains may be exclusively with the RS, or shared between the RS and SS.
The Article does not specify what is a capital gain and how is to be computed, this being left to the applicable domestic law.

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</table>

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<td></td>
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<td>

The Article contains rules for taxation of gains from alienation of different assets such as immovable property, immovable property forming part of a PE, ships & aircrafts, etc.
In respect of shares, the 2017 OECD and UN MCs are identical. Rights are conferred to the SS if more than 50% of the value of shares during the preceding 365 days is derived from immovable property in such SS.

</td>
</tr>
<tr>
<td>14</td>
<td>Indepen-dent personal services</td>
<td>
This Article present only in the UN MC deals with the taxation of income derived by a person for professional or specified services which are offered in the SS through some presence.
Right of CS to tax income from professional services (IPS) [UN MC]
<table>
<tr>
<td>Right of RS</td>
<td>Income derived by a resident of a CS in respect of professional services or other activities of an independent character is taxable only in the RS.</td>
</tr>
<tr>
<td>Right of SS</td>
<td>In the following circumstances, however, IPS may also be taxed in the other CS (i.e., the SS):
<table>
<tr><th>Circumstance</th><th>Extent of income taxable in SS</th></tr>
<tr><td>If he has a fixed base regularly available to him in the SS for the purpose of performing his activities</td><td>Only so much of the income as is attributable to that fixed base may be taxed in the SS.</td></tr>
<tr><td>If his stay in the SS is for a period > 183 days in any 12 month period commencing or ending in the fiscal year concerned</td><td>Only so much of the income as is derived from his activities performed in the SS may be taxed in that State</td></tr>
</table>
</td>
</tr>
</table>
Definition of “Professional Services” [UN MC]
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.
Note – OECD MC does not contain a separate article on IPS. The same is dealt with as “Business Profits (Article 7)” under the OECD MC.
</td>
</tr>
<tr>
<td>21</td>
<td>Other income (OI)</td>
<td>
This Article deals with taxation of items of income which are not specifically taxable under any other specific Article [i.e., upto Article 20].
<table>
<tr><th></th><th>OECD MC</th><th>UN MC</th></tr>
<tr><td>Right to tax OI</td><td>Exclusive right to tax is with the RS.</td><td>Contains an additional para, Article 21(3), which provides that SS may also tax other income</td></tr>
</table>
</td>
</tr>
</table>

		Right to tax income [other than income from immovable property] effectively connected with PE	Article 21(2) of both OECD and UN MC provides that for income effectively connected with a PE maintained in a CS by a resident of the other CS, taxation is governed by the provisions of Article 7 (Business Profits). Additionally, UN Model provides that if the aforesaid income is effectively connected with a fixed base situated in a CS by a resident of the other CS, taxation would be governed by the provisions of Article 14 (IPS).
	Chapter V : Methods for the Elimination of Double Taxation		
23A/ 23B	**Exemption method/ Credit Method**	In many cases, the application of tax treaty may result into double taxation (DT) for tax payers. In such a case, Articles 23A and 23B provide for the mechanism through which tax credit/exemption may be available in the RS for taxes deducted in the SS.	

- **Two approaches for elimination of DT under MCs**:

Exemption method (Article 23A)	Credit method (Article 23B)
Tax exemption may be available in the RS for taxes deducted in the SS.	Tax credit may be available in the RS for taxes deducted in the SS.

These methods are not mutually exclusive and there may be cases where a treaty may adopt exemption method for certain types of income and credit method for other incomes.

- **Juridical DT and Economic DT:**

	Juridical DT	Economic DT
Meaning	The same income or capital is taxable in the hands of the same person by more than one State	Two different persons are taxable in respect of the same income or capital
Example	FTS may be taxable in the hands of the recipient both in the RS as well as in SS, based on the domestic laws of the CSs.	In respect of dividend distributed by a Co., DDT may be payable by the Co. in SS, whereas the dividend may be taxable in the hands of the shareholder of the other CS, on the basis of his residence.
Type of DT addressed by Article 23A & 23B	Articles 23A & 23B address Juridical DT.	The Articles do not address Economic DT. If two States wish to solve problems of economic DT, they must do so in bilateral negotiations.

	Chapter VI : Special Provisions	
25	**Mutual agreement procedure (MAP)**	Where a tax payer believes that the treatment accorded by either or both CSs is not in accordance with the provisions of the tax treaty, this Article provides for dispute resolution through bilateral negotiations between competent authorities (CAS) of both CSs.

