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CA FINAL MAY'19

SUBJECT- INTERNATIONAL TAXATION

Test Code - FNJ 7189

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Answer to case study 1:

I. ANSWERS TO MCQs (Most appropriate answers)

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

II. ANSWERS TO DESCRIPTIVE QUESTIONS

1. (i) As per Article 4(1) of the India and Country "Q" DTAA, the term "resident of a Contracting State" means any person who is a resident of a Contracting State in accordance with the taxation laws of that State.

Therefore, for determining whether Mr. Shivam is a resident of India or Country "Q", first, the residential status as per the taxation laws of respective countries has to be ascertained.

As per section 6(1) of the Income-tax Act,1961, an individual is said to be resident in India in any previous year if he satisfies any one of the following conditions:

a) He has been in India during the previous year for a total period of 182 days or more; or

b) He has been in India during the 4 years immediately preceding the previous year for total period of 365 days or more and has been in India for at least 60 days in the previous year.

An Indian citizen, who leaves India in the previous year for the purpose of employment outside India, shall be considered as resident only if the period of his stay during the relevant previous year in India is 182 days or more.

Since Shivam left on 30th September 2018, he stayed in India during the P.Y. 2018-19 for 183 days. Therefore, he is a resident in India for the P.Y.2018-19.

Further, Shivam had come back to India after completing his engineering in Mid 2011 and since then he has been working in India. Hence, he fulfils the following conditions for resident and ordinarily resident:

(i) He is a resident in atleast 2 out of 10 years preceding the relevant previous year, and

(ii) His total stay in India in last seven years preceding P.Y. 2018-19 is 730 days or more.

Thus, Shivam is Resident and Ordinarily Resident in India for the P.Y.2018-19.

As per Country "Q" tax residency rules, Shivam qualifies to be resident for the year 2018-19 in Country "Q", since he stays for 182 days (more than 180 days) in Country "Q" in the Financial Year 2018-19.

Thus, as per the domestic tax laws of India and Country "Q", Shivam qualifies to be a resident both in India and Country "Q" during the year 2018-19. Hence, the tie-breaker rule provided in Article 4(2) of the India-Country "Q" DTAA will come into play.

This Rule provides that where an individual is a resident of both the countries, he shall be deemed to be resident of that country in which he has a permanent home and if he has a permanent home in both the countries, he shall be deemed to be resident of that country, which is the centre of his vital interests i.e. the country with which he has closer personal and economic relations.

From the facts, it is evident that Shivam has been living in a rented accommodation in Defence Colony, Delhi. Even after he moved to Country "Q", his family continues to stay in the same rented accommodation in Delhi. Hence, it can be considered as permanent home for him in India. In Country "Q", he has been provided with a rent-free accommodation by his employer for a period of three years, which would be considered as permanent home for him. Since he has a permanent home both in India and Country "Q", the next test needs to be analysed.

Shivam owns a house property in India from which he derives rental income. His family also resides in India. He performs in Carnatic music concerts in India, both in Delhi and in Chennai. Therefore, his personal and economic relations with India are closer, since India is the place where -

(a) the residential property is located and

(b) social and cultural activities are closer

Thus, by applying Article 4 of the India-Country "Q" DTAA, Shivam shall be deemed to be resident in India.

(ii) Article 26 of India-Country "Q" DTAA deals with the international exchange of information between the tax authorities of the countries. The purpose is wider than mere tax compliances; it is also meant to counter tax evasion and avoidance. The competent authorities of the two Contracting States can exchange information which is

'foreseeably relevant' for the proper application of agreement or for the administration or enforcement of their domestic laws, as long as taxation under the laws in not inconsistent with the treaty agreement.

Paragraph 3 of the Article lists the types of information, the request for which either country is not obligated to comply.

However, paragraph 4 of the Article further clarifies that even though obligation to provide information is subject to the limitation contained in paragraph 3, the requested country cannot decline to supply information solely because it has no domestic interest in such information.

Accordingly, Country "Q" tax authorities are **not justified** in denying to provide information stating that it will not get any revenue benefit by providing such information. Country "Q" is obligated to provide the requested information, even if it has no revenue interest in the case to which the request relates.

