SUGGESTED SOLUTION

FINAL MAY 2019 EXAM

SUBJECT- INTERNATIONAL TAXATION

Test Code - FNJ 7145

BRANCH - () (Date :)

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Answer 1:

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 artilces 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 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 DTAAs specifies the 'taxes covered' under the DTAA entered into between the Contracting States. In the DTAAs 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 DTAAs, 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 calcu lation 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.*

Answer 2:

I. ANSWERS TO MCQs (Most appropriate answers)

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

I. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1:

Computation of total income of Mr. Arjun Batra for the A.Y.2018-19

Particulars	Rs. In lakhs	
Income from house property		
Rent received [Rs.2 lakhs +Rs.3 lakhs]	5.0	
Less: Deduction u/s 24(a) at 30% of NAV	1.5	3.5
Profits and gains of business or profession		
Own business income [Rs.2.2 lakhs (Country E) + Rs.3.3 lakhs (Country F) + Rs.1.5 lakhs (India)]	7.0	
Loss from partnership firm in Country E [Rs.1 lakh] and Country F [Rs.1.5 lakhs]	(2.5)	4.5
[Share of profit from foreign firm is not exempt. Hence, loss can be set-off against business income]		
Capital gains		
Long-term capital gains on transfer of residential house in Mumbai	45.0	
Less: Exemption u/s 54 – Purchase of residential house in Jaipur in wife's name within two years from the date of transfer	37.0	
Net long-term capital gains	8.0	

Short-term capital gains on transfer of vacant site in Country E	15.0	23.0
Income from other sources		
Agricultural income in Country E and Country F [Rs.1.2 lakhs + Rs.1.8 lakhs]	3.0	
Agricultural income from lands in Bengaluru [exempt u/s 10(1) since earned in India]	-	3.0
Gross Total Income		**34.0**
Less: Deduction under Chapter VI-A: Section 80C – PPF		1.5
Total Income		**32.5**

Computation of tax liability of Mr. Arjun Batra for A.Y.2018-19	**Rs.**
Tax on Rs.35.7 lakhs, being non-agricultural income [Rs.32.5 lakhs] + agricultural income [Rs.3.2 lakhs]	
Tax on LTCG of Rs.8 lakhs@20%	1,60,000
(+) Tax on other income of Rs.27.7 lakhs	6,43,500
	8,03,500
(-) Tax on Rs.5.7 lakhs, being agricultural Income [Rs.3.2 lakhs] + Basic Exemption Limit [Rs.2.5 lakhs]	26,500
	7,77,000
Add: Education cess and SHEC@3%	23,310
	8,00,310
Indian rate of tax = 8,00,310 x 100/32,50,000 = 24.625%	
Less: Rebate u/s 91 on income of Country E + Country F	4,47,817
Tax payable in India	**3,52,493**
Tax payable (Rounded off)	**3,52,490**
<u>Computation of average rate of tax in Country E</u>	**Rs. in lakhs**
Gross rental receipts from commercial property [No deduction is allowed from this in Country E]	2.0
Share income from partnership firm (loss) to be ignored	-
Business income	2.2
STCG from sale of vacant site on 1-11-2017	15.0
Agricultural income [Exempt in Country E]	-
Total income	**19.2**
<u>Rates of tax in Country E</u>	
Upto 3 lakhs Nil	-
3 to 6 lakhs 15%	0.45
Above 6 lakhs 22%	2.904
	3.354
Average rate of tax in Country E = 3.354 x 100/19.2 = 17.469%	
Doubly Taxed Income (in Country E)	**Rs. in lakhs**
Gross rental receipts form commercial property (Rs.2 lakhs – Rs.0.6 lakhs, being 30% of Rs.2 lakhs)	1.4
Share of loss from partnership firm	(1.0)

Business income	2.2
STCG from sale of vacant site on 1-11-2017	15.0
	17.6
Double Taxation Relief at India rate of tax or rate of tax in Country E, whichever is lower	17.469%
Double Taxation Relief = 17.469% of Rs.17.6 lakhs = Rs.3,07,454	
Doubly Taxed Income (in Country F)	
Gross rental receipts from commercial property [Rs.3 lakhs (-) 30% of Rs.3 lakhs]	2.1
Business income	3.3
Share of loss from partnership firm	(1.5)
Agricultural income	1.8
Total income	5.7
Rate of Tax in Country F	27%
Double Taxation Relief at Indian rate of tax (24.625%) or rate of tax in Country F (27%), whichever is lower	24.625%
Double Taxation Relief = 24.625% of Rs.5.7 lakhs = Rs.1,40,363	
Double Taxation Relief [Country E & Country F] = Rs.3,07,454 + Rs.1,40,363	4,47,817

Answer to Q.2:

Any undisclosed foreign income or foreign asset will be chargeable to tax under the provisions of Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 ("BM Act").