	OECD MC	**UN MC**
Request for MAP	The taxpayer may make a request to either CS	**Alternative A** - Taxpayer has to approach RS or the country of his nationality **Alternative B** - Reference to an arbitration process as part of MAP. The decision arrived at through the process is binding unless a person directly affected does not accept it.
Time limit	Stipulates a time limit of 2 years from the date when all the information required by the CAS in order to address the case need to be provided to both CAS.	An arbitration may be initiated if the competent authorities (CAS) are unable to reach an agreement on a case within 3 years from presentation of that case [Alternative B]
Who can request for Arbitration?	Arbitration must be requested in writing by the person who initiated the case	Arbitration must be requested by the CAS of one of the CS. Once such a request is made, the taxpayer will be notified [Alternative B]
Departure from arbitration by CAS	No specific provision for departure from arbitration.	The CAS may depart from the arbitration decision if they agree to do so within 6 months after the decision has been communicated to them [Alternative B]

26 **Exchange of information (EOI)**

Purpose of Article 26

In order to complete tax cases, a country may require certain info which may be available with the treaty partner.

Article 26 provides for:

- the info which may be exchanged

- the manner in which such a request has to be made.

Importance of Article 26:

- facilitates effective exchange of information between CSs.
- curtails cross-border tax evasion and avoidance,
- curtails the capital flight that is often accomplished through tax evasion & avoidance. This is particularly relevant in the perspective of developing countries.

Similar provisions contained in OECD and UN MCs

- A CS cannot be expected to provide confidential financial info to another CS unless it has confidence that the info will not be disclosed to unauthorized persons.
- A CS can avoid the EOI obligations by showing that the info pertains to communication between an attorney and his client which is protected from disclosure under domestic law.
- Lack of interest or use in such info cannot, however, form the basis for a CS to not co-operate with the EOI obligations.

ANNEXURES

ANNEXURE – 1:	Rule 11UB - Fair market value of assets in certain cases and Rule 11UC - Determination of Income attributable to assets in India
ANNEXURE – 2:	Rule 115 - Rate of exchange for conversion into rupees of income expressed in foreign currency and Rule 26 - Rate of exchange for the purpose of deduction of tax at source on income payable in foreign currency
ANNEXURE – 3:	Rule 37BB - Furnishing of information for payment to a non-resident, not being a company, or to a foreign company
ANNEXURE – 4:	Rule 114DB - Information or documents to be furnished under section 285A
ANNEXURE – 5:	Rule 128 - Foreign Tax Credit
ANNEXURE – 6:	Press Note dated 20th September, 2019.

ANNEXURE – 1

Rule 11UB - Fair market value of assets in certain cases

(1) The fair market value of asset, tangible or intangible, as on the specified date, held directly or indirectly by a company or an entity registered or incorporated outside India (hereafter referred to as "foreign company or entity"), for the purposes of clause (i) of sub-section (1) of section 9, shall be computed in accordance with the provisions of this rule.

(2) Where the asset is a share of an Indian company listed on a recognised stock exchange on the specified date, the fair market value of the share shall be the observable price of such share on the stock exchange:

> **Provided** *that where the share is held as part of the shareholding which confers, directly or indirectly, any right of management or control in relation to the aforesaid company, the fair market value of the share shall be determined in accordance with the following formula, namely:—*
>
> Fair market value = (A+B)/C
>
> Where;
>
> A = the market capitalisation of the company on the basis of observable price of its shares quoted on the recognised stock exchange;
>
> B = the book value of liabilities of the company as on the specified date;
>
> C = the total number of outstanding shares :
>
> **Provided further** *that where, on the specified date, the share is listed on more than one recognised stock exchange, the observable price of the share shall be computed with reference to the recognised stock exchange which records the highest volume of trading in the share during the period considered for determining the price.*

(3) Where the asset is a share of an Indian company not listed on a recognised stock exchange on the specified date, the fair market value of the share shall be its fair market value on such date as determined by a merchant banker or an accountant in accordance with any internationally accepted valuation methodology for valuation of shares on arm's length basis as increased by the liability, if any, considered in such determination.

