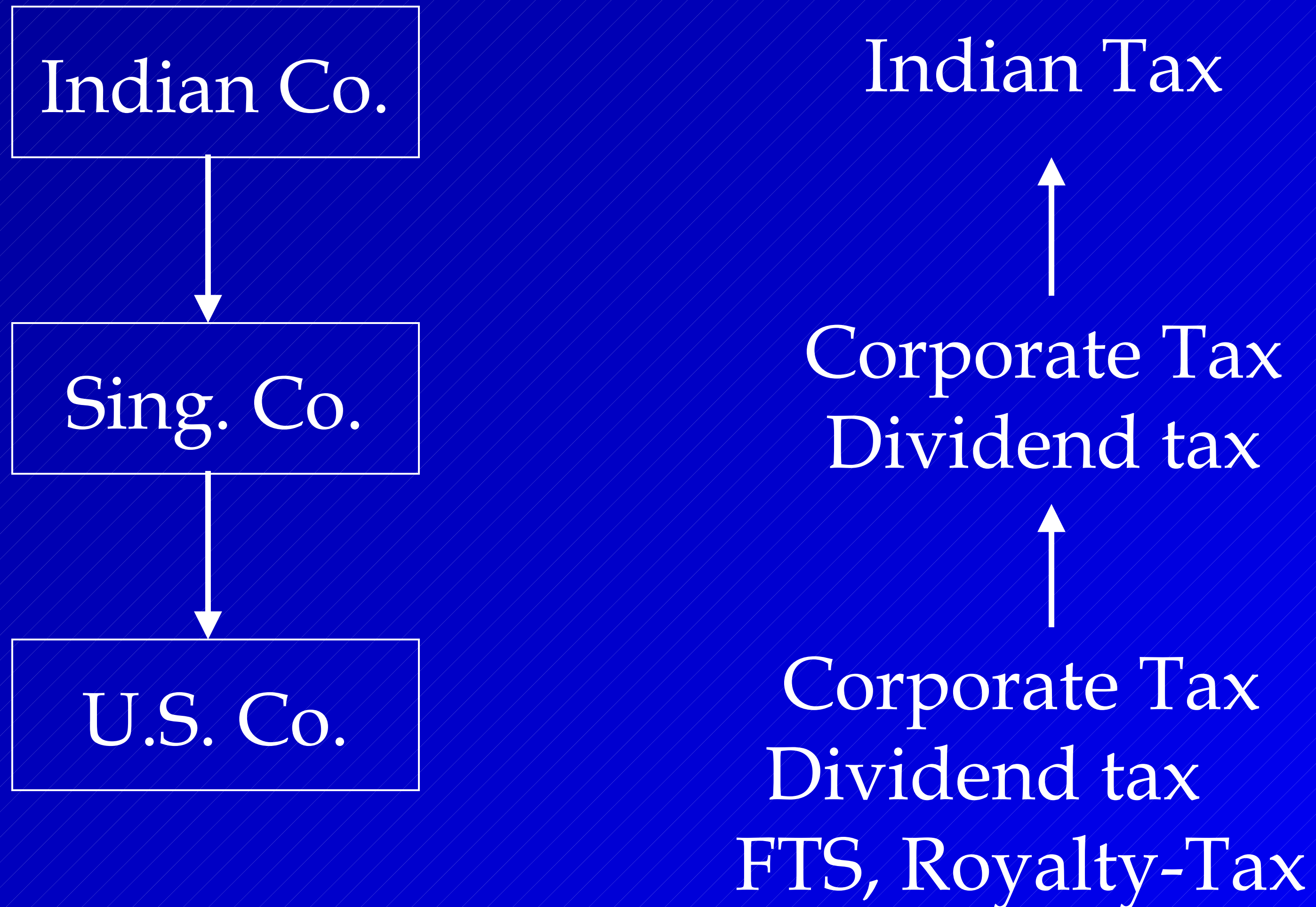
The Institute of Chartered Accountants of India
Thane