However, in case the reason of denial is in accordance with the specific limitations contained in paragraph 3, then, Country "Q" tax authorities shall be under no obligation to provide the requested information. Hence, denial by tax authorities on the ground that exchange of such information would be contrary to public policy **is justified.**

2. (a) (i) As per paragraph 3(b) of Article 5 'Permanent Establishment' of India-Country "R" DTAA, a service PE is established if the foreign enterprise provides services in India through employees or other personnel engaged for more than 180 days in a fiscal year. Thus, Service PE is not dependent upon the fixed place of business. It is only dependent on the continuation of the activity, which does not mandate physical presence/fixed place.

Hence, the project of Cure House for providing consultancy services, will expose it to creation of service PE in India.

(ii) As per section 245N(b)(A)(I), an application for advance ruling can be made *inter-alia* by a non-resident in relation to a transaction which has been undertaken or is proposed to be undertaken by it.

Hence, Cure House Inc., a non-resident applicant, can file an application to Authority of Advance Rulings, alongwith the prescribed fees, for determination in relation the transaction undertaken by it in India i.e., rendering consultancy services in the field of medicine.

As per section 245N(b)(A)(III), a resident applicant who has undertaken or has proposed to undertake one or more transactions of value of INR 100 crore or more in total can file an application for Advance Ruling for determination by the AAR in relation to his/her tax liability arising out of such transactions and such determination shall include the determination of any question of law or of fact specified in the application.

In the present case, since the project value is only INR 70 crore, Sudha, a resident Indian cannot file an application with AAR for determination of her tax liability arising out of the said project.

(b) Section 9(1)(i) requires existence of business connection for deeming business income to accrue or arise in India. DTAAs may, however, provide that business income is taxable only if there is a permanent establishment in India.

Therefore, in cases covered by DTAAs, where there is no permanent establishment in India, business income cannot be brought to tax due to existence of business connection as per section 9(1)(i). However, in cases not covered by DTAAs, business income attributable to business connection is taxable.

Hence, business income earned by a resident of Country "Q" can be brought to tax only if he has a PE in India. However, business income of a resident of Country "N" attributable to his business connection in India, can be brought to tax in India.

3. Computation of total income of Shivam for A.Y. 2019-20

Particulars	INR	INR
Income from Salaries		
Salary from services rendered in India (April - September 2018)		
Basic Salary (INR 70,000 x 6)	4,20,000	
Dearness Allowance (INR 30,000 x 6)	1,80,000	
Special Allowance (INR 5,000 x 6)	30,000	
Bonus	3,00,000	
[Even though bonus is paid in an overseas bank account after the commencement of his overseas assignment, however, since it pertains to services rendered in India, it would be taxable in India]		9,30,000
Salary from services rendered in Country "Q" (October 2018 - March 2019)		
Basic Salary [See Note (i)]	3,93,680	
Cost of Living Allowance [See Note (i)]	2,81,200	6,74,880
		16,04,880
Less: Standard deduction u/s 16(ia)		40,000
		15,64,880
Income from House Property at Mumbai		
Net Annual Value [See Note (ii)]	6,00,000	
Less: Standard deduction @ 30%	(1,80,000)	
		4,20,000
Income from Other Sources		
Interest earned from investment of security deposit (INR 1,00,000 @10%)	10,000	
Interest earned on saving bank account with Country "Q" [QGD 150 x INR 48.61] [See Rule 115 in Note (i)]	7,292	

Interest on Securities of a Country "Q" company [QGD 5000 x INR 48.52] [See Rule 115 in Note (i)]	2,42,600	
Interest on bonds issued by Country "P" Government	30,000	
Dividend from a Country "Q" Company (QGD 1000 x INR 48.52] [See Rule 115 in Note (i)]	48,520	
(Dividend from foreign company is taxable in India)		
		3,38,412
Gross Total Income		23,23,292
***Less:* Deductions under Chapter VI-A**		
Deduction u/s 80DD	75,000	
(Flat deduction of INR 75,000 is allowed in respect of medical treatment of dependent disabled, irrespective of the expenditure incurred)		
Deduction u/s 80GG [See Note (iii)]	60,000	1,35,000
Total Income		**21,88,292**
Total Income (rounded off)		**21,88,290**

Computation of tax liability of Shivam for A.Y. 2019-20

Particulars	INR	INR
Tax on INR 21,88,290		4,68,987
Add: Health and education cess @4%		18,759
Tax Liability		4,87,746
Less: Foreign Tax Credit [See Note (v)]		
- on salary income	98,709	
- on interest income	36,390	1,35,099
Net tax liability		**3,52,647**
Net tax liability (rounded off)		**3,52,650**

