These Topics are Applicable for CA-FINAL New Course Students Only
**Q-1** What do you understand by base erosion and profit shifting? Describe briefly its adverse effects.

**Sol.** 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.

**Adverse Effects of BEPS:**

1. **Governments have to cope with less revenue and a higher cost to ensure compliance.**

2. **In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth.**

3. **BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. 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.**

4. **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.**

**Q-2** Why is there a need for international collaboration between countries?

**Sol.** Interaction of domestic tax laws with other countries' laws may either lead to gaps (no taxation in either country or taxed at a nominal rate) or double taxation. Since there is no principle of matching (payment deductible by the payer is generally taxable in the hands of the recipient, unless specifically exempted) at the international level, it
leaves considerable scope of arbitrage by taxpayers. BEPS relates to instances where the interaction of tax rules of different countries leads to double non-taxation and arrangements that achieve low or no taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. International standards have tried to reduce these frictions, 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.

Q-3 What are the fundamental pillars around which the Action Plans are structured?

Sol. 1) Reinforcing of 'substance' requirements in existing international standards
2) Alignment of taxation with location of value creation and economic activity
3) Improving transparency and tax certainty

Q-4 What are the significant OECD Recommendations under Action Plan 1 of BEPS? Which recommendation has been adopted in Indian tax laws?

Sol. The OECD has recommended several options to tackle the direct tax challenges which include:

(1) Modifying the existing Permanent Establishment (PE) rule to provide that 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.

(2) 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.

(3) 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 permanent establishment 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.

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 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.

**Q-5** Discuss the provision incorporated in the Income-tax Act, 1961 in line with the OECD recommendations under Action Plan 3 of BEPS.

**Sol.** Controlled Foreign Company (CFC) rules mitigate the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base country of residence and other countries by shifting income into a CFC. Without such rules CFCs provide opportunities for profit shifting and long term deferral of taxation.
OECD has recommended following building blocks for CFCs

- 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 controlled ownership.

- Prevention and elimination of double taxes – 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 off 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 they earn income that raises BEPS concerns without having them addressed.

- CFC exemptions and threshold requirements – companies should be exempted from CFC rules where they are subjected 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.

Currently there are no FC rules but are part of the proposed Direct Tax Code. In order to encourage repatriation of profits Sec 115BBD provides a concessional rate of 15% on dividends received from a foreign company in which Indian company holds at least 26% of shares.

Q-6 What are the ways in which hybrid mismatch arrangements are used to achieve unintended double non-taxation or long-term tax deferral?

Sol 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 -

(1) Creation of two deductions for a single borrowal;

(2) Generation of deductions without corresponding income inclusions;

(3) Misuse of foreign tax credit; and

(4) Participation exemption regimes.
Q-7  Discuss the provision incorporated in the Income-tax Act, 1961 in line with the OECD recommendations under Action Plan 4 of BEPS.

**Sol**  In line with the recommendations of OECD BEPS Action Plan 4, new section 94B has been inserted in the Income-tax Act, 1961, 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.

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.

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.

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 nonresident, being an 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.

Q-8  What is the meaning of, and difference between, a hybrid mismatch and branch mismatch? Briefly mention the reasons why hybrid mismatch arrangements arise. Which Action Plan of BEPS gives recommendations in this regard?
A hybrid mismatch is an arrangement that exploits a difference in the tax treatment of an entity or an instrument under the laws of two or more tax jurisdictions to achieve double non-taxation.

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.

Hybrid mismatch arrangements arise due to
(i) Creation of two deductions for a single borrowal
(ii) Generation of deductions without corresponding income inclusions
(iii) Misuse of foreign tax credit
(iv) Participation exemption regimes

Specific country laws that allow taxpayers to opt for the tax treatment of certain domestic and foreign entities may aid hybrid mismatches.

BEPS Action Plan 2 gives recommendations to neutralise the effects of hybrid mismatch arrangements, which include general changes to domestic law followed by a set of dedicated anti-hybrid rules. Treaty changes are also recommended. 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.

Q-9 Explain the nexus approach recommended by OECD in BEPS Action Plan 5 which has been adopted in the Income-tax Act, 1961.
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.

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, new section 115SBBF has been inserted in the Income-tax Act, 1961 to provide that where the total income of the eligible assessee (being a person resident in India who is the true and first inventor of the invention and whose name is entered in the patent register as the patentee in accordance with the Patents Act, 1970 and includes 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.) 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 at least 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.