Elimination of Double Taxation – Article 23

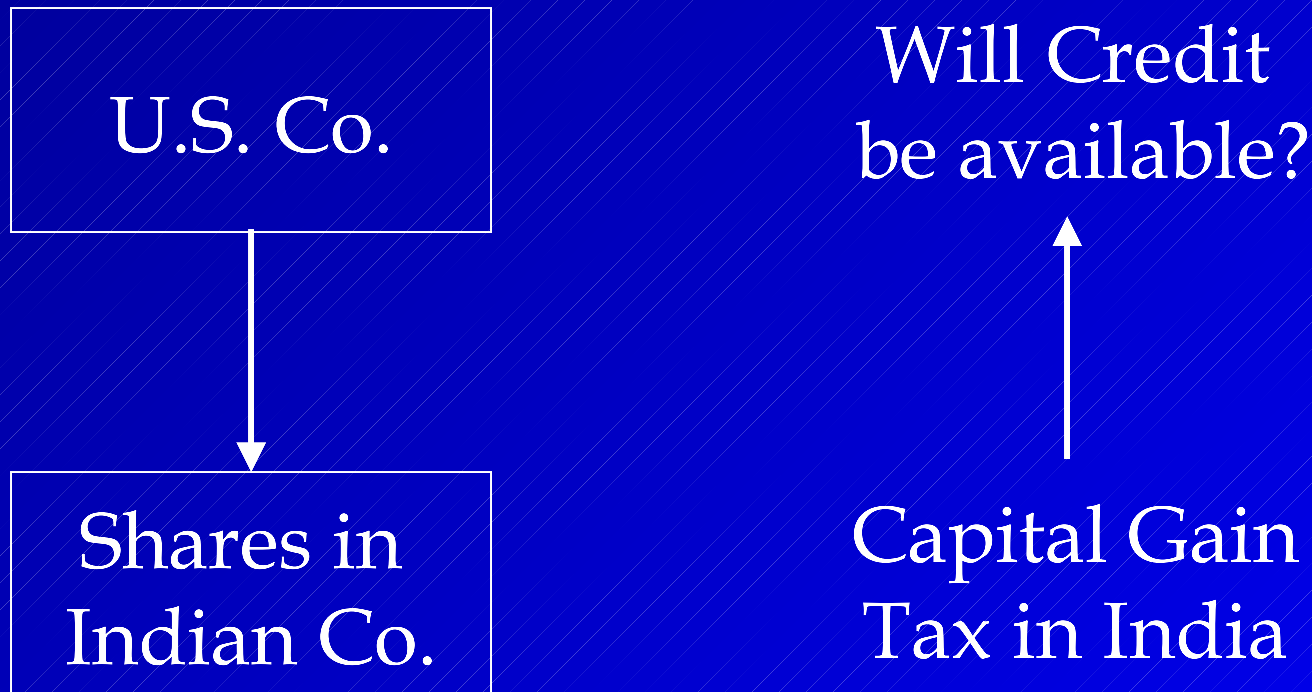
18th July, 2015

Naresh Ajwani
Partner
Rashmin Sanghvi & Associates
Chartered Accountants

Tax Credit - Outbound Investment



Tax Credit - Inbound Investment



Elimination of Double Tax

- The article may not always eliminate double tax.

  Or it may also lead to double non-taxation.
- The manner, procedure, documents & rules for relief are left to the domestic law.

Double Tax Reduction

- Divert income by booking expenses in a foreign company.
- Interpose a company in a favourable country.
- Attempt re-characterisation of income.
- Shift operations to another jurisdiction.

- Claim credit for tax paid in one country.

(This presentation deals with this issue only.)