Notes:

(i) In accordance with Rule 115, following rate of exchange has been used for conversion of income earned outside India :

- *Salary* – last day of the month immediately preceding the month in which the salary is due
- *Interest on securities*- last day of the month immediately preceding the month in which the income is due i.e. rate as on 28.02.2019
- *Interest earned on other than securities* i.e. interest on bank deposits- last day of the previous year i.e. rate as on 31.03.2019

- *Dividends* - last day of the month immediately preceding the month in which the dividend is declared, distributed or paid by the company i.e. rate as on 28.02.2019

Accordingly, income earned outside India in Indian currency would be computed in the following manner:

Overseas salary for the period October 2018 to March 2019:

Month	Basic Salary in QGD (1)	Cost of living Allowance (COLA) (2)	Rate of Exchange (3)	Basic Salary in INR (1 x 3)	COLA in INR (2 x 3)
Oct 18	1400	1000	45.95	64,330	45,950
Nov 18	1400	1000	46.85	65,590	46,850
Dec 18	1400	1000	45.10	63,140	45,100
Jan 19	1400	1000	46.95	65,730	46,950
Feb 19	1400	1000	47.83	66,962	47,830
Mar 19	1400	1000	48.52	67,928	48,520
Total	**8400**	**6000**	**-**	**3,93,680**	**2,81,200**

(ii) In absence of information relating to fair market value, standard rent and municipal rent, actual rent received is considered as Gross Annual Value

(iii) As Shivam is not receiving any house rent allowance from his employer and the house property owned by him is not in the same city of his residence/employment, Shivam is eligible to claim deduction under section 80GG as under :

Deduction shall be lower of the following:

- INR 5,000 per month = INR 60,000
- 25% of the adjusted total income = 25% of INR 22,48,292 = INR 5,62,073
- Actual rent – 10% of adjusted total income = INR 3,00,000 (25,000*12) – INR 2,24,829 (10% of 22,48,292) = INR 75,171

Adjusted total income = Gross total income after providing for deduction under section 80C to 80U but before deduction under section 80GG = INR 23,23,292 – INR 75,000 = INR 22,48,292.

Hence, deduction under section 80GG shall be INR 60,000.

(iv) Deduction under section 80TTA is allowed only on interest earned on saving deposits with Indian bank and not with overseas bank account.

(v) Since Shivam is a resident and ordinarily resident in India for the A.Y.2019-20 by virtue of section 6 of the Income-tax Act, 1961, his global income is taxable in India. In such

case, the income arising in Country "Q" is doubly taxed. In order to avoid double taxation, Shivam can take the benefit of DTAA between India and Country "Q" by way of foreign tax credit in respect of the tax paid in Country "Q" or tax paid on such income in India, whichever is lower.

An income earned outside India which is exempt from tax in the respective country cannot be considered as doubly taxed income for the purpose of calculation of foreign tax credit, since no taxes have been paid on such income. Hence, interest on bonds issued by Country "P" Government, interest on savings bank account in Country "Q" and dividend earned on shares of a Country "Q" Company, though taxed in India but shall not be eligible for claiming foreign tax credit as they are exempt from tax in their respective countries.

(vi) With reference to Article 23 of India-Country "Q" DTAA, Indian resident shall be allowed credit of taxes paid in Country "Q" on the income which is also taxed in Country "Q". Hence, foreign tax credit shall be calculated as below:

<u>Calculation of foreign tax credit</u>

Doubly taxed Salary Income		**INR**
Basic Salary		3,93,680
Cost of Living Allowance		2,81,200
		6,74,880
Less: Standard deduction (40,000 x 6,74,880/16,04,880)		16,821
Doubly taxed salary income		**6,58,059**
Computation of foreign tax credit on doubly taxed salary income:		
Lower of:		
Tax withheld in Country "Q" on salary income at 15%	98,709	
Tax payable in India on salary income@22.29% (INR 4,87,746/ INR 21,88,290)	1,46,681	
Foreign tax credit		**98,709**

Double taxed Interest Income	**INR**
Interest Income on Securities of Country "Q" company	2,42,600
Computation of foreign tax credit on doubly taxed interest income:	
Lower of:	
Tax withheld in Country "Q" on interest income at 15%, which is also the rate as per the DTAA	36,390
Tax payable in India on interest income@22.29%	54,076
Foreign tax credit	**36,390**

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

Answer to Case Study 2:

I. ANSWERS TO OBJECTIVE TYPE QUESTIONS

1. (b) Banking and Insurance business

2. (d) Rs1 Crore

3. (c) A Inc., USA; A LLC, Cyprus; and AA Ltd., China.