Q-10 Explain Action Plan 6 in detail.

Sol. Countries can prevent treaty abuse by –
- Combined approach of Limitation of Benefits (LoB) and Principle Purpose Test (PPT) rule
- PPT rule alone
LoB should be supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties

Section A – Treaty Anti abuse Rules

This includes rules that provide safeguard against abuse of treaty provisions and offer a certain degree of flexibility on how to do so. It also includes new rules to be included in tax treaties in order to address other forms of treaty abuse, like:

- Dividend transfer transactions intended to artificially lower withholding taxes payable on dividends
- Transactions that find a way around application of the treaty rule that allows source taxation of shares of companies that derive their value primarily from immovable property
- Situation where an entity is resident in 2 countries
- Situation where State of Residence exempts income of PE in third states and where shares, rights or property are transferred to PE set up in countries that either don't tax such income or tax it at a preferential rate

This report also addresses 2 specific issues-

- First, application of tax treaties to restrict a country's right to tax its own residents
- Second, with respect to to exit taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident is triggered in the event that the resident ceases to be resident of that State.

Section B – Clarity of intent to eliminate double taxation states that tax treaties are not intended to be used to generate double taxation.

Section C – Identifying tax policy considerations before entering into a treaty
Q-11  Explain Action Plan 7 briefly.

Sol.  Prevent the artificial avoidance of PE status

This report includes changes to definition of PE in OECD MC 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 deemed to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business and will also restrict the application of a number of exceptions to the definition of PE to activities that are of preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions.
Thus the following steps have been advocated:

- Reworking exceptions to PE definition.
- Analysing arrangements entered through contractual agreements.

**Before**

- Warehouse facilities used for storage or delivery of goods: no PE risk
- A purchasing office solely performing purchasing functions: no PE risk
- Existing anti-fragmentation rule covers only activities undertaken by one enterprise in several locations

**After**

- Warehouse facilities used for storage or delivery of goods would be exempted only if the activity of the fixed place of business is of a preparatory or auxiliary character, otherwise there is a PE.
- A purchasing office merely performing purchasing functions would constitute a PE where that purchasing function forms an essential and significant part of the enterprise’s overall activity.
- A PE may exist if the enterprise or a connected enterprise carries on business activities at the same location, or different location in the same country, and such activities constitute complementary functions that are part of a cohesive business operation, and such activities when combined, exceed what is preparatory or auxiliary.

**Q-12 Explain what is stated in Action Plans 8-10?**

**Sol.** Action plans represent work on transfer pricing which has been a core focus of the BEPS action plans. The specific action focus on intangibles, risks and capital and other high-risk transactions.

**Action plan 8 focuses on**
Addresses transfer pricing issues relating to controlled transactions involving intangibles. Misallocation of the profit generated by valuable intangibles is a significant cause of BEPS.

**Action plan 9 focuses on**

Contractual allocation of risk only when they are supported by actual decision making and thus exercising control over these risks.

**Action plan 10 focuses on**

Focus on high risk areas like, scope for-

- Addressing profit allocations resulting from controlled transactions which are not commercially rational.

- Targeting use for transfer pricing methods which result in diverting profits from the most economically important activities of the MNE group, and

- Use of certain types of payment between members of the MNE group to erode the tax base.

**Significant recriminations in Final Report (2015)**

- Analysis of contractual relations between parties in combination with the conduct of the parties. Risk and return to be allocated to the party exercising control financial capacity to assume the risks

- Allocation of returns to MNE group members controlling economically significant risks and contributing assets
- Actual nature of transaction to be determined mined for pricing, in case economic substance differs from form

- Pricing methods to ensure that the profits are located to the most important economic activity

**OECD’s guidance on transfer pricing for low value adding intragroup services under BEPS actions 8-10**

**Key features**

- A process for determining costs associated with low value adding services
- Standard 5% mark up
- Elective simplified approach
- Ability to use general allocation keys
- Simplified benefits test
Q-13 Define the 6 indicators of Action plan 11.

