The ICAI

Introduction to International Taxation

Mumbai

16th July, 2014.

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KNOWLEDGE IS A WEALTH THAT

- **The thief cannot thieve;**	न चोर चोर्य
- **Income-tax department cannot acquire;**	न च राजहार्य
- **Brother cannot share;**	न भ्रातृ भाज्यं
- **Does not weigh on you;**	न च भारकारि
It grows faster as you give.	व्यये कृते वर्धत एव नित्यं
Truly, knowledge is the greatest wealth.	विध्याधनं सर्वधन प्रधानम्

(With modification from Bhartruhari’sNitiShataka)

Knowledge is a wealth that :
The thief cannot steal;
Income-tax department (King) cannot acquire;
Brother cannot demand a share;
Does not weigh on you;
It grows forever as you share;

Truly, knowledge is the greatest wealth.

I. Preface:

1. International Tax (Int) is **not a complicated subject**. In fact, for an Indian CA, no financial/commercial law in the world is beyond his comprehension.

However, there are some **basic principles** and issues in Int. which distinguish it from domestic tax. These issues are generally not learned during our articleship. Hence the subject looks difficult. Let us consider those issues in this session.

2. Int. is **not independent** practice by itself. One has to be a master of the Indian Income-tax (IIT). Then only he can be a good practitioner on Int.Within Indian tax (IIT) – sections 4, 5, 6 and 9; 90 & 91, 195 & 201 are normally, not used in our domestic tax practice. We have to again refresh our knowledge of these sections.

3. IIT involves only the Government of India and the assessee. If there is a difference of opinion, either party can appeal to the appropriate Indian Court of Law. Int. involves two or more countries and their assesses. And if there is a difference of opinion between the two Governments, to which court do they appeal! Well, Governments don't appeal. **The assessee suffers.**

4. Int. involves **FEMA,** Vienna Convention, Double Tax Avoidance Agreement (DTA), Transfer Pricing and E-Commerce. These issues are not relevant for IIT practice. Hence one needs to study these provisions.

Not a big deal. All these provisions together will be less than 10% of the syllabus that we study for final C.A. examination. We have studied more. This **we can** study.

5. There is a **myth** that Int. tax is involved only in big matters like foreign collaborations. And only big firms can practise it. Far from it. Today so many individuals go abroad for employment or own business. Many NRIs return to India. So many businessmen make payments to non-residents where tax has to be deducted at source. Today residential houses are available in many countries at prices lower than Bangalore prices.

All these issues involve international tax. And FEMA.

Please note:

International Tax Practice – is not reserved only for the "Big" CAs. Any CA/ advocate can practise it. And needs to practise.

Preface completed

II. Indian Direct Tax System:

Indian Tax System is one of the BEST in the world - from the assessee's point of view.

1. It is good for the **wealthy**.

We have no Estate Duty, no Gift tax; (except as an anti-avoidance measure-S.56). Almost negligible wealth-tax; andReasonable rates of Income-tax.

In the U.S., individuals in the highest tax brackets want to give up U.S. citizenship to avoid estate duty that can reach 40%.They cannot give up.

2. With a reasonable rate structure, a large part of tax planning has become redundant on – "Cost – Benefit" analysis. This has simplified life for the **businessman**.

3. Our rate structure is good for the **poor**. Our average per capita income peryear is more than Rs.80,000 at current prices. Asagainst this, income upto Rs. 2***,00,000*** per year is exempt from tax (assessment Year – 2014-15). 2.5 times the average income. Many nations around the world have lowest tax brackets starting at or below the average per capita income.

4. It is good for the **middle class** people. Upto an income of Rs. 5,00,000 per year the tax payable is only Rs. 26,000 or 5.2%. This calculation is without considering Chapter VIA reliefs.

When we know that we are better than other countries, we know how to talk with foreigners/ NRIs.

III. Concepts of International Taxation.

1. Residence. Especially for companies. Registered Office.
2. Nexus or Connecting Factors: Jurisdiction.
3. Tax Base.
4. Source of Income – Concept.Rules.Country of Value Addition.

5. Categorisation of Income.
6. Permanent Establishment.
7. Allocation of taxing rights.

8. Elimination of Double Tax.
9. How Tax havens erode tax base.

Note: Properly discussing all these concepts can take a few sessions. We will discuss it briefly. For detailed articles, please see articles on International Tax on our firm website.

1. Relationship between International tax and Indian tax

Jurisdiction to tax. How does a Government acquire rights to tax a person!

1.1 Connecting factors.

Assessee – Residential Status - Sections 4 & 6

Income – Source – Sections 4, 5 & 9.