Any undisclosed foreign income will be taxed as the income of the previous year to which it pertains. Hence Rs 5 lakhs will be taxed as the income of the previous year 2016 -17.

An undisclosed asset located outside India shall be charged to tax on its value in the previous year in which such asset comes to the notice of the Assessing Officer. Thus, the value of the undisclosed foreign asset will be taxed as the income of the previous year 2018-19.

The undisclosed asset is gold jewellery. The value of the same is the higher of:

(a) Purchase price (Rs 4.2 lakhs), and

(b) Value as on valuation date (1st April of the previous year) as per report of a Valuer recognized by the Government (Rs 5.2 lakhs).

The tax consequences are as under:

Particulars	P.Y. 2016-17	PY 2018-19	Tax (@30%)
Undisclosed income	Rs.5,00,000		Rs.1,50,000
Undisclosed jewellery		Rs.5,20,000	Rs.1,56,000

Case Study 3:

I. ANSWERS TO MCQs (Most appropriate answers)

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

II. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1:

First stage: Professionals have been hired in India for preparing a report over a period of two months. Based on the contents of the report, it is possible to take a view that the work done by the professionals is merely preparatory and auxiliary in nature. Once the activities are preparatory and auxiliary in nature, the activities cannot be classified as triggering a PE implication for Athena Ltd. in India as per Article 5(4) of the India-Country A DTAA. In any case, at this stage, there is no revenue generation to trigger the concept of PE.

Second stage: Article 5(6) of the DTAA with Country A does not expressly provide for exclusivity of relationship with the principal as a test of agent's dependence. However, "exclusive" relationship with the principal is a relevant factor, although not entirely determinative, in ascertaining an agent's independence. In this case, considering that Shyam is an agent exclusively for Athena Ltd., it is possible to take a view that he is a dependent agent. As per Article 5(5) of the DTAA with Country A, a dependent agent in India would constitute a PE for Athena Ltd. only if it is shown that he has the authority to conclude contracts in the name of Athena Ltd. In this case, it can be seen that the role of the agent does not extend to concluding contracts on behalf of the principal. Here, the agent can only engage in preliminary negotiations with the final say being reserved exclusively for Athena Ltd. alone. Further, he has to identify potential customers and sell the products at the initial offer price which is also decided by the Board of Athena Ltd. Due to these reasons, the agent in India does not constitute a PE for Athena Ltd.

Third stage: The traditional meaning and understanding of a fixed place PE connotes a physical space which is at the disposal of the non-resident enterprise and through which the latter conducts its business. With respect to a website, it has been held that it is merely a software. In the absence of the server supporting the website being located in India (here, it is in Cayman Islands), there can be no PE liability for Athena Ltd. The server, through which business is carried on, is located in Cayman Islands, a no tax jurisdiction, and not in India.

Furthermore, a warehouse in India would not constitute a PE as per Article 5(4) of the India-Country A DTAA.

Fourth stage – In this stage, Athena Ltd. sets up a branch in Mumbai, which constitutes a PE in India as per Article 5(1)/(2) of the India-Country A DTAA. Accordingly, profits of Athena Ltd. as are attributable to the PE in

India would be liable to tax in India.

Answer to Q.2(a):

(i) The rise of e-commerce has led to an emergence of digital economy. Physical locations of the servers of such digital businesses were considered to establish the tax jurisdiction in which the profits of digital businesses could be taxed. Servers were, therefore, placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

In the third stage, the business in India is to be carried on through the website hosted on the server located in Cayman islands, which is a no tax jurisdiction. In fact, the server located in Cayman islands carries on the entire set of operations. A website consists of data and programmes in digitised form which is stored on a server of the internet service provider. On the other hand, a permanent establishment, as the name itself suggests, is a fixed place of some permanence from where a business is carried on. Therefore, existence of a website in India would not constitute a permanent establishment.