**Sol.**
- The profit rates of MNE affiliate is located in low tax countries higher than their groups average worldwide profit rate
- The effective tax rates paid by large MNE entity are estimated to be lower than the similar enterprises only domestic operations
- FDI is increasingly concentrated
- The suppression of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomena and has grown rapidly
- Royalties received by entity is located in the low tax countries accounted for 3% of total royalty
- Debt from both related and third parties is more concentrated in higher statutory tax rate countries

Q-14 What are the design principles and significant objectives of a mandatory disclosure regime under Action Plan 12?

**Sol.**
- 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 use of information collected
- Ensuring effective use of information collected

The primary object of mandatory disclosure regime is to increase transparency by providing admin with early information regarding potentially abusive or aggressive tax planning and to identify users of those schemes.
Q-15 What are the key design features for an effective mandatory disclosure regime under Action Plan 12?

Sol. Final report suggests use of different hallmarks to identify cross border schemes, given that tax benefit of a cross border scheme may arise in a different country.

Q-16 Describe the three tier structure for transfer pricing documentation mandated by BEPS Action Plan 13.

Action 13 contains a three-tiered standardized approach to transfer pricing documentation which consists of:

(a) Master file: 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.

(b) 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
(c) Country-by-country (CBC) report: 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.

Q-17 What is the objective of measures developed under Action Plan 14 of BEPS.

Sol.

Objective of measures developed under Action 14 of BEPS

Minimize the risk of uncertainty

Minimize unintended double taxation

through

Consistent and proper implementation of tax treaties

Effective and timely resolution of disputes regarding their interpretation or application through MAP

Minimum standard: Ensure effective implementation of MAP

The minimum standard will 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.
Q-18 How are multilateral instruments developed? Explain in relation to Action Plan 15.

Sol. This plan provides for an analysis of the tax and public international law issues related to development of multilateral instrument to enable countries that wish to do so to implement measures developed in the course of work on BEPS and amend bilateral tax treaties. Subsequently, 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 Plan 15 is to streamline the implementation of the treaty related BEPS measures. Formation of adhoc group to develop a multilateral instrument on tax treaty measures to tackle BEPS.
### Q-1 Explain briefly the significant differences between the UN and OECD Model Tax Convention.

**Sol.** Organization for Economic Cooperation and Development (OECD) and the United Nations (UN) have developed certain Model Tax Treaties, not legally binding on any countries.

OECD Model is essentially a model treaty between two developed nations whereas UN Model is a model convention between a developed country and a developing country.

Further, OECD Model advocates the residence principle, i.e., it lays emphasis on the right of state of residence to tax the income, whereas the UN Model is a compromise between the source principle and residence principle, giving more weight to the source principle as against the residence principle.

**Note –** There is also a Model Convention used by the US while entering into tax treaties with various countries known as the US Model Tax Convention.

**Note –** “Contracting States” mean the countries between which the treaty is signed.

### Q-2 What are some of the significant Articles of UN and OECD MC?

**Sol.**

1. **Article 1 – Persons covered**
   
   It applies to persons who are resident of at least one Contracting State.

2. **Article 2 – Taxes Covered**
   
   It applies to taxes on Income and on Capital levied by the Contracting States. It shall also apply to any identical or substantially similar taxes imposed after the date of signing of the MC.
Overview of Model Tax Conventions

Article 3 – Definitions

Person – Individual, company or any other body of persons

Company – Body Corporate

Enterprise – Carrying on of any business (Only OECD)

International traffic – Transport by a ship or aircraft operated by an enterprise that has its POEM (Place Of Effective Management) in a Contracting State, except when it is operated solely between places in the other Contracting State

National – Any individual possessing nationality (or citizenship, as per OECD) of the Contracting State.

Business – As per OECD MC, it includes performance of professional services and of other activities of an independent nature.

Note – If a particular term is not defined here, then the meaning shall be taken as per the domestic tax laws.

Article 4 – Resident

It helps avoiding juridical double taxation. Resident means any person who is liable to tax because of his domicile, residence, place of residence (and place of incorporation, as per UN MC). However, it excludes any person who is liable to tax in that country in respect of Income or Capital in the said country (Source in that state).