4. (d) 30%

5 (c) Rs95 lakhs

6 (d) Rs 1 lakh – fixed penalty

7. (c) A.Y.2027-28

8. (d) 90 days from 30th November of the assessment year

9. (c) A.Y.2018-19 and the amount of primary adjustment is Rs1.05 crore

10. (c) Deemed loan approach

II. ANSWERS TO DESCRIPTIVE QUESTIONS

1. Section 94B is applicable to an Indian company or a permanent establishment of a foreign company in India, being the borrower who pays interest in respect of any form of debt issued by

- non-resident, being an associated enterprises (AE) of such borrower or
- by a lender which is not an AE but where the AE provides either implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, then such debt would be deemed to have been issued by an AE.

In order to determine the interest disallowance amount under Section 94B, the interest paid to non-resident AEs and deemed AEs needs to be determined. Payment of interest to resident AEs is not to be considered for disallowance since the interest payment

made to non-resident AEs alone are to be taken into account for such purpose. In the present case, the interest disallowance and permissible interest deduction under the head "Profits and gains from business or profession" would be –

Particulars	Amount (Rs in crores)
Interest paid to A LLC Cyprus [See Note (i)]	80.00
Interest paid to Bank of Chennai based on guarantee provided by A Inc, USA [See Note (ii)]	8.00
Guarantee Fee paid to A Inc, USA [See Note (iii)]	0.50
Interest paid to TN Mercantile bank based on letter of comfort by director of A Ltd. [See Note (iv)]	Nil
Interest paid to Union City Bank, India [See Note (v)]	Nil
Interest paid to Bank of Taiwan [See Note (vi)]	Nil
Guarantee fee paid to AAA Ltd., Taiwan [See Note (vi)]	Nil
Interest paid to Wells Cargo Bank based on deposits made by A Inc, USA [See Note (vii)]	Nil
Interest paid to Bank of USA based on deposits made by A Inc, USA [See Note (viii)]	12.00
Interest paid to AA Ltd, China, being interest on delayed payment to creditor [See Note (ix)]	1.00
Interest paid or payable to non-resident AE	**101.50**
EBIDTA	200.00
Excess Interest: lower of the following would be disallowed	**41.50**
- Interest paid or payable to non-resident AE in excess of 30% of EBIDTA [Rs 101.50 crores - Rs 60.00 crores] Rs 41.50 crores	
- Interest paid or payable to non-resident AE Rs 101.50 crores	

Therefore, interest paid or payable allowable as deduction under the head "Profits and gains of business or profession" would be Rs 76.25 crores [Rs 60 crores (Rs 101.50 crores – Rs 41.50 crores), being the amount paid or payable to non-resident AE ***plus*** Rs 16.25 crores, being the amount paid to other entities].	76.25

Notes:

(i) Interest paid to a non-resident AE falls within the scope of section 94B. A LLC is deemed to be an AE of A Ltd., since the loan advanced by it constitutes not less than 51% of the book value of total assets of A Ltd. Hence, interest paid to A LLC is to be considered for the purpose of limitation of interest deduction under section 94B.

(ii) The proviso to Section 94B(1) states "where the debt is issued by a lender which is not associated but an associated enterprise either **provides an implicit or explicit guarantee to such lender** or deposits a corresponding and matching amount of funds with the lender, such debt shall be **deemed to have been issued by an associated enterprise**."

Since A Ltd., India is a wholly owned subsidiary of A Inc., USA, A Ltd. and A Inc. are AEs.

Thus, the debt issued by Bank of Chennai would be deemed as issued by the A Inc. USA, being the AE, hence, the amount of interest paid on such debt has to be considered for the purpose of limitation of interest deduction under section 94B.

(iii) As per section 94B(5)(ii), debt means, *inter alia,* any loan that gives rise to interest which is deductible while computing business income.

Though guarantee fee is not specifically referred to in the meaning of the term "debt" defined under section 94B(5)(ii), the term 'interest' is defined in section 2(28A) of the Income-tax Act, 1961 to mean interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized." Therefore, given the wide definition that interest

partakes, guarantee fee can be classified as interest. Accordingly, the same has to be considered for the purpose of limitation of interest deduction under section 94B.

