

ELECTIVE PAPER 6C: INTERNATIONAL TAXATION

SOLUTION TO CASE STUDY 7

I. ANSWERS TO MCQs (Most appropriate answers)

1. (c)
2. (d)
3. (a)
4. (b)
5. (a)
6. (c)
7. (b)
8. (b)
9. (b)
10. (c)

II. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1

- (i) The eligibility of partnership firms for tax treaty benefits have been a controversial area and is a classic case of economic double taxation. This is due to the fact that each country has its own methodology to tax partnership firms. For instance, India taxes the income of a partnership in the firm's hands, but the Contracting State, in this case, Country Y and Country Z, taxes such income in the hands of the partner directly, treating the partnership as "fiscally transparent entity". In both cases, the income is subject to tax in both countries albeit in the hands of different persons i.e., in the hands of the partners in the country of residence and in the hands of the firm in the source country, namely, India.

The conditions for eligibility of benefits under the DTAA are provided in Article 1 read along with the other relevant articles of the DTAA. These conditions have to be fulfilled including the condition that the entity has to be a **person** and **resident** of the either of the contracting states.

- (a) As per Article 3(1)(d) of the India-Country Y DTAA, the term 'person' includes any entity which is treated as a taxable unit under the tax laws in force in the respective States.

In order to be eligible for the DTAA, it has to be seen whether the partnership firm is a resident of the Contracting State. Article 4(1) of the India-Country Y DTAA defines a "resident of a Contracting State" to mean a person "liable to tax in that State by reason of his domicile, residence, place of management or any other criterion of similar nature".

As per Article 2 of the India-Country Y DTAA, the scope of the DTAA extends to both income-tax and trade tax as may be levied under the laws of Country Y. Since trade tax is being levied on the Gryffindors Y partnership firm, it can be held that the firm is "liable to tax" and therefore the requirement in Article 4 gets satisfied. Accordingly, Gryffindors Y partnership firm shall be eligible to access the India-Country Y DTAA based on this line of reasoning.

- (b) As per Article 3(1)(d) of the India-Country Z DTAA, the term 'person' includes any other entity which is taxable under the laws in force in the either Contracting States.

Article 4(1) of the India-Country Z DTAA defines a "resident of a Contracting State" to mean any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. Further, in the case of income derived or paid by a partnership, this term applies only to the extent that the income derived by such partnership, is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners.

Thus, Article 4(1) of the treaty clearly provides that in the case of income derived or paid by a partnership, the term "resident of a contracting state", in case of a firm, applies to the extent that the income derived by such partnership, is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners. The article clearly permits a firm to be treated as a resident of a contracting state in respect of income which is either liable to tax in its hands or in the hands of the partners. Therefore, Gryffindors Z partnership firm would be entitled to the benefits of the India-Country Z tax treaty, even though it is a fiscally transparent entity as per the tax laws of Country Z.

- (ii) Article 14 of the India-Country Y and India-Country Z tax treaties deal with Independent Personal Services. Professional services rendered by independent professionals like lawyers, doctors, engineers, accountants etc. are covered by the provisions of this article.

It may be noted that the India-Country Y DTAA restricts the scope of Article 14 to income derived by an individual who is a resident of the Contracting State. Consequently, Article 14 of the DTAA with Country Y cannot be invoked in the case of income derived by a firm.

However, the India-Country Z DTAA does not restrict the scope of Article 14 to income derived by a resident individual and includes within its scope, a resident firm as well. Therefore Article 14 of the India-Country Z DTAA can be invoked in respect of income derived from such services by Gryffindors Z firm, which is resident in Country Z.

- (iii) Article 2 of the DTAA specifies the 'taxes covered' under the DTAA entered into between the Contracting States. In the DTAA which India has entered into with Country X, Country Y and Country Z, taxes covered include income tax including **any surcharge thereon**. The issue under consideration is whether surcharge, education cess and secondary and higher education cess (SHEC) have to be added separately to the rate provided in the DTAA. In this regard, since the DTAA specifically mentions in Article 2 that taxes include surcharge, there is no requirement to include surcharge.