1.2 Sections 90 and 91
Double Tax Avoidance Treaties – S.90
Unilateral Credit - S. 91.

Before discussing fundamentals of International Taxation, We may briefly consider the relevant fundamentals of Indian Taxation.

2. Fundamentals of Indian Income tax Act.

2.1 The charging section 4 levies a charge of Income-tax -
On an **Assesee**
For his Total **Income.**
These two are important factors on which the charge of tax is determined.

A Government needs a **connection**, a nexus to have a jurisdiction to levy a tax.

2.2 Qua the **assessee,** the connecting factor is – **residential status.**

For an individual, the status is determined by his personal connection with the country. For example, he should be **resident** of that country, or citizen, domicile etc.

In case of a **non-individual** entity, the logical factor is its seat of power, where the control and management is situated. In practice, most countries' Income-tax Acts simplify the whole issue by providing that the place of **registration** of the company shall determine its residential status.

All factors affecting residential status are **geographical** in nature.

2.3 For the Income, the connecting factor is – "**Source**" its geographical location (situs) within a country.

Good Books for fundamentals of Income tax –(i) Late Mr. N.A. Palkhiwala's Commentary on Income-tax – First two chapters. (ii) Mr. Rajesh Kadakia's book on "The Law & Practice of Tax Treaties" and (iii) Chamber of Tax Consultants' four volume Compendium on International Taxation.

3. Indian Income-tax.

Provisions pertaining to International Taxation

A list –Summary of main sections

Section 4	Charging Section . Charge of tax on a person, on his Total Income, during a previous year.
Section 5	Scope of Total Income.
5.1	For Residents, World Income.
5.2	For non-residents And NORs } Indian sourced income.
Section 6	Residential status.
Section 9	Deeming provisions.
	Business connection.Agent.
	Technical knowhow fees and Royalties.
Sections 160, 161,163	Deemed agent and his liabilities.
Section 90 91	Double Tax Avoidance Agreement Unilateral Credit.
Section 195 197	TDS Certificate for No/Lower TDS.
Section 201	Consequences of failure to deduct.
Section 206AA	PAN even for non-resident receiver.

4. Connecting factors & Jurisdiction:

How does a country get <u>jurisdiction</u> tolevy income tax!
If there is a connecting factor between the country and the assessee or the income; the government gets a jurisdiction to tax.

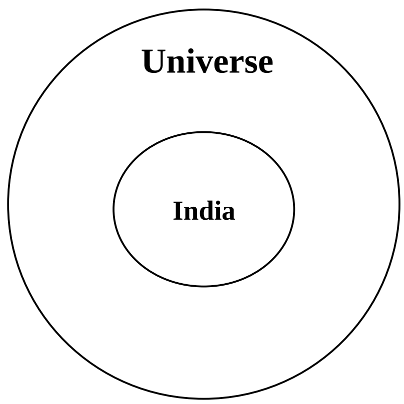
Nexus or
Connecting Factors

Assessee → Residential Status

Income → Source

Classical System of Taxation.
Built-in-Overlap.

5. Income - Tax Base:



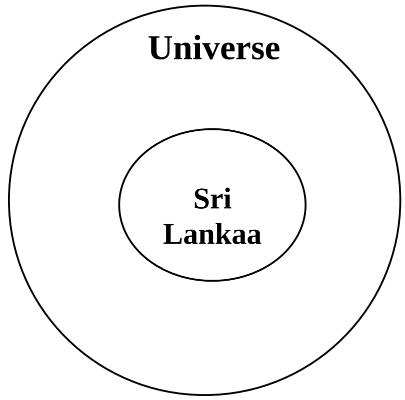
Resident of India - Universal income is taxable in India .

For a Non-Resident of India. - India Sourced income is taxable in India

Non-Resident's income sourced outside India is not a tax base for India.

Consider an illustration where – an Indian resident has income sourced in Sri Lanka; and a Sri Lankan resident has income sourced in India.

Income - Tax Base.



Resident of Sri Lanka - Universal income is taxable in Sri Lanka.

For a Non-Resident of Sri Lanka. - Sri Lankan Sourced income is taxable in Sri Lanka.

Non-Resident's income sourced outside Sri Lanka is not a tax base for Sri Lanka.

Assured Overlapping.

The Indian Resident's income sourced in Sri Lanka; and -
The Sri Lankan Resident's income sourced in Indiaboth -are Tax Bases for both the countries.

Assured overlapping of Tax Bases.
Assured Double Taxation.

Tax Base.

For the Indian draftsman, India is at the centre of the Universe.

But similarly, for 200 countries' draftsmen, their own country is at the centre of the universe.

Everyone (almost) wants to tax income accruing even outside his own country.