(iv) Since the loan is obtained based on a letter of comfort provided by a resident director of A Ltd., the said interest will not be factored for the purpose of excess interest disallowance under section 94B.

(v) Since loan was obtained by A Ltd independently from a third-party lender Union City Bank of India, interest paid on such loan shall not be considered for the purposes of Section 94B, as the same is paid to an enterprise which is not a non-resident AE.

(vi) Since A Ltd.'s voting power in AAA Ltd., Taiwan is less than 26%, AAA Ltd., Taiwan is not an AE of A Ltd. Since loan was obtained by A Ltd from Bank of Taiwan, Indian branch, for which guarantee was given by an enterprise, not being an AE, this interest shall not be considered for the purposes of section 94B. Likewise, guarantee fee paid to AAA Ltd. shall also not be considered for the purposes of section 94B.

(vii) The proviso to section 94B(1) provides that "**where the debt is issued by a lender** which is not associated **but an associated enterprise** either provides an implicit or explicit guarantee to such lender or **deposits a corresponding and matching amount of funds with the lender**, such debt shall be deemed to have been issued by an associated enterprise."

Here, the loan of $ 10 million taken by A Ltd and the amount of $ 5 million deposited by A Inc., USA with Wells Cargo Bank can be viewed as not corresponding and matching to the amount of issued debt, hence, such debt is **not** deemed to have been issued by an AE.

Alternate view *– It is also possible to take a view that interest on loan to the extent of the deposit made by the non-resident AE has to be considered for the purposes of section 94B. In such a case, Rs 3 crores being interest corresponding to loan of $ 5 million would be considered for the purposes of section 94B.*

(viii) In the given case, the loan taken by A Ltd and the amount deposited by A Inc. USA in Bank of USA is US $ 20 million. Since A Inc. USA, being an AE has **deposited a corresponding and** matching **amount of funds** with the lender, the debt issued by

Bank of USA shall be deemed to have been issued by A Inc., being an AE. Thus, the amount of interest paid on such debt to Bank of USA would be considered for the purpose of limitation of interest deduction under section 94B.

(ix) Section 94B(5)(ii) defines the term “debt” as any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income chargeable under the head "Profits and gains of business or profession".

In the present case, interest paid is towards delayed payment to AA Ltd China, being its creditor for supply of raw material can be considered as an arrangement that gives rise to interest or other finance charges that are deductible in computation of Income under the head "Profits and gains of business or profession[1]".

Further, since 90% of raw materials required by A Ltd. is supplied by AA Ltd., China and price and other conditions for supply of raw material are also influenced AA Ltd., China, AA Ltd., is deemed to be an AE of A Ltd. Thus, the amount of interest paid towards delayed payment has to be considered for the purpose of limitation of interest deduction under section 94B.

ALTERNATE ANSWER:

Section 94B(1) of the Income-tax Act, 1961, provides that notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature exceeding one crore rupees which is deductible in computing income chargeable under the head "Profits and gains of business or profession" in respect of any debt issued by a non-resident, being an associated enterprise of such borrower, the interest ***shall not be deductible*** *in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2).*

As per section 94B(2), the excess interest shall mean an amount of ***total interest paid or payable*** *in excess of 30% of earnings before interest, taxes, depreciation and*

amortization (EBITDA) of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less.

As per Explanatory Memorandum to the Finance Bill, 2017, the interest expenses claimed by an entity to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less. It implies that "excess interest" means the amount

- *interest paid or payable by an entity to its non-resident associated enterprises in excess of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or*
- *interest paid or payable to non-resident associated enterprises for that*

previous year, whichever is less.

The intent behind insertion of this section also appears to restrict the interest paid to non-resident AE to 30% of EBITDA. In the above solution, the excess amount is computed in line with the intent expressed in section 94B(1) read with the Explanatory Memorandum.

However, an alternate view may also be possible on the basis of the interpretation as per the plain reading of section 94B(2).

On a plain reading of provisions of section 94B(2), it appears that the "excess amount" has to be computed by taking–

- ***total interest paid or payable** by the borrower in excess of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or*
- *interest paid or payable to associated enterprises for that previous*

year, whichever is less.