(4) Where the asset is an interest in a partnership firm or an association of persons, its fair market value shall be determined in the following manner, namely:—

- *(i)* *the value on the specified date of such firm or association of persons, shall be determined by a merchant banker or an accountant in accordance with any internationally accepted valuation methodology as increased by the liability, if any, considered in such determination;*
- *(ii)* *the portion of the value computed in clause (i) as is equal to the amount of its capital shall be allocated among its partners or members in the proportion in which capital has been contributed by them and the residue of the value shall be allocated among the partners or members in accordance with the agreement of partnership firm or association of persons for distribution of assets in the event of dissolution of the firm or association, or, in the absence of any such agreement, in the proportion in which the partners or members are entitled to share profits and the sum total of the amount so allocated to a partner or member shall be*

treated as the fair market value of the interest of that partner or member in the firm or the association of persons, as the case may be.

(5) The fair market value of the asset other than those referred to in sub-rules (2), (3) and (4) shall be the price it would fetch if sold in the open market on the specified date as determined by a merchant banker or an accountant as increased by the liability, if any, considered in such determination.

(6) The fair market value of all the assets of a foreign company or an entity shall be determined in the following manner, namely:—

(i) where the transfer of share of, or interest in, the foreign company or entity is between the persons who are not connected persons, the fair market value of all the assets owned by the foreign company or the entity as on the specified date, for the purpose of such transfer, shall be determined in accordance with the following formula, namely:—

Fair market value of all assets = A+B

Where;

A = Market capitalisation of the foreign company or entity computed on the basis of the full value of consideration for transfer of the share or interest;

B = Book value of the liabilities of the company or the entity as on the specified date as certified by a merchant banker or an accountant;

(ii) in any other case, if, —

(a) the share of the foreign company or entity is listed on a stock exchange on the specified date, the fair market value of all the assets owned by the foreign company or the entity shall be determined in accordance with the following formula, namely:—

Fair market value of all the assets = A + B

Where;

A = Market capitalisation of the foreign company or entity computed on the basis of the observable price of the share on the stock exchange where the share of the foreign company or the entity is listed;

B = book value of the liabilities of the company or the entity as on the specified date:

Provided *that where, as on the specified date, the share is listed on more than one stock exchange, the observable price in the aforesaid formula shall be in respect of the stock exchange which records the highest volume of trading in the share during the period considered for determining the price;*

(b) the share in the foreign company or entity is not listed on a stock exchange on the specified date, the value of all the assets owned by the foreign company or the entity shall be determined in accordance with the following formula, namely:—

Fair market value of all the assets = A+ B

Where;

A = fair market value of the foreign company or the entity as on the specified date as determined by a merchant banker or an accountant as per the internationally *accepted valuation methodology;*

B = value of liabilities of the company or the entity if any, considered for the determination of fair market value in A.

*(7) Where fair market value has been determined on the basis of any interim balance sheet referred to in the first proviso to clause (*ix*) of the* Explanation*, then the fair market value shall be appropriately modified after finalisation of the relevant financial statement in accordance with the applicable laws and all the provisions of this rule and rules 11UC and 114DB shall apply accordingly.*

(8) For determining the fair market value of any asset located in India, being a share of an Indian company or interest in a partnership firm or association of persons, all the assets and business operations of the said company or partnership firm or association of persons shall be taken into account irrespective of whether the assets or business operations are located in India or outside.

(9) The rate of exchange for the calculation in foreign currency, of the value of assets located in India and expressed in rupees shall be the telegraphic transfer buying rate of such currency as on the specified date.

Explanation: *For the purposes of this rule and rule 11UC,—*

(i) "accountant" means an accountant referred to in the Explanation *to sub-section (2) of section 288 and for the purposes of sub-rule (6) includes any valuer recognised for undertaking similar valuation by the Government of the country where the foreign company or the entity is registered or incorporated or any of its agencies, who fulfils the following conditions, namely:—*

(a) if he is a member or partner in any entity engaged in rendering accountancy or valuation services then,—

(i) the entity or its affiliates has presence in more than two countries; and

(ii) the annual receipt of the entity in the year preceding the year in which valuation is undertaken exceeds ten crore rupees;

(b) if he is pursuing the profession of accountancy individually or is a valuer then,—

(i) his annual receipt in the year preceding the year in which valuation is undertaken, from the exercise of profession, exceeds one crore rupees; and

(ii) he has professional experience of not less than ten years.