As per sub-section (11) and (12) of section 2 of the Finance Act, 2017, the amount of income-tax as increased by the applicable surcharge shall be further increased by an additional surcharge to be called "Education cess" and "secondary and higher education cess". Therefore, education cess and secondary and higher education cess are nothing but an additional surcharge. Since as per the DTAA, taxes covered include any surcharge on income-tax, additional surcharge called as education cess and SHEC are also included therein.

Therefore, if the tax treaty rate is invoked, the tax rate specified thereunder is all inclusive and there is no requirement to separately add surcharge, education cess and SHEC over and above the rate prescribed in the DTAA.

Answer to Q.2

- (i) In this case, payment is to be made to the law firm in Country X in respect of income earned outside India i.e. in Country X. Considering the nature of income, it is possible to characterise the same either as Royalty or Fees for technical services (FTS). Section 9(1)(vi)/(vii) spells out the cases where royalty and fees for technical services is deemed to accrue or arise in India as well as the exceptions thereto. The income earned by the law firm in Country X is covered under exceptions to Section 9(1)(vi)(b) and 9(1)(vii)(b). Income by way of royalty payable by a person who is a resident is deemed to accrue or arise in India, **except where the royalty is payable in respect of any right, property or information used or services utilized 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.** Likewise, income by way of fees for technical services payable by a person who is resident, is deemed to accrue or arise in India **except where the fees are payable in respect of services utilized in 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.**

In this case, since the payment is to be made for information used or services to be utilised for making or earning a new source of income outside India, these payments fall within the exceptions spelt out in section 9(1)(vi)/(vii). Accordingly, such income would not be deemed to accrue or arise in India in the hands of the non-resident law firm. Hence, such income earned by the law firm in Country X is not taxable in India as per the provisions of the Income-tax Act, 1961.

- (ii) Since the income is not chargeable to tax in India as per the domestic tax laws, the same cannot be taxed under the DTAA. The fundamental principle of tax treaty is that it can only relieve tax burden. DTAA simply tries to eliminate double taxation. It does not grant any tax jurisdiction to any Government nor take away any jurisdiction already existing. DTAA does not create any additional tax in any state; it can only relieve tax. This is known as the principle of non-aggravation.

Further, section 90(2) of the Income-tax Act, 1961 clearly specifies that provisions of the Act shall apply to the extent they are more beneficial to the assessee. Also, the Supreme Court, in the case of *Azadi Bachao Andolan 263 ITR 706 and Ishikawajima Harima 288 ITR 408*, has held that tax treaties cannot create more onerous obligations or liabilities than provided under the Income-tax Act, 1961. Therefore, the India-Country X DTAA cannot bring into existence a new claim, if the said income is not taxable under the Income-tax Act, 1961.

- (iii) Assuming that the income earned by Country X is taxable in India, M/s Gryffindors LLP, a Country X based partnership firm, can mitigate the tax by taking recourse to the grossing up provisions under section 195A of the Income-tax Act, 1961. In such a case, the resident payer shall have to bear the burden of tax on payments due to the non-resident. The amount paid by the resident payer will be considered as net of tax payment and the payment is required to be grossed up for calculation of tax liability. The grossed-up amount will be treated as the amount agreed to be paid and tax shall be calculated at the prescribed rate on the gross amount. Such tax would be payable by Abhimanyu Holdings Bank Ltd., India, in this case. Therefore, the Country X firm, being non-resident in India, can enter into a suitable agreement based on which the firm will not bear the Indian tax liability, even if taxes are to be withheld. The tax liability would be borne by Abhimanyu Holdings Bank Ltd., India, the payer, in this case.

- (iv) The Country X firm, being a non-resident, may apply for an advance ruling under section 245N for determination of tax liability in relation to a transaction which is proposed to be undertaken by it with a view to avoiding litigation and providing certainty. Therefore, in this case, the Country X firm can make an application to the Authority of Advance Rulings in the prescribed form and manner to determine its taxability in India for the proposed Assignment C to be undertaken by it.

Note – *Questions based on interpretation of articles of a DTAA may have alternate views.*