Accordingly, the interest disallowance and amount of interest paid or payable by A Ltd allowable

as deduction under the head "Profits and gains of business or profession" would be –

Particulars	**Amount (Rs in crores)**
Interest paid to A LLC Cyprus	80.00

Interest paid to Bank of Chennai based on guarantee provided by A Inc, USA	8.00
Guarantee Fee paid to A Inc, USA	0.50
Interest paid to TN Mercantile bank based on letter of comfort by director of A Ltd.	4.00
Interest paid to Union City Bank, India	3.00
Interest paid to Bank of Taiwan	3.00
Guarantee fees paid to AAA Ltd., Taiwan	0.25
Interest paid to Wells Cargo Bank based on deposits made by A Inc, USA	6.00
Interest paid to Bank of USA based on deposits made by A Inc, USA	12.00
Interest paid to AA Ltd., China being interest on delayed payment to creditor	1.00
Total interest paid or payable by A Ltd.	**117.75**
Interest paid or payable to non-resident AE (computed above)	**101.50**
EBIDTA	200.00
Excess Interest: lower of the following would be disallowed,	**57.75**
- Total interest paid or payable in excess of 30% of EBIDTA Rs 57.75 crores **[i.e., Rs 117.75 crores – Rs 60.00 crores]** - Interest paid or payable to non-resident AE Rs 101.50 crores	
Therefore, interest paid or payable allowable as deduction under the head "Profits and gains of business or profession" would be Rs 60 crores (Rs117.75 crores – Rs 57.75 crores)	60.00

2 **(a)** **(i)** A company is typically financed or capitalized through a mixture of debt and equity. The manner in which company raises capital has a significant impact on the amount of profit it reports for tax purposes. This is due to the reason that tax legislations of countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus, the amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax

efficient method of finance than equity. Since in such a structure, equity financing is less, it is referred to as Thin Capitalization. Thin capitalization, thus, refers to the process of funding an entity by debt instead of equity with a view to take advantage of interest deduction benefits.

(ii) Multinational groups are often able to structure their financing arrangements to maximize these benefits. To prevent tax erosion on account of such arrangements, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross- border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base. Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in its Action plan 4. The OECD has recommended several measures in its final report to address this issue. In view of the above, section 94B has been inserted in the Income-tax Act, 1961, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest paid or payable by an entity to its non-resident associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to non-resident associated enterprises, whichever is less.

Section 94B(4) provides that interest amount disallowed in a particular assessment year shall be carried forward and allowed as deduction against the profits and gains, if any, ***of any business*** carried on by the assessee. Therefore, based on the same, it can be concluded that A Ltd shall be eligible to carry forward the disallowed interest amount and claim the same as a deduction against the profits and gains from any business or profession carried on by it.

(b) (i) Section 92CE, provides that where a primary adjustment for an amount exceeding Rs 1 crore has been made by the Assessing Officer in respect of

A.Y.2017-18 or thereafter, which has been accepted by the assessee, a secondary adjustment shall be made. In the first scenario, where the assessee has not gone on an appeal against the order passed by the Assessing Officer, it may be considered that the adjustment made by the Assessing Officer has been accepted by the assessee. Hence, secondary adjustment has to be made by A Ltd. in the A.Y.2018-19. Further, if the "excess money" (i.e., Rs 40 crores, in this case) which is available with A LLC., Cyprus is not repatriated to India within 90 days from the date of order of the Assessing Officer then, such excess money would be deemed to be an advance made by the A Ltd. to A LLC, Cyprus and interest on such advance shall be computed in the prescribed manner.

In the second scenario, where the assessee files an appeal before the CIT(Appeals) it is evident that the primary adjustment made by the Assessing Officer is not accepted by the assessee and therefore, secondary adjustment is not required.

(ii) If the CIT (Appeals) increases the Arm's Length Price determined by the Assessing Officer to Rs 50 crores by considering the arm's length interest rate to be 5% (instead of 4%) and the same is accepted by A Ltd., then, A Ltd. has to make secondary adjustment and the "excess money" [i.e., Rs 30 crores, (Rs 80 crores – Rs50 crores)] has to repatriated to India within 90 days from the date of the order of CIT (Appeals).

(a) As an anti-avoidance measure, section 94A was introduced in the Income-tax Act, 1961 with respect to transactions with persons located in a Notified Jurisdictional Area (NJA). As per section 94A, the Central Government may, having regard to the lack of effective exchange of information with any country or territory outside India, specify the said country or territory as a notified jurisdictional area in relation to transactions entered into by any assessee. Any payment made to a person located in a NJA shall be liable for withholding tax @ 30% or the rate