Topics Involved

- Scope of Article 23 and DTA for double tax relief.
- Credit Method / Exemption Method.
- Indian Rules / Some decisions.
- DDT/Education Cess/Surcharge.
- Underlying Tax Credit / Tax Sparing.
- Some practical issues.
- Checklist for Foreign Tax Credit.

Elimination of Double Tax

- Article 23 – The Final Destination.
- It casts a **responsibility on Country of Residence** (COR) to eliminate double tax.
- Title is misleading. Not just this article, but the whole of the DTA is for elimination of Double tax.

Elimination of Double Tax

- Articles 6-22 – Distributive articles – (**largely the responsibility of COS**)

  - COS may exempt the income totally – e.g. capital gains as per India – Mauritius DTA.

  - COS may only tax the income. COR cannot tax it – e.g. Govt. pension.
- Unilateral domestic rules may eliminate double tax.

Elimination of Double Tax

- For unrelieved double tax under articles 6 to 22, Article 23 comes into picture.
- COR may exempt the income if it is taxable in COS. **[Exemption method]**
- COR may grant credit for tax paid in COS. **[Credit method]**

Elimination of Double Tax

- Three kinds of credits are available:
  - Direct tax credit.
  - Underlying tax credit.
  - Tax Sparing.
- The article works in combination with the Distributive Rules of the DTA, domestic tax rules. Non-discrimination article and Mutual Agreement Procedure may also be applicable.

Double Taxation - different kinds

- **Economic double taxation** – same income is taxed in two persons' hands.

  DTA does not eliminate this double taxation.
- **Juridical double taxation** – income is taxed in one person's hands in two different jurisdictions.

  DTA seeks to eliminate this double taxation. [Article 23 & other articles].

Double Taxation - different kinds

- **Dual residence** – Both countries may seek to tax the person on global income basis.

  DTA allocates residence to one country with tie-breaking rules. [Article 4].
- **Dual source** – the income may be considered as sourced in both countries.

  DTA does not eliminate this double taxation.

Basic Rule – Credit Method

- **Article 23B(1):**

  Where a resident of U.K., derives income which,

  in accordance with the provisions of this DTA, may be taxed in India,

  U.K. shall allow a **deduction from the tax** on the income, an amount equal to **tax paid in India**.

Basic Rule – Credit Method

- **Article 23B(2):**

  Where the income derived by a resident of U.K., is exempted from tax in U.K.,

  U.K. can **take into account** the exempted income, to calculate tax on the unexempted income.

Credit Method

- **Full credit –** COR gives credit for the entire tax amount paid in COS.
- **Ordinary credit (proportionate credit) –** COR gives credit for tax paid in COS, which is payable on that **portion of income which is taxable in both –** COR & COS.

Basic Rule – Exemption Method

- **Article 23A(1):**

  Where a resident of U.K., derives income which,

  in accordance with the provisions of the DTA may be taxed in India,

  U.K. shall, subject to the provisions of paragraphs 2 and 3,

  exempt such income from tax.

Basic Rule – Exemption Method

- **Article 23A(2):**

  Where a resident of U.K. derives income which,

  in accordance with the provisions of **articles 10, 11 and 12**, may be taxed in India,

  U.K. shall allow as a **deduction from the tax** of that resident an amount equal to the tax paid in India.

Basic Rule – Exemption Method

Such deduction shall not exceed that part of the tax, which is attributable to such items of income derived from India.

Basic Rule – Exemption Method

- **Article 23A(3):**

  Where in accordance with any provision of this DTA,

  income derived by a resident of a U.K. is exempt from tax in U.K.,

  U.K. can **take into account** the exempted income, to calculate tax on the unexempted income.

Basic Rule – Exemption Method

- **Article 23A(4) – [OECD Model only]:**

  The provisions of paragraph 1 (i.e. U.K. exempts the income) shall not apply to income of a U.K. resident,

  where India applies the provision of DTA (beneficially to the tax payer) to exempt such income or applies concessional rate as per article 10(2) or 11.