Where an individual is a resident of both Contracting States then he will be treated as resident of contracting state (Tie-Breaker Rules)
Overview of Model Tax Conventions

- He has a permanent home
- If home available in both countries, then deemed to be a resident of the country with which economic and personal relationship is closer (center of vital interest)
- If center of vital interest cannot be determined, or if no permanent home in either country, deemed to be resident of country in which he has a habitual abode
- If abode in both or none, resident of the state of which he is a national
- If national in both or none, competent authorities shall settle his residency by mutual agreement

Where a person, other than an individual, is a resident of both Contracting States, he is deemed to be a resident of the State in which POEM is situated.

Article 5 – Permanent Establishment

PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. (Ex – office, branch, etc)

However, it is deemed to not include:

- Use of facilities solely for storage or display of goods
- Maintenance of stock solely for the purpose of storage or display or for processing by other enterprise
- Maintenance of fixed place of business solely for purchasing goods or collecting information

Note - Where person (other than an agent) habitually concludes contracts in the name of the enterprise, etc, then also it would not constitute a PE. However, an insurance enterprise, except for re-insurance will be deemed to have PE if it collects premiums or insures risks through an independent person.

Further, an enterprise shall also not be deemed to have a PE in simply because it carries business in that state through a broker, commission agent, etc.
Overview of Model Tax Conventions

If a company, resident of one Contracting State, controls or is controlled by a company resident of/carrying business in another Contracting State, shall not mean one company is PE of the other.

Article 7 – Business Profits

It deals with taxability of business profits and contains rules for taxation and ascertainment of profits of a foreign enterprise in the resident country. It also contains rules for computing profits attributable to PE. It says –

- Profits of a country shall be taxed in the same country, except when it has a PE.
- Profits attributable to PE are the profits that it might be expected to make had it been a separate entity.
- UN MC – In calculation of profits of a PE, a deduction of general admin expenses shall be allowed. However, no deduction if PE makes any payment to head office or any other branch by way of royalty, fees, etc.
- Profit attributed to PE shall be determined by the same method year by year.

Article 11 – Interest

Interest arising in a country and paid to resident of another country may be taxed in such other country.

However, interest arising in a country may be taxed in that country but if the beneficial owner is a resident of the other Contracting State, tax charged shall not exceed 10% (OECD)/percentage specified (UN).

Further, it does not apply to interest arising through a PE.

Interest shall be deemed to arise in a country where the payer is resident. However, if he has a PE in connection with which interest paid is incurred, interest will be deemed to accrue where PE is located.
# Overview of Model Tax Conventions

**Article 12 – Royalties**

*As per OECD – Royalty arising in a country and beneficially owned by resident of other country shall be taxable in such other country.*

*As per UN – Royalty arising in a country and beneficially owned by resident of other country may be taxable in such other country. But the tax so charged shall not exceed (prescribed) percentage of gross amount of royalties.*

However, if beneficial owner, resident of one country, carries on business through another country where royalties arise through PE, royalties shall be taxable as per Article 7.

**Article 13 – Capital Gains**

*The right to tax income from CG may either be with the country of residence or shared between both the countries. (Normally taxable in the country in which property is situated)*

**Article 14 – Independent Personal Services**

*Income derived by resident of a country shall only be taxable in that country except:*

- If he has a fixed base in the other country
- If his stay in the other country exceeds 183 days in the PY, only income earned in the other country shall be taxed in the other country.

**Article 21 – Other Income**

*Income of a resident of one country, if not covered under above Articles, shall be taxable in that country.*
Overview of Model Tax Conventions

Article 23 A & B – Methods for Elimination of Double Taxation

Article 23A – Exemption Method

Article 23B – Credit Method

Article 24 – Non discrimination

Tax provisions cannot be discriminatory just because one person is NR.

Article 25 – Mutual Agreement Procedure (MAP)

It provides a special procedure to attempt reconciliation of the conflict at the level of the competent authorities so as to prevent double taxation.

Article 26 – Exchange of Information

A country is not allowed to conduct tax investigation in another, as per the International Law. So this empowers both countries to exchange information.
Q-1 What are the provisions given for courts by the International Court of Justice?

Sol. ▶ International conventions which establish rules recognized by the contesting states.
▶ International custom (general practice accepted as law)
▶ General principles recognized by civilized nations
▶ Judicial decisions (Court rulings) of various nations

Q-2 Mention the sources of origin of International Tax Law.

Sol. ▶ Multinational international agreements
▶ DTAA
▶ Customary international law and its general practices

Q-3 What do you mean by double taxation? Discuss the connecting factors which lead to double taxation.