Hence there is ASSURED OVERLAPPING of income.

Countries like Singapore & Hong Kong have a system of taxing only the income sourced within their countries (plus income received within the country).

6. **Core issues: Core issues** accepted at present are:

6.1 **Geographical** base for connecting factors.

This has to be natural in international taxation because political divisions of the earth (known as countries) have geographical boundaries.

The case is different within a nation. For example, within India, taxes may be shared by different states based on –

(i) Collections,
(ii) Population,
(iii) Need for poverty alleviation, and
(iv) Extra need for border states/hilly region states etc.

6.2 A **Tangible** presence for the PE."Tangible" presence amounts to clinging to the past. A PE had to have a "fixed base" and a "physical presence".Electronic Commerce involves movement of pure energy – Electronics – an antithesis to "tangibility".

7. International Taxation

7.1 Terms to Understand
7.1.1 Country of source (COS), Country of Residence (COR).
7.1.2 Permanent Establishment (PE).
7.1.3 Residential status goes with assessee and not PE.

7.2 Presumptions:

7.2.1 Country of Residence & Country of Source both get their**jurisdiction** to tax from their domestic legislation. DTA does not grant jurisdiction. There is no mention of jurisdiction in DTA.

7.2.2 Country of Source agrees to **restrict** its rights to tax. Articles 6 to 22. The restriction varies with the category of income.

7.2.3 Country of Residence gives the **credit** for tax paid at the country of source. Or exempts the income taxed at the COR. Article 23.

8. Fundamental Principles

8.1 Treaty or Act whichever is **more beneficial** to the assessee shall prevail.Sections 90 (1) and (2). (Treaty Overrides the Act). (GAAR)

8.2.1 Business Connection and PE.
Two different and yet related concepts.
Both are the nexus for the non-resident to be taxed in the country of source.

8.2.2 But BC is very wide and in some cases, can cause injustice. Hence it is advisable to seek DTA when doing business or investment in another country.

Concept of PE is reasonable for traditional business. For E-Commerce, it cannot be applied.

Wherever there is a DTA, Business connection may not be applicable.

9. Concept of Residence:
Dubai – Residence.

9.1 "Liability to tax".By reason of his domicile, residence……etc. Article 4.
(Not by reason of the source of Income)

9.2 Dubai – Residence.
When there is no Double tax, where is avoidance of Double-tax !
(India & UAE have signed a protocol to give clarity to "Residential Status".)

9.3 Agricultural Income S.10 Exempt
Income below Rs. 2,00,000
S. 10 A exemption-Reliefs.

10. Double Tax Avoidance Agreements (DTA).

Double Tax Avoidance Agreements (DTA) are co-ordinated efforts to avoid this assured double taxation.

10.1 Source:

Taxing a Non-Resident based on source of Income.

What is "Source"?

Accrual & Arising of Income.

Can we equate 'Source' with 'Payment'?

Can we equate 'Source' with 'Market'?

Can we say that 'Source' is value addition made by the assessee who is sought to be taxed!

Taxable Income (Net Profits) included in Value Addition made by the Tax payer.

Illustrations:

(i) Motor Car company outsourcing some components to India.

(ii) Mercedes Benz Co. selling a motor car to a travel agency in India.

Rent **Royalty** **Dividend** **Interest**

Indian Software sales to USA

German Car sale to Indian Travel Agent

Foreign Television Broadcasting Company-Indian Footprint

Foreign TV Co. - Foreign Advertiser

10.2 Categorisation of Income:

A Machinery Provision.

(i) Income from Immovable Property,

(ii) Business Income,

(iii) Air Line & Shipping,

(iv) Royalty,

(v) Salary, etc. etc.

Why categorisation in DTA?

To determine the location of source of the income

OR

To determine Country of Source (COS) and hence the taxing rights of a country.

"Different tax rates for different categories of income" – is an important cause for litigation.

11. Tax Sharing- Article 23 of the OECD model.

11.1 DTAs attempt to eliminate the double tax in two manners –

Credit method ; andExemption method.

India has adopted Credit Method.
Which means the COS will deduct at a lower rate; and COR will give credit for the tax paid at COS.

COR will levy normal tax.
If foreign tax is more, COR will not give refund.

Different methods are used for different categories of income.