Exemption Method

- **Full exemption** – COR does not consider at all the income taxed in COS. It considers as if the resident never earned that income.
- **Exemption with progression** – COR does not tax the income taxed in COS; but considers that income for determining the tax on the unexempted income.

Credit Method	Exemption Method
Considers tax.	Considers income.
Total Tax payable is usually equal to the higher of the rates in two countries.	Tax could be lower than the rate in COR.
The benefit of tax reliefs in COS are enjoyed by COR.	COS can give fiscal benefits which investors can enjoy.
Losses in COS are considered in COR. (Tax on Global income principle).	Losses in COS ignored. (Territoriality principle).
Investment Export Neutrality.	Investment Import Neutrality.

Indian DTAs – Relief Method

- Normally ordinary credit method is adopted by India.
- In DTAs with Greece (1965 DTA), Bulgaria & Poland, India also has adopted Exemption Method.
- In DTAs with Austria, Belgium, Norway, Switzerland & Turkey, the other country has adopted exemption method.

Foreign Tax Credit – Indian Rules

- There are no rules for FTC.
- Section 91 – applicable where there is no DTA.

  Indian residents are given credit for **doubly taxed income**. Lower of foreign tax rate or Indian tax rate is available as credit.
- Section 90 – applicable only when there is a DTA. DTA lays down principles.

Foreign Tax Credit – Indian Rules

- Very few precedents.
- Chettiar (267 ITR 654)

  Malaysian income taxed in Malaysia is exempt from tax in India.

  Credit method is converted into Exemption method.
- Notification u/s. 90 & 90A.

FTC– Some judicial decisions

- Income to be considered is **ordinary commercial income** for the purpose of foreign tax credit. (Best & Crompton – 284 ITR 225 – Madras HC).
- Tax paid abroad has to be considered **country-wise** u/s. 91. (Bombay Burmah Trading – 259 ITR 423 – Bombay HC).

FTC– Some judicial decisions

- Credit is available for **income which is doubly taxed**.

	Income	**Tax**
Software income in Country A	1,000	200 (20%)
Income in India:		
Software income – 10AA	1,000	-
Other income	200	60 (30%)
	1,200	60

Tax Credit - NIL

FTC– Some judicial decisions

- Tax Credit is on **proportionate basis**.
  K. L. Parekh (208 ITR 965).
  (Mois (M.A.) - 210 ITR 284).

- Thus tax credit is available on a source by source, country by country and proportionate basis.

Foreign Tax – Deductible expenditure

- Tax paid in a foreign country cannot be considered as expenditure.

  South India Shipping (240 ITR 24).

  Kerala Lines (201 ITR 106).

  Tax paid is money spent out of profits, & not money spent to earn profits.

  S.40(a)(ii) – disallowance of Income-tax applies to foreign taxes also.

Foreign Tax – Deductible expenditure

- Business tax paid in Thailand was allowed as an expenditure as it was based on turnover. It was not considered disallowable u/s. 40(a)(ii).

  (K.E.C. International – 256 ITR 354).

Taxes

- Article 2 – deals with taxes covered by the DTA.
- Nature of tax should be income-tax.
- Income-tax levied in any form by any authority - is eligible for DTA relief.
- In some countries, only Federal Tax is eligible e.g. U.S.A.

Taxes

- Surcharge; Education Cess.
- DDT.
- MAT; Tonnage Tax; Agricultural Tax.

- R & D Cess.
- STT / CTT.
- Municipal Tax; RTO Tax.
- Social Security Tax.

Dividend Distribution Tax (DDT)

- Can credit be available for DDT as:
  - Direct Credit.
  - UTC.
- Is DDT tax on income?
- Can we consider that DDT has been paid by earner of income?
- Is it necessary that income earner should pay the tax?

Dividend Distribution Tax (DDT)

- S.115-O – Dividends shall be charged to **additional income-tax.**

  S.115-O(2) fixes the liability on the company. Thus company pays income-tax +DDT.
- **This is a COR issue.**
- Can DDT be considered as a part of UTC?