(ii) "connected person" shall have the meaning as assigned to it in clause (4) of section 102;

(iii) "right of management or control" shall include the right to appoint majority of the directors or to control the management or policy decision exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner;

(iv) "telegraphic transfer buying rate" shall have the meaning as assigned to it in the Explanation to rule 26;

(v) "observable price" in respect of a share quoted on a stock exchange shall be the higher of the following:—

(a) *the average of the weekly high and low of the closing prices of the shares quoted on the said stock exchange during the six months period preceding the specified date; or*

(b) *the average of the weekly high and low of the closing price of the shares quoted on the said stock exchange during the two weeks preceding the specified date;*

(vi) *"book value of the liabilities" means the value of liabilities as shown in the balance-sheet of the company or the entity as the case may be, excluding the paid-up capital in respect of equity shares or members' interest and the general reserves and surplus and security premium related to the paid up capital;*

(vii) *"specified date" shall have the meaning as assigned to it in clause* (d) *of* Explanation *6 to clause* (i) *of sub-section (1) of section 9;*

(viii) *the terms "merchant banker" and "recognised stock exchange" shall have the meaning as assigned to them in rule 11U;*

(ix) *"balance sheet",—*

(a) *in relation to an Indian company, means the balance-sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn up on the specified date which has been audited by the auditor of the company appointed under the laws relating to companies in force; and*

(b) *in any other case, means the balance-sheet of the company or the entity (including the notes annexed thereto and forming part of the accounts) as drawn up on the specified date and submitted to the relevant authority outside India under the laws in force of the country in which the foreign company or the entity is registered or incorporated:*

Provided *that where the balance-sheet as on the specified date is not drawn up, pending finalisation of accounts, as mentioned in clauses* (a) *and* (b)*, the balance-sheet shall mean an interim balance-sheet drawn up as on the specified date and approved by the board of directors of the company or an equivalent body in case of any other entity:*

Provided further *that where the specified date is the date referred to in sub-clause (ii) of clause* (d) *of Explanation 6 to clause (i) of sub-section (1) of section 9, the balance-sheet means the balance-sheet as drawn up on the specified date and certified by an accountant.*

Rule 11UC- Determination of Income attributable to assets in India.

(1) The income from transfer outside India of a share of, or interest in, a company or an entity referred to in clause (i) of sub-section (1) of section 9, attributable to assets located in India, shall be determined in accordance with the following formula, namely:—

$$A \times \frac{B}{C}$$

Where;

A = Income from the transfer of share of, or interest in, the company or the entity computed *in accordance with the provisions of the Act, as if, such share or interest is located in India;*

B = Fair Market Value of assets located in India as on the specified date, from which the share or interest referred to in A derives its value substantially, computed in accordance with rule 11UB;

C = Fair Market Value of all the assets of the company or the entity as on the specified date, computed in accordance with rule 11UB:

Provided *that if the transferor of the share of, or interest in, the company or the entity fails to provide the information required for the application of the aforesaid formula then the income from the transfer of such share or interest attributable to the assets located in India shall be determined in such manner as the Assessing Officer may deem suitable.*

(2) The transferor of the share of, or interest in, a company or an entity that derives its value substantially from assets located in India, shall obtain and furnish along with the return of income a report in Form No.3CT duly signed and verified by an accountant providing the basis of the apportionment in accordance with the formula and certifying that the income attributable to assets located in India has been correctly computed.

ANNEXURE – 2

Rule 115 - Rate of exchange for conversion into rupees of income expressed in foreign currency

(1) The rate of exchange for the calculation of the value in rupees of any income accruing or arising or deemed to accrue or arise to the assessee in foreign currency or received or deemed to be received by him or on his behalf in foreign currency shall be the telegraphic transfer buying rate of such currency as on the specified date.

Explanation: For the purposes of this rule,—

(*1*) "telegraphic transfer buying rate" shall have the same meaning as in the *Explanation* to rule 26;

(*2*) "specified date" means—

(*a*) in respect of income chargeable under the head "Salaries", the last day of the month immediately preceding the month in which the salary is due, or is paid in advance or in arrears;

(*b*) in respect of income by way of "interest on securities", the last day of the month immediately preceding the month in which the income is due;

(*c*) in respect of income chargeable under the heads "Income from house property", "Profits and gains of business or profession" not being income referred to in clause (*d*) and "Income from other sources" (not being income by way of dividends and "Interest on securities"), the last day of the previous year of the assessee;