Sol. The taxability of a foreign entity in any country depends upon whether it is doing business with that country or in that country. There are two types of connecting factors to determine the jurisdiction, 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. 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 only, 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.

a) Jurisdictional 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 "jurisdictional double taxation".
In order to avoid such double taxation, a company can invoke provisions of DTAA with the host/source country, or in the absence of such an agreement, invoke provisions of section 91 of the Income-tax Act, 1961, providing unilateral relief in the event of double taxation.

b) 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 (because of lack of subject identity).

Q-4 "In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into tax treaty". Elucidate.

Sol. In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into a tax treaty, as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretations of tax treaty
- 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 (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country

(b) Capital import neutrality (CIN) provides that the level of tax imposed on non-residents as well as the residents must be similar

(iii) Promotion of mutual economic relations, trade and investment
### Q-5 Define “Treaty”.

**Sol.** “Treaty” means 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.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity by sharing of tax revenues by the concerned states on a rational basis thereby reducing Double taxation to a tolerable level.

### Q-6 What are the various types of DTAA?

**Sol.** Types of DTAA:

- **Limited DTAA** – Limited to certain types of Income only
  
  *Ex.: DTAA between India and Pakistan is limited to shipping and aircraft profits only*

- **Comprehensive DTAA** – They cover almost all types of incomes covered by any model convention.
  
  *Ex.: Sometimes, a treaty covers wealth tax, gift tax, etc.*

### Q-7 What are the directives set out by Article 51 of Indian Constitution to be followed by the State in the context of International Agreements?

**Sol.** The State shall endeavor to

- Promote international peace and security;
- Maintain just and honorable relations amongst nations;
- Foster respect for international law and treaty obligations in the dealings of organized people with one another; and
- Encourage settlements of international disputes by arbitration.
Q-8  What are the Principles under Vienna Convention of Law of Treaties?

Sol.

- **Article 26** – *Pacta Sund Servanda (in good faith)*
  
  *Every treaty in force is binding upon the parties and must be followed by them in good faith.*

- **Article 28** – *Non retroactivity of treaties*
  
  *Treaty provisions are not binding on a party for any act which ceased to exist before the date of the entry into force of the treaty with the respect to that party.*

- **Article 29** – *Territorial scope of treaties*
  
  *A treaty is binding upon each party in respect of its entire territory, unless a different intention appears from the treaty.*

- **Article 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 its text, 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.

- Article 32 – Supplementary means of Interpretation

When interpretation according to Article 31

- Leaves meaning ambiguous
- Leads to an unreasonable result

- Article 33 – Interpretation of Treaties authenticated in 2 or more languages

- Text shall be equally authoritative in each language
- A version of treaty in another language shall be considered authentic if treaty so provides
- Terms of the Treaty shall be presumed to have the same meaning in each text

- Article 34 – General rule regarding third states

A treaty creates neither obligations nor rights for a third State without its consent.

- Article 42 – Validity and continuance in force of treaties

- Article 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 party entitles the other to invoke the
breach as a ground for terminating the treaty or suspending its operation wholly or partly.

- However, in case of a material breach of a multilateral party,
  - Other parties may unanimously agree to suspend the operation of the treaty wholly or partly or terminate it.
  - A party specially affected by the breach to invoke it as a ground for suspending the operation wholly or partly in relation between itself and Contracting State.
  - Any party other than the Defaulting State to invoke the breach as a ground for suspending the operation of the Treaty wholly or partly with respect to itself if the treaty is of such nature.

- Material breach means
  - Repudiation (rejection) of the treaty not yet sanctioned
  - Violation of an essential provision

- Article 61 – Supervening impossibility of performance
  - In case of permanent disappearance or destruction of an object indispensable for the execution of the Treaty, a party may terminate or withdraw from the Treaty.
  - But impossibility of performance shall not be invoked if impossibility is a result of a breach of an obligation by that party.

- Article 62 – Fundamental change of circumstances
  - A fundamental change of circumstances which has occurred with regard to those existing at the time of 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-
    - The existence of those circumstances constituted an essential basis of the consent of the parties bound by the Treaty, and
    - 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

- If the treaty establishes a boundary, or
- If the fundamental change is the result of a breach by the party invoking it either of an obligation owed to any other party to the treaty

If a party invokes 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.