However, the server is a system which carries out activities initiated by an end-user's computer. In this case, Athena Ltd. itself owns and operates the server and the business is carried on through the server, it could be construed to be a permanent establishment. However, the server is located in Cayman Islands, which is a no tax jurisdiction. Location of the server owned and operated by Athena Ltd., which constitutes a PE in this case, in a no tax jurisdiction may be viewed as a strategy adopted by Athena Ltd. to avoid tax in India, considering the fact that Athena Ltd. is a Country A based company, its Board of Directors are residents of Country B and it wishes to expand its market in India. However, it has chosen to locate the server through which it carries on business in a fourth place, namely, Cayman islands, which is a no tax jurisdiction. This may be viewed as a strategy adopted by Athena Ltd. to avoid tax in India in the third stage.

(ii) Owing to the 'intangibility' attached to the digital model of business, tax authorities often face challenges in rightly bringing to tax the profits earned from a digital business.

Action Plan 1 of the BEPS project was developed by the OECD which outlines the methods and principles based on which physical and digital economies can be taxed at par.

The OECD recommends the following options to address the challenges of the digital economy -

- Modifying the existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE, if it maintained a significant digita l presence in another country's economy.
- 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
- 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 PE in other contracting state.

Answer to Q.2(b)

The process of determination of POEM is primarily based on the fact as to whether or not the company is engaged in active business outside India.

A company shall be said to be engaged in "active business outside India"

- if the passive income is not more than 50% of its total income; **and**
- less than 50% of its total assets are situated in India; **and**
- less than 50% of total number of employees are situated in India or are resident in India; **and**
- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Passive income is the aggregate of, -

(i) income from the transactions where both the purchase and sale of goods is from/to its associated enterprises; and

(ii) income by way of royalty, dividend, capital gains, interest or rental income;

(1)	(2)	(3)	(4)	(5)	(6)
Particulars	**Country A**	**Country B**	**India**	**Total**	**% of (4) to total in (5)**
Value of assets	Rs.400 lakhs	Rs.100 lakhs	Rs.210 lakhs	Rs.710 lakhs	29.58%
Number of employees	30	10	20	60	33.33%
Payroll expenses on employees	Rs.160 lakhs	Rs.35 lakhs	Rs.65 lakhs	260	25.00%

It can be seen that the value of assets in India is only 29.58% of the total assets of the company, the number of employees in India is only 33.33% of the total number of employees and the payroll expenses incurred on such employees is only 25% of its total payroll expenditure. Thus, three out of four conditions for active business outside India are met. However, the passive income test has also to be met for active business to be outside India.

Passive income = income from transactions where both purchases and sales are from/to associated enterprises + total income by way of dividend and interest = Rs.110 lakhs + Rs.35 lakhs = Rs.145 lakhs

Percentage of passive income to total income = 145/250 × 100 = 58%

In this case, the passive income is more than 50% of the company's total income. Hence, the passive income test has failed, consequent to which the company cannot be said to have active business outside India.

Answer to Q.3:

(a) Equalisation levy@6% is attracted on the amount of consideration for specified services received or receivable by a non-resident not having PE in India from a resident in India who carries on business or profession or from a non-resident having PE in India. Specified services include online advertisement and any provision for digital advertising space or any other facility or service for the purpose of online advertisement.

In this case, Google Inc is a non-resident not having PE in India. It receives consideration of Rs.30 lakhs from Athena Ltd., a non-resident having PE in India, for online advertisement services provided by it. Hence, equalization levy@6% on Rs.30 lakhs is attracted in the hands of Google Inc.

In the hands of Athena Ltd., the amount of Rs.30 lakhs paid to Google Inc. would be allowable as business expenditure, provided equalization levy has been deducted at source.

(b) Athena Ltd. is liable to deduct equalization levy of Rs.1.80 lakhs from the amount of Rs.30 lakhs payable to Google Inc. In case it fails to so deduct equalization levy, it shall, notwithstanding such failure, be liable to pay the levy to the credit of the Central Government by 7th April, 2018. Further, penalty of an amount equal to Rs.1.80 lakhs would be attracted for failure to deduct equalization levy. Also, disallowance of the expenditure of Rs.30 lakhs would be attracted under section 40(a)(ib) while computing business income of Athena Ltd.

(c) Section 10(50) of the Income-tax Act, 1961 exempts income arising from providing specified service of online advertisement, which are subject to equalization levy, from income-tax.