(*d*) in respect of income chargeable under the head "Profits and gains of business or profession" in the case of a non-resident engaged in the business of operation of ships, the last day of the month immediately preceding the month in which such income is deemed to accrue or arise in India ;

(*e*) in respect of income by way of dividends, the last day of the month immediately preceding the month in which the dividend is declared, distributed or paid by the company;

(*f*) in respect of income chargeable under the head "Capital gains", the last day of the month immediately preceding the month in which the capital asset is transferred :

Provided that the specified date, in respect of income referred to in sub-clauses (*a*) to (*f*) payable in foreign currency and from which tax has been deducted at source under rule 26, shall be the date on which the tax was required to be deducted under the provisions of the Chapter XVII-B.

(2) Nothing contained in sub-rule (1) shall apply in respect of income referred to in clause (*c*) of the *Explanation* to sub-rule (1) where such income is received in, or brought into India by the assessee or on his behalf before the specified date in accordance with the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973).

Rule 26 - Rate of exchange for the purpose of deduction of tax at source on income payable in foreign currency

For the purpose of deduction of tax at source on any income payable in foreign currency, the rate of exchange for the calculation of the value in rupees of such income payable to an assessee outside India shall be the telegraphic transfer buying rate of such currency as on the date on which the tax is required to be deducted at source under the provisions of Chapter XVIIB by the person responsible for paying such income.

Explanation : For the purposes of this rule, "telegraphic transfer buying rate", in relation to a foreign currency, means [the rate or rates of exchange] adopted by the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), for buying such currency, having regard to the guidelines specified from time to time by the Reserve Bank of India for buying such currency, where such currency is made available to that bank through a telegraphic transfer.

ANNEXURE – 3

Rule 37BB - Furnishing of information for payment to a non-resident, not being a company, or to a foreign company.

(1) The person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum chargeable under the provisions of the Act, shall furnish the following, namely:—

(i) *the information in Part A of Form No.15CA, if the amount of payment or the aggregate of such payments, as the case may be, made during the financial year does not exceed five lakh rupees;*

(ii) *for payments other than the payments referred in clause (i), the information,—*

(a) *in Part B of Form No.15CA after obtaining,—*

(I) a certificate from the Assessing Officer under section 197; or

(II) an order from the Assessing Officer under sub-section (2) or sub-section (3) of section 195;

(b) *in Part C of Form No.15CA after obtaining a certificate in Form No. 15CB from an accountant as defined in the* Explanation *below sub-section (2) of section 288.*

(2) The person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum which is not chargeable under the provisions of the Act, shall furnish the information in Part D of Form No.15CA.

(3) Notwithstanding anything contained in sub-rule (2), no information is required to be furnished for any sum which is not chargeable under the provisions of the Act, if,—

(i) *the remittance is made by an individual and it does not require prior approval of Reserve Bank of India as per the provisions of section 5 of the Foreign Exchange Management Act, 1999 (42 of 1999) read with Schedule III to the Foreign Exchange (Current Account Transaction) Rules, 2000; or*

(ii) *the remittance is of the nature specified in column (3) of the specified list below:*

SPECIFIED LIST

Sl. No.	*Purpose code as per RBI*	*Nature of payment*
(1)	*(2)*	*(3)*
1	*S0001*	*Indian investment abroad - in equity capital (shares)*
2	*S0002*	*Indian investment abroad - in debt securities*
3	*S0003*	*Indian investment abroad - in branches and wholly owned subsidiaries*
4	*S0004*	*Indian investment abroad - in subsidiaries and associates*
5	*S0005*	*Indian investment abroad - in real estate*
6	*S0011*	*Loans extended to Non-Residents*
7	*S0101*	*Advance payment against imports*
8	*S0102*	*Payment towards imports - settlement of invoice*
9	*S0103*	*Imports by diplomatic missions*
10	*S0104*	*Intermediary trade*
11	*S0190*	*Imports below Rs.5,00,000 - (For use by ECD offices)*
12	*SO202*	*Payment for operating expenses of Indian shipping companies operating abroad*
13	*SO208*	*Operating expenses of Indian Airlines companies operating abroad*
14	*S0212*	*Booking of passages abroad - Airlines companies*
15	*S0301*	*Remittance towards business travel*
16	*S0302*	*Travel under basic travel quota (BTQ)*
17	*S0303*	*Travel for pilgrimage*
18	*S0304*	*Travel for medical treatment*
19	*S0305*	*Travel for education (including fees, hostel expenses etc.)*