Article 64 – Emergence of new peremptory norm of general international law

If a new peremptory norm (to be implemented immediately) emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated.

Q-9 What are the various anti-avoidance measures to prevent double taxation?

Article 4 of DTAA – Gateway to avail tax benefits

Sol.

A person shall be entitled to a tax treaty only if he is a resident of one of the countries. This provision aims to curb 'treaty shopping' practices.

Determination of residential status of a person is crucial since ultimately the country of residence may have the full right to tax international 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 source country.

Q-10 "Treaty prevents not only 'current' but also merely 'potential' double taxation". Elucidate.

Sol.

Tax treaties only distribute or assign taxing jurisdiction but do not impose tax. After assigning 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 impose 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 part the right of tax with the other state, that state may or may not levy tax and if the state in whose favor right to tax is devolved, chooses not to tax such income, then it may result into double non-taxation. The argument in favor 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, it takes care of future liability of tax. Prof. Klaus Vogel, commenting on US – German DTAA observed: "Thus, it is said that the treaty prevents not only 'current' but also merely 'potential' double taxation." (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. 26 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. 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. E.g., Indo-Jordan DTAA provides that a capital gain on sale of shares arising to a resident of Jordan is taxed only in Jordan. However, if Jordan does not tax such a gain, then the right to tax reverts to India.

Q-11 What is the difference between "Monist Views" and "Dualist Views"?

Sol. The Income-tax Act, 1961 provides that where the Indian Government has entered into
DTAs which are applicable to the taxpayers, then the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer. Internationally this situation is known as "Monist View" wherein International and National laws are part of the same system of law, where DTAA overrides domestic law. Some other countries which follow such a system are: Argentina, Italy, the Netherlands, Belgium and Brazil.

The other prevalent view is known as "Dualistic View" wherein International Law and National Law are separate systems and DTAA becomes part of the national legal system by specific incorporation/legislation. In case of Dualistic View, DTAs may be made subject to provisions of the National Law. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

Q-12 What are the basic principles of interpretation of a Treaty?

Sol. These principles would be relevant only where terms or words used in treaty are ambiguous or vague. Following are some important Principles of Customary International Law in interpretation of tax treaties:

i) Golden Rule – Objective Interpretation

Ideally any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind and the term has to be interpreted contextually. However, if grammatical interpretation would result in absurdity or inconsistency, it should not be adopted.

ii) Subjective Interpretation

Terms of Treaty are to be interpreted according to the common intention of the Contracting parties at the time treaty was concluded.

iii) Teleological or Purposive Interpretation (Objects and Purpose method)
Application and Interpretation of Tax Treaties

Treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the Treaty.

iv) The Principle of Effectiveness

A treaty should be interpreted in a manner to have effect rather than make it void.

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.

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.

vii) Treated 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.

viii) Reasonableness 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. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.
Q-13 **What are the Extrinsic Aids to interpretation of a tax treaty?**

Sol. 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 parimateria (i.e., relating to the same subject matter), in case of doubt.

Q-14 **Explain, with examples, the role of Protocol and Preamble in interpretation of tax treaty**

Sol. (i) 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, protocol must be referred to before arriving at any final conclusion in respect of any tax treaty provision.

(ii) Preamble: Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of Union of India v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC), the Apex Court observed that 'the preamble to the IndoMauritius Double Tax Avoidance
Convention 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.

Q-15 What are the objectives of Tax Treaties?

Sol. OECD MC – Principal purpose of double taxation conventions is to promote exchange of goods and services and the movement of capital and persons, by eliminating international double taxation. Prevention and avoidance of tax evasion is also a purpose of tax conventions to prevent tax avoidance and evasion.

UN MC – Principle objectives of UN MC are as follows:

- To protect taxpayers against double taxation
- To encourage free flow of international trade and investment
- To encourage transfer of technology
- To prevent discrimination between taxpayers
- 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 2 states
- To improve the co-operation between tax authorities in carrying out their duties

Q-16 What is the difference between Ambulatory and Static Approach?

Sol. To decide what meaning is to be assigned to the said term, 2 views can be taken:

- Static – It looks at the meaning at the time when the Treaty was signed.
- Ambulatory – It provides that one looks to the meaning of the term at the time of application of Treaty Provisions. All Model Commentaries favor this Approach, however with one caution that this approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the said term.