Dividend Distribution Tax (DDT)

- **India-UK DTA - Article 24(1)(b):**

If Indian company pays dividend to a UK company,

and the UK company controls directly or indirectly at least 10 per cent of the voting power of the Indian company,

the **credit shall take into account** the tax payable by the Indian company in respect of the profits out of which such dividend is paid.

Dividend Distribution Tax (DDT)

This credit is in addition to any Indian tax for which credit may be allowed under the provisions of sub-paragraph (a) of this article (i.e. tax on dividend).

Dividend Distribution Tax (DDT)

- U.K. & Mauritius have clarified that they will give credit for DDT – as UTC.
- Can DDT be restricted to DTA rate?

  India-U.K. DTA- Article 11(2) –
- Can an Advance Ruling be obtained?

  S.245N(a)(i) – Does the non-resident bear the tax?

  S.245N(a)(ii) – Is it a tax liability of the non-resident?

Education Cess

- Cess normally means a tax for specific purpose.
- When levied as **increment to an existing tax**, the name matters not for the validity of the cess must be judged of in the **same way as the validity of the tax to which it is increment**.

  (Chaturvedi & Pithisaria, fifth edition, Page 2377.)

Education Cess

	E.C. after FTC	E.C. before FTC
Tax in India on Foreign Income	300	300
I. **Less:** Foreign Tax	- 200	
	100	
Add: Education Cess @ 3%.	3	9
		309
II. **Less:** Foreign Tax		200
Tax in India	**103**	**109**

Education Cess

	E.C. is not a part of I.Tax	E.C. is part of I.Tax
Tax in India on Foreign Income	300	300
Add: Education Cess	9	9
Total Tax	309	309
Foreign Tax – 400		
Restricted to	300	309
Net Tax in India	**9**	**-**

Underlying Tax Credit (UTC)

- UTC means **credit for corporate tax**.
- UTC operates only when **dividends** are paid.

  If dividends are paid by the company, the shareholder gets credit for:

  - Tax on dividends

  +

  - Corporate tax on profits out of which dividends are paid.

Underlying Tax Credit

Example:

Corporate profit of Co. A.	1,000
Less: COS Tax @ 30%	300
Net Profit after tax	700
Dividend declared – say	350
COS Tax on dividend @ 10%	35

Underlying Tax Credit

Tax in shareholder's COR.	**With UTC**	**Without UTC**
Dividend received	350	350
Add: COS Corp. tax – 50% of 300	150	-
Taxable	500	350
COR Tax on dividend @ 40%	200	140
Less: Tax credit – Direct.	35	35
- UTC.	150	
Balance tax in COR	15	105

Underlying Tax Credit

- **Without UTC – Cascading effect of taxes:**

  An Indian company invests in Mauritius. Mauritian company invests in U.K. company. Dividends are declared by U.K. company which flow through to Indian company.

Underlying Tax Credit

Cascading effect of taxes…

Income in U.K.	1,000
Less: Tax in U.K. – 30%.	300
Net profit declared as dividend.	700
Tax on dividend in U.K. – say 20%.	140
Net Funds	**560**

Underlying Tax Credit

Cascading effect of taxes …

Net Funds	**560**
Tax in Mauritius – 15% on 700.	105
Less: Tax credit (140) – Restricted to.	105
Net profit declared as dividend.	560
Less: Tax in India – 30%.	168
Net funds after tax.	**392**

Underlying Tax Credit

- **With UTC – Cascading effect reduced:**

Income in Mauritius.	700
Add: UTC – Tax in U.K.	300
Gross income for Mauritius tax.	1,000
Tax in Mauritius @ 15%.	150
Less: Tax credit (300 + 140).	
- Restricted to.	150
Net Funds declared as dividend.	**560**

Underlying Tax Credit

With UTC.