20	S0401	*Postal services*
21	S0501	*Construction of projects abroad by Indian companies including import of goods at project site*
22	S0602	*Freight insurance - relating to import and export of goods*
23	S1011	*Payments for maintenance of offices abroad*
24	S1201	*Maintenance of Indian embassies abroad*
25	S1202	*Remittances by foreign embassies in India*
26	S1301	*Remittance by non-residents towards family maintenance and savings*
27	S1302	*Remittance towards personal gifts and donations*
28	S1303	*Remittance towards donations to religious and charitable institutions abroad*
29	S1304	*Remittance towards grants and donations to other Governments and charitable institutions established by the Governments*
30	S1305	*Contributions or donations by the Government to international institutions*
31	S1306	*Remittance towards payment or refund of taxes*
32	S1501	*Refunds or rebates or reduction in invoice value on account of exports*
33	S1503	*Payments by residents for international bidding.*

(4) The information in Form No. 15CA shall be furnished,—

(i) electronically under digital signature in accordance with the procedures, formats and standards specified by the Principal Director General of Income-tax (Systems) under sub-rule (8) and thereafter printout of the said form shall be submitted to the authorised dealer, prior to remitting the payment; or

(ii) electronically in accordance with the procedures, formats and standards specified by the Principal Director General of Income-tax (Systems) under sub-rule (8) and thereafter signed printout of the said form shall be submitted to the authorised dealer, prior to remitting the payment.

(5) An income-tax authority may require the authorised dealer to furnish the signed printout of Form No.15CA referred to in clause (ii) of sub-rule (4) for the purposes of any proceedings under the Act.

(6) The certificate in Form No. 15CB shall be furnished and verified electronically in accordance with the procedures, formats and standards specified by the Principal Director-General of Income-tax (Systems) under sub-rule (8).

(7) The authorised dealer shall furnish a quarterly statement for each quarter of the financial year in Form No.15CC to the Principal Director General of Income-tax (Systems) or the person authorised by the Principal Director General of Income-tax (Systems) electronically under digital signature within fifteen days from the end of the quarter of the financial year to which such statement relates in accordance with the procedures, formats and standards specified by the Principal Director General of Income-tax (Systems) under sub-rule (8).

(8) The Principal Director General of Income-tax (Systems) shall specify the procedures, formats and standards for the purposes of furnishing and verification of Form 15CA, Form 15CB and Form 15CC and shall be responsible for the day-to-day administration in relation to the furnishing and verification of information, certificate and quarterly statement in accordance with the provisions of sub-rules (4), (6) and (7).

Explanation.— *For the purposes of this rule 'authorised dealer' means a person authorised as an authorised dealer under sub-section (1) of section 10 of the Foreign Exchange Management Act, 1999 (42 of 1999).*

ANNEXURE – 4

Rule 114DB - Information or documents to be furnished under section 285A

(1) Every Indian concern referred to in section 285A shall, for the purposes of the said section, maintain and furnish the information and documents in accordance with this rule.

(2) The information shall be furnished in Form No.49D electronically under digital signature to the Assessing Officer having jurisdiction over the Indian concern within a period of ninety days from the end of the financial year in which any transfer of the share of, or interest in, a company or entity incorporated outside India (hereafter referred to as "foreign company or entity") referred to in Explanation 5 to clause (i) of sub-section (1) of section 9 has taken place:

Provided *that where the transaction in respect of the share or the interest has the effect of directly or indirectly transferring the rights of management or control in relation to the Indian concern, the information shall be furnished in the said Form within ninety days of the transaction.*

(3) The Indian concern shall maintain the following along with its english translation, if the documents originally prepared are in foreign languages and produce the same when called upon to do so by any income-tax authority in the course of any proceeding to substantiate the information furnished under sub-rule (2), namely:—

(i) details of the immediate holding company or entity, intermediate holding company or companies or entity or entities and ultimate holding company or entity of the Indian concern;

(ii) details of other entities in India of the group of which the Indian concern is a constituent;

(iii) the holding structure of the shares of, or the interest in, the foreign company or entity before and after the transfer;

(iv) any transfer contract or agreement entered into in respect of the share of, or interest in, any foreign company or entity that holds any asset in India through, or in, the Indian concern;