Articles	Category of Income	Country of Residence	Country of Source
7(1)	Business Income	Full tax	Exemption
7(2)	Permanent Establishment	Residual tax	Full tax
8	Shipping & AirlinesProfits	Full tax	Exemption
10	Dividends	Residual tax	Restricted tax
11	Interest	Residual tax	Restricted tax
12	Royalties & Technical knowhow fees	Residual tax	Restricted tax
13	Capital Gains on		
13.1	Immovable Properties	Residual tax	Full tax

Articles	Category of Income	Country of Residence	Country of Source
13.2	Movable Properties of PE	Residual tax	Full tax
13.3	Sale of PE	Residual tax	Full tax
13.4	Sale of ship or aircraft	Full tax	Exemption
13.5	Other Properties (Movable) (Shares, etc.)	Full tax	Exemption Or restricted tax.
	Shares representing immovable properties	Residual tax	Full tax
14.1	Independent Personal ServicesProfessional Income without fixed base.	Full tax	Exemption
14.1	Fixed Base	Residual tax	Full tax
15.1	Salary Income	Full tax	Exemption

	Dependent Personal Services		
15.1	Employment exercised in the other state	Residual tax	Full tax
15.2	Employment aboard a ship or aircraft operated in international traffic	To be taxed in the country of residence of the ship	
16	Director's Fees	Residual tax	Full tax
17	Artists & Sports men Tax Planning. Tax Haven Co. having rights	Residual tax ?	Full tax Full tax
18	Pensions	Full tax	Exemption
19(1)(a)	Government Service (Other than Pension)	Exemption	Full tax. Employer**Government** will be treated as having jurisdiction

Articles	**Category of Income**	**Country of Residence**	**Country of Source**
19(1)(b)	Government service		If the employee is a Regular resident & citizen of the country where services are rendered – Source country will levy Full tax.
Example - If Indian Government pays salaries to an Indian citizen who is employed in U.K.; the tax jurisdiction will lie with India. If Indian Government pays salaries to a British citizen plus resident for employment in U.K. ; the tax jurisdiction will be with U.K.			
20	(a) Student studies in a	Full tax	Country

	country. Income from another country. (b) Studies in a country. Income from the same country.	Country of Residence one & the same. In other cases – Residual tax	where he studies will not tax. Exemption Full tax
21.1	Other Incomes	Full tax	Exemption
21.2	Other Income through PE or Fixed Base	Residual tax	Full tax

Categorisation of Income: The reason for excessive litigation under DTA is: different restrictions on COS taxing rights based on categorisation of income. Assessees try to categorise income as 'Business Income with no

PE" and try to escape tax in COS. Income tax department tries to categorise even pure business income as royalty or FTS & demand TDS.

12. Tax Havens

12.1 Tax Haven – Characteristics.

Harmful Tax Competition.
Promise – "We will not tax a Non Resident's Foreign Income".
Free Foreign Exchange.
No permission to do local business. (Except bank deposits.)
Permission for opening companies, trusts etc. in the "offshore" field to all foreigners.

12.2 What are the benefits for a Tax Haven !
Switzerland, the mother of Tax Havens.
United Kingdom, biggest abettor of Tax Havens.

12.3 One up man ship between tax havens and other countries.

Liability to tax.
Residence - **Treaty Shopping**
Malta, Mauritius, Cyprus.

13. Permanent Establishment (PE)

The Concept.
What is the practical use of the concept?
Attribution of Profits to the PE.

14. Allocation of taxing rights

Since tax bases overlap, the taxing rights of Governments have to be restricted to avoid double tax.

DTA places restrictions on the rights of COS to levy tax on a Non – Resident of the COS. The COR has right to levy full tax – and has the responsibility to give credit for tax paid in COS. (Credit Method).

Under exemption method, the COR exempts foreign income.

15. Other Concepts:

1. Treaty Shopping – Indo Mauritian Treaty.

2. E-Commerce FII, BPO
   Permanent Establishment Television Companies
3. Jurisdiction – to what steps will it extend! (Foreign advertiser on Foreign TV channels)

4. Whole emphasis under existing rules is on COR. Article 7.
5. There is nothing fundamental in International Taxation.

6. Vodafone case.

7. Tax Planning by Google.

16. Residence of a Global Corporation:

A Global corporation having own websites & providing services on the web.

Global Corporation.
Chairman, Resident (R) ofIndia.
Managing Director, resident of Brazil.

2 directors fromU.S.A.

Board of Directors.

2 directors

1 director fromJapan

Board meetings held by Video conferences. No central place for **control and management.**

Shares quoted at Mumbai – NSE, Chicago, Tokyo and Frankfurt stock exchanges. **Share holders** from 50 different countries.

Company registered in BVI. Tax Haven.

Marketing & Distribution. Faciliti es at 50 different countries; and also through Internet, T.V., radio & cable T.V.

Production.

Software development & website maintenance facilities; and mirror servers located at :

Malaysia | India | Japan | U.K. | U.S.A.

Where is the Company Truly Resident?

Where should it pay its main tax on the Global Income?

Thank You

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