Net Funds declared as dividend		**560**
Add: Tax in Mauritius – UTC.		150
		710
Tax in India – 30%.	213	
Less: Tax credit – Mauritius UTC.	150	63
Net Funds. (560 – 63)		**497**

Tax Sparing Credit

- It is a credit for tax which is forgone by COS due to tax benefits which it gives.
- Tax relief in the COS is enjoyed by the COR.
- To avoid transfer of funds from COS to COR, tax sparing credit is given.

Tax Sparing - Example

Profit from infrastructure activity.	1,000
Less: Relief U/s. 80 –IA.	- 1,000
Tax Profit.	-
Tax saved (or spared). -	300
assuming @ 30%.	

Tax Sparing - Example

	With T.S.	Without T.S.
Profit in home country.	1,000	1,000
Tax @ 40%.	400	400
Less: Tax Sparing Credit.	300	-
Balance tax paid.	100	400

Without tax sparing – 300 saved in India, will be enjoyed by the other country.

Amount of Tax Credit

Singapore income of Indian resident:

Profit before depreciation in Singapore.	10,00,000
Less: Depreciation as per Sing. law.	(-) 1,50,000
Profit after depreciation.	8,50,000
Tax in Singapore @ 20%.	1,70,000

Amount of Tax Credit

Total Income of India resident:

Profit in India – Singapore income.	10,00,000
Less: Depreciation as per Indian laws.	(-) 3,00,000
(Only Sing. assets. No Indian assets.)	
Singapore income after depreciation	7,00,000
Indian business income.	5,00,000
Total & Net income.	12,00,000
Tax in India @ 30% - On Sing. income	2,10,000
- On Indian income	1,50,000
- On Total income	3,60,000

Amount of Tax Credit

- **Tax Credit in India – Different possibilities.**

I. Indian Tax.	3,60,000
Less: Credit for Singapore Tax.	(-) 1,70,000
Net Tax paid in India.	**1,90,000**
II. Singapore income (10,00,000 – 3,00,000)	7,00,000
Credit for tax in Singapore @ 20%	1,40,000
Net Tax paid in India.	**2,20,000**
(3,60,000 – 1,40,000)	

Amount of Tax Credit

III. Singapore Income before depreciation	10,00,000
Less: Depreciation – proportionate. (3,00,000 x 10,00,000/15,00,000)	2,00,000
Taxable income	8,00,000
Credit for tax in Singapore @ 20%.	1,60,000
Net Tax paid in India. (3,60,000 – 1,60,000)	**2,00,000**

PE Losses – Indian situation

- Indian resident earns income from a PE in Japan:

  R. M. Muthaiah (202 ITR 508) (Madras HC).

  SRM Firm (208 ITR 400) (Madras HC).

  Chettiar (267 ITR 654) (Supreme Court)

  PE income is not taxable in India.

PE Losses – Indian situation

- Patni Computers (109 TTJ 742)
  Exclude the foreign income.
  Loss is deductible.
  Therefore it results in Double Dip.

PE Losses

Exemption Method in India (COR).		
	Year 1	**Year 2**
Income in India	80,000	1,20,000
Loss / Income in COS (branch outside India)	-20,000	30,000
Total Income.	**60,000**	**1,50,000**
Tax in COS	**Year 1**	**Year 2**
Income / Loss	-20,000	30,000
Less: B/f Loss	-	-20,000
Net Taxable Income.	-	**10,000**
Tax @ 30%	-	**3,000**

PE Losses

Tax in India		
	Year 1	**Year 2**
I. Total exclusion of COS income in India:		
Income in India	80,000	1,20,000
Tax @ 30%.	24,000	36,000
Tax in COS.	-	3,000
Total Tax	**24,000**	**39,000**
Total tax in 2 years.		**63,000**

PE Losses

II. Exclude income; but allow loss [Double Dip]		
	Year 1	**Year 2**
Income in India	60,000	1,20,000
Tax @ 30%.	18,000	36,000
Tax in India	-	3,000
Total tax	**18,000**	**39,000**
Total tax in 2 years.		57,000

Pick and Choose

- U.S. Treasury Explanation – India– U.S. DTA. U.S. company has 3 sources of income in India.