(v) financial and accounting statements of the foreign company or entity which directly or indirectly holds the assets in India through, or in, the Indian concern for two years prior to the date of transfer of the share or interest;

(vi) information relating to the decision or implementation process of the overall arrangement of the transfer;

(vii) information in respect of the foreign company or entity and its subsidiaries, relating to,—

(a) the business operation;

(b) personnel;

(c) finance and properties;

(d) internal and external audit or the valuation report, if any, forming basis of the consideration in respect of shares, or the interest;

(viii) the asset valuation report and other supporting evidence to determine the place of location of the share or interest being transferred;

(ix) the details of payment of tax outside India, which relates to the transfer of the share or interest;

(x) the valuation report in respect of Indian asset and total assets duly certified by a merchant banker or accountant with supporting evidence;

(xi) documents which are issued in connection with the transactions under the accounting practice followed.

(4) Where there are more than one Indian concerns that are constituent entities of a group, the information may be furnished by any one Indian concern, if,—

(i) the group has designated such Indian concern to furnish information on behalf of all other Indian concerns that are constituent of the group, and

(ii) the information regarding the designated Indian concern has been conveyed in writing on behalf of the group to the Assessing Officer:

Provided *that nothing contained in this sub-rule shall have effect if the designated Indian concern fails to furnish the information in accordance with the provisions of this rule.*

(5) The Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems), as the case may be, shall specify the procedure for electronically filing of Form No.49D and shall also be responsible for evolving and implementing appropriate security, archival and retrieval policies in relation to the information so furnished under this rule.

(6) The information and documents specified in sub-rule (3) shall be kept and maintained for a period of eight years from the end of relevant assessment year.

Explanation: For the purposes of this rule,—

(i) "constituent entity" shall have the meaning as assigned to it in clause (d) of sub-section (9) of section 286;

(ii) "group" shall have the meaning as assigned to it in clause (e) of sub-section (9) of section 286;

(iii) "intermediate holding company or entity" means a company or an entity that has controlling interest in another company or entity and is itself controlled by, or is subsidiary of, another company or entity;

(iv) "immediate holding company or entity" means the company or the entity that directly maintains the controlling interest in the Indian concern;

(v) "ultimate holding company or entity" means a company or an entity that has ultimate control of the Indian concern directly or indirectly and such company or entity is not itself controlled by, or is subsidiary of, any other company or entity.

ANNEXURE – 5

Rule 128 - Foreign Tax Credit

(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule :

Provided *that in a case where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.*

(2) The foreign tax referred to in sub-rule (1) shall mean,—

- *(a) in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A, the tax covered under the said agreement;*
- *(b) in respect of any other country or specified territory outside India, the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in clause (iv) of the* Explanation *to section 91.*

(3) The credit under sub-rule (1) shall be available against the amount of tax, surcharge and cess payable under the Act but not in respect of any sum payable by way of interest, fee or penalty.

(4) No credit under sub-rule (1) shall be available in respect of any amount of foreign tax or part thereof which is disputed in any manner by the assessee:

Provided *that the credit of such disputed tax shall be allowed for the year in which such income is offered to tax or assessed to tax in India if the assessee within six months from the end of the month in which the dispute is finally settled, furnishes evidence of settlement of dispute and an evidence to the effect that the liability for payment of such foreign tax has been discharged by him and furnishes an undertaking that no refund in respect of such amount has directly or indirectly been claimed or shall be claimed.*

(5) The credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:—

- *(i) the credit shall be the lower of the tax payable under the Act on such income and the foreign tax paid on such income :*

  Provided *that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess shall be ignored for the purposes of this clause;*
- *(ii) the credit shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.*

(6) In a case where any tax is payable under the provisions of section 115JB or section 115JC, the credit of foreign tax shall be allowed against such tax in the same manner as is allowable against any

tax payable under the provisions of the Act other than the provisions of the said sections (hereafter referred to as the "normal provisions").

(7) Where the amount of foreign tax credit available against the tax payable under the provisions of section 115JB or section 115JC exceeds the amount of tax credit available against the normal provisions, then while computing the amount of credit under section 115JAA or section 115JD in respect of the taxes paid under section 115JB or section 115JC, as the case may be, such excess shall be ignored.

