

## Double Taxation Avoidance Agreements – A Brief Overview

Fiscal jurisdiction is often the most aggressively guarded jurisdiction of any nation. As a consequence, even in times when economies are going global and borders fading, leading to liquid movement of goods, services and capital, double taxation is still one of the major obstacles to the development of inter-country economic relations. Nations are often forced to negotiate and accommodate the claims of other nations within their heavily guarded fiscal jurisdiction by the means of double taxation avoidance agreements, in order to bring down the barriers to international trade.

The Fiscal Committee of OECD in the Model Double Taxation Convention on Income and Capital, 1977, defines 'the phenomenon of international juridical double taxation' as 'the imposition of comparable taxes in two or more states on the same tax payer in respect of the same subject matter and for identical periods'. Therefore, the basic cause of international multiple taxation is the exercise by sovereign states of their inherent right to levy tax extra-territorially. Most of the countries subject their residents to tax, on the basis of 'personal jurisdiction', on their global income including income arising or having its source in foreign countries.

Double tax treaties comprise of agreements between two countries, which, by eliminating international double taxation, promote exchange of goods, persons, services and investment of capital. These are bilateral economic agreements where the countries concerned evaluate the sacrifices and advantages which the treaty brings for each contracting state, including tax forgone and compensating economic advantages.

The interaction of two tax systems each belonging to different country, can result in double taxation. Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of taxable entity, maintenance of Permanent Establishment and so on. Double Taxation of the same income in the hands of same entity would give rise to harsh consequences and impair economic development. Double Taxation Agreements between two countries therefore aim at eliminating or mitigating the incidence of double taxation.

In this article an attempt has been made to give a brief description of the various concepts related to double taxation avoidance agreements.

### Classification

Double taxation avoidance agreements, depending on their scope, can be classified as Comprehensive and Limited.

Comprehensive Double Taxation Agreements provide for taxes on income, capital gains and capital, while Limited Double Taxation Agreements refer only to income from shipping and air transport, or estates, inheritance and gifts. Comprehensive agreements ensure that the taxpayers in both the countries would be treated equally and on equitable basis, in respect of the problems relating to double taxation.

## **Objectives**

The object of a Double Taxation Avoidance Agreement is to provide for the tax claims of two governments both legitimately interested in taxing a particular source of income either by assigning to one of the two the whole claim or else by prescribing the basis on which tax claims is to be shared between them.[2]

The need and purpose of tax treaties has been summarized by the OECD in the 'Model Tax Convention on Income and on Capital' in the following words:

It is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation.

The objectives of double taxation avoidance agreements can be enumerated in the following words:

First, they help in avoiding and alleviating the adverse burden of international double taxation, by -

- a) laying down rules for division of revenue between two countries;
- b) exempting certain incomes from tax in either country ;
- c) reducing the applicable rates of tax on certain incomes taxable in either countries

Secondly, and equally importantly tax treaties help a taxpayer of one country to know with greater certainty the potential limits of his tax liabilities in the other country.

Still another benefit from the tax-payers point of view is that, to a substantial extent, a tax treaty provides against non-discrimination of foreign tax payers or the permanent establishments in the source countries vis-à-vis domestic tax payers.

## **Pattern of taxation**

Double taxation agreements allocate jurisdiction with respect to the right to tax a particular kind of income. The principle underlying tax treaties is to share the revenues between two countries. If each country gets a reasonable share of tax revenues, the bilateral and multilateral trade prospers and the overall tax collection also increases as a result of which both countries tend to benefit.[3] A double tax avoidance agreement deals by and large with business income, income from moveable property and from immovable property.

There are well established patterns of taxation of various types on income. The agreements provide of allocation of taxing jurisdiction to different contracting parties in respect of different heads of income.

In general, the rules are to the following effect:

- Income from the business[4] is taxed –

only in the resident country, if the business entity has no activity in the source state;  
only on the source state, if there is a fixed place of business, i.e. Permanent Establishment and to the extent it is attributable to that place

- Income form immovable property[5] arising to a non-resident is taxed primarily in the state of its location, i.e. the source[6] state.

· Income from movable property such as dividends[7], interest[8] and royalties[9] are primarily taxed in the resident state, but the source state may impose a reduced tax.

## **Methods of Eliminating Double Taxation**

The objective of double taxation can be achieved Tax treaties employ various methods or a combination of

### **(i) Exemption Method -**

One method of avoiding double taxation is for the residence country to altogether exclude foreign income from its tax base. The country of source is then given exclusive right to tax such incomes. This is known as complete exemption method and is sometimes followed in respect of profits attributable to foreign permanent establishments or income from immovable property. Indian tax treaties with Denmark, Norway and Sweden embody with respect to certain incomes.

### **(ii) Credit Method**

This method reflects the underline concept that the resident remains liable in the country of residence on its global income, however as far the quantum of tax liabilities is concerned credit for tax paid in the source country is given by the residence country against its domestic tax as if the foreign tax were paid to the country of residence itself.

### **(iii) Tax Sparing**

One of the aims of the Indian Double Taxation Avoidance Agreements is to stimulate foreign investment flows in India from foreign developed countries. One way to achieve this aim is to let the investor to preserve to himself/itself benefits of tax incentives available in India for such investments. This is done through "Tax Sparing". Here the tax credit is allowed by the country of its residence, not only in respect of taxes actually paid by it in India but also in respect of those taxes India forgoes due to its fiscal incentive provisions under the Indian Income Tax Act.