Source	PE Status	Income
A	No PE	500
B	No PE	-300
C	PE exists	1,000

Pick and Choose

- Can the assessee elect as under:

  For source A, no PE; no tax.

  For source B, "opt" for I.T. Act; set off the loss against source C.
- "Pick and choose" not permitted.

  Do not set off source B Loss; or offer source A also to tax.

Individual going Abroad

Example:

- Individual is deputed to U.S.A. in Nov. 2014 for two years.

  Prior to that he was an Indian resident.
- Nov. 2014 – March, 2015 – Salary is taxable in U.S. & India.
- **Jan. '15 – Mar. '15 – How much credit should be claimed?**

Individual going Abroad

Final U.S. tax will be known after Dec. ‘14. [U.S. has a calendar year.]

In India, return has to be filed by July, ’14.

- Practically, file the return on the basis of withholding taxes paid upto March. ‘14.
- After U.S. assessment is over, file revised return in India.
- **May be better to pay less tax in India at the time of filing the original return.**

Individual going Abroad

If assessment is over, & refund has to be claimed, it may be lost.

[For old refunds – CBDT instruction No. 13/2006 dt. 22.12.06].

[Hindustan Latex (42 ITD 325) – Principles of natural justice should prevail over technical & procedural issues.]

Individual going Abroad

- U.S. taxes – Will **State & City tax** be available as credit?

  U.S. – India DTA applies only to Federal tax.

  Section 91 – credit is available for foreign taxes, only where there is no DTA.

  [U.S. residents also do not get credit of foreign tax against state & city tax.]

Individual going Abroad

- Social security tax – Is credit available?

  DTA does not apply to social security tax.

  [OECD – social security charges means charges paid where there is a direct connection between the levy and individual benefits to be received.]

  Can exemption be claimed by claiming – Diversion by overriding title?

Timing Mismatch - Examples

- Emigrants from Australia pay capital gains tax on deemed basis as if assets have been sold on date of emigration. Will they get credit in COR when assets are actually sold?

Timing Mismatch - Examples

- Singapore – DTA applies only to the extent income remitted to Singapore.

  [Thoresen Chartering – Mumbai Tribunal – June, '08 – 24 SOT 433 - Tax charged at full rates if income is not remitted to Singapore]

  In subsequent year, if the income is remitted, will Singapore give credit for excess tax paid in India? Will India give refund?

Documents for Tax Credit

- DTA does not prescribe any documents or procedure. It is left to the domestic law.
- Indian Income-tax Act / Rules also do not prescribe any procedures/documents.
- Following documents help
  - Foreign TDS certificate.
  - Tax payment slips / challans.
  - Foreign tax return.
  - Certificate from foreign C.A.

Checklist for Foreign Tax Credit

- Identify the **person –** who has earned the income, & who has borne the tax?
- Is the tax covered under the **DTA?**

  If yes, credit available as per DTA.
- Are there **domestic FTC rules?**
- Is the DTA FTC limited by domestic FTC rules?

Checklist for Foreign Tax Credit

- How much income can be considered as **foreign income as per ordinary commercial principles?**
- Determine **taxable income earned abroad**.

  Expenses attributable to foreign income should be deducted from foreign income.

  Apply COR rules for computing foreign income.
- Determine tax on doubly taxed income in COR.

Checklist for Foreign Tax Credit

- Finality of tax in COS is generally available for credit.
- Timing mismatches.

  [Practically tax credit may be available without strictly going into detailed rules.]

Questions & Comments are welcome.

Naresh Ajwani
naresh@rashminsanghvi.com