(8) Credit of any foreign tax shall be allowed on furnishing the following documents by the assessee, namely:—

- *(i) a statement of income from the country or specified territory outside India offered for tax for the previous year and of foreign tax deducted or paid on such income in Form No.67 and verified in the manner specified therein;*
- *(ii) certificate or statement specifying the nature of income and the amount of tax deducted therefrom or paid by the assessee,—*
  - *(a) from the tax authority of the country or the specified territory outside India; or*
  - *(b) from the person responsible for deduction of such tax; or*
  - *(c) signed by the assessee:*

    Provided *that the statement furnished by the assessee in clause (c) shall be valid if it is accompanied by,—*

    - *(A) an acknowledgement of online payment or bank counter foil or challan for payment of tax where the payment has been made by the assessee;*
    - *(B) proof of deduction where the tax has been deducted.*

(9) The statement in Form No.67 referred to in clause (i) of sub-rule (8) and the certificate or the statement referred to in clause (ii) of sub-rule (8) shall be furnished on or before the due date specified for furnishing the return of income under sub-section (1) of section 139, in the manner specified for furnishing such return of income.

(10) Form No.67 shall also be furnished in a case where the carry backward of loss of the current year results in refund of foreign tax for which credit has been claimed in any earlier previous year or years.

Explanation.—For the purposes of this rule 'telegraphic transfer buying rate' shall have the same meaning as assigned to it in Explanation to rule 26.

ANNEXURE – 6

Press Note dated 20th September, 2019

The Government has brought in the Taxation Laws (Amendment) Ordinance 2019 to make certain amendments in the Income-tax Act 1961 and the Finance (No. 2) Act 2019. This was announced by the Union Minister for Finance & Corporate Affairs Smt Nirmala Sitaraman during the Press Conference in Goa today. The Finance Minister elaborated further , the salient features of these amendments , which are as under:-

a. In order to promote growth and investment, a new provision has been inserted in the Income-tax Act with effect from FY 2019-20 which allows any domestic company an option to pay income-tax at the rate of 22% subject to condition that they will not avail any exemption/incentive. The effective tax rate for these companies shall be 25.17% inclusive of surcharge & cess. Also, such companies shall not be required to pay Minimum Alternate Tax.

b. In order to attract fresh investment in manufacturing and thereby provide boost to 'Make-in-India' initiative of the Government, another new provision has been inserted in the Income-tax Act with effect from FY 2019-20 which allows any new domestic company incorporated on or after 1st October 2019 making fresh investment in manufacturing, an option to pay income-tax at the rate of 15%. This benefit is available to companies which do not avail any exemption/incentive and commences their production on or before 31st March, 2023. The effective tax rate for these companies shall be 17.01% inclusive of surcharge & cess. Also, such companies shall not be required to pay Minimum Alternate Tax.

c. A company which does not opt for the concessional tax regime and avails the tax exemption/incentive shall continue to pay tax at the pre-amended rate. However, these companies can opt for the concessional tax regime after expiry of their tax holiday/exemption period. After the exercise of the option they shall be liable to pay tax at the rate of 22% and option once exercised cannot be subsequently withdrawn. Further, in order to provide relief to companies which continue to avail exemptions/incentives, the rate of Minimum Alternate Tax has been reduced from existing 18.5% to 15%.

d. In order to stabilise the flow of funds into the capital market, it is provided that enhanced surcharge introduced by the Finance (No.2) Act, 2019 shall not apply on capital gains arising on sale of equity share in a company or a unit of an equity oriented fund or a unit of a business trust liable for securities transaction tax, in the hands of an individual, HUF, AOP, BOI and AJP.

e. The enhanced surcharge shall also not apply to capital gains arising on sale of any security including derivatives, in the hands of Foreign Portfolio Investors (FPIs).

f. In order to provide relief to listed companies which have already made a public announcement of buy-back before 5th July 2019, it is provided that tax on buy-back of shares in case of such companies shall not be charged.

g. The Government has also decided to expand the scope of CSR 2 percent spending. Now CSR 2% fund can be spent on incubators funded by Central or State Government or any agency or Public Sector Undertaking of Central or State Government, and, making contributions to public funded Universities, IITs, National Laboratories and Autonomous Bodies (established under the auspices of ICAR, ICMR, CSIR, DAE, DRDO, DST, Ministry of Electronics and Information Technology) engaged in conducting research in science, technology, engineering and medicine aimed at promoting SDGs.

The total revenue foregone for the reduction in corporate tax rate and other relief estimated at Rs. 1,45,000 crore.