Thus, tax sparing credit is an extension of the normal and regular tax credit to taxes that are spared by the source country i.e. forgiven or reduced due to rebates with the intention of providing incentives for investments.

The regular tax credit is a measure for prevention of double taxation, but the tax sparing credit extends the relief granted by the source country to the investor in the residence country by the way of an incentive to stimulate foreign investment flows and does not seek reciprocal arrangements by the developing countries.

## **Applicability of Treaty benefits**

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

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

## **Residence of a Person/ Resident**

The determination of the residential status is of great significance as the taxability of

income under the domestic laws depends upon it, and as also only the resident of a contracting state can seek relief from double taxation.

The expression 'resident of contracting state' is defined to mean any person who, under the laws of that state, is

1. liable to tax therein by reason of
2. domicile, residence, place of management or
3. any other criterion of a similar nature.

The treaty provisions set forth rules for determination whether a person is a resident of a contracting state for purposes of the treaty. The determination looks for first to a person's liability to tax as a resident under the respective taxation laws of the contracting state. If a person is resident in both the contracting states, there are provisions to assign a single state of residence to him for purposes of the treaty through tie-breaking rules.

### **Business Income**

The business income of a non-resident is taxable in India under section 9(1)(i) of the ITA only if it accrues or arises, directly or indirectly, through or from any business connection in India, property in India, asset or source of income in India, or through the transfer of an Indian capital asset. Explanation 2 of section 9(1) (i) contain an inclusive definition of business connection; as per which a business connection is said to exist if any person carrying on a business activity acts on behalf of a non-resident and:

# has and habitually exercises an authority to conclude contracts on behalf of the non-resident

# 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

# habitually secures orders in India, mainly or wholly for the non-resident or its affiliates.

### **Permanent Establishment**

Double taxation agreement restricts the jurisdiction of the contracting states to taxing business income of a foreign enterprise only if such enterprise carries on business in India through a permanent establishment.

The term "permanent establishment" as defined in Article 5 means a fixed place of business through which business of an enterprise is carried on. The definition requires performance of business activity through a fixed place of business in another country. The expression has been defined as:

- a. fixed place of business through which the business of an
- b. enterprise is
- c. Wholly or partly carried on.

The first part of Article 5(1) postulates that the existence of a fixed place of business whereas the second part postulates that the business is carried on through a fixed place. If the second part is not attracted, there is no permanent establishment.[10] Thereby meaning that there should necessarily be a fixed place of business through

which the enterprise must conduct business activity and that activity must be income generating.

### **Treating shopping**

Treating shopping is an expression which refers to the act of a resident of a third country taking advantage of a fiscal treaty between states. A person acts through a legal entity created in a state essentially to obtain treaty benefits that would not be available directly to such person.

The basic feature of treaty shopping is the establishment of base companies in other states solely for the purpose of enjoying the benefit of a particular treaty rules existing between the state involved and the third state. An example of treaty shopping can be the India-Mauritius double Taxation agreement where various companies have been incorporated in Mauritius to take advantage of the Indo-Mauritius DTAA in which capital gains are to be assessed as per the law of the state of residence of the entity. However, under the Mauritian law, tax is not levied on capital gains which means that the capital gains made by the Mauritian entity on transfer of shares in an Indian company go unassessed.

However, the last few years have seen a change in the approach of the States in the wake of wide reports of extensive money laundering and the tax evasion. As a consequence, a lot of countries are adopting a "Limitation of Benefits" clause in the tax treaties so as to restrict third parties from taking advantage of tax treaties between two other states.

### **Indian Tax Regime**

The Income Tax Act, 1961 (ITA) governs taxation of income in India. According to section 5 of the ITA, Indian residents<sup>[11]</sup> are taxable on their worldwide income, and nonresidents are taxed only on income that has its source in India.<sup>[12]</sup> Section 6 of the ITA defines who may be a tax resident and contains different residency criteria for companies, firms, and individuals. The scope of section 5 is expanded by the "legal fiction contained in section 9," which deems certain kinds of income to be of Indian source.

The ITA favors source-based taxation as compared to the OECD model conventions or treaties entered into by many developed countries that favor residence based taxation. Indian courts have supported source based taxation in several cases in the past.

### **Indian Policy With Respect To Double Taxation Avoidance Agreements**

*The policy adopted by the Indian government in regard to double taxation treaties may be worded as follows:*

Trading with India should be relieved of Indian taxes considerably so as to promote its economic and industrial development.

There should be co-ordination of Indian taxation with foreign tax legislation for Indian as well as foreign companies trading with India

The agreements are intended to permit the Indian authorities to co-operate with the foreign tax administration.

Tax treaties are a good compromise between taxation at source and taxation in the country of residence

India primarily follows the UN model convention and one therefore finds the tax-sparing and credit methods for elimination of double taxation in most Indian treaties as well as more source-based taxation in respect of the articles on 'royalties' and 'other income' than in the OECD model convention.

### **Conclusion**

The regime of international taxation exists through bilateral tax treaties based upon model treaties, developed by the OECD and the UN, between the Contracting States. India has entered into a wide network of tax treaties with various countries all over the world to facilitate free flow of capital into and from India. However, the international tax regime has to be restructured continuously so as to respond to the current challenges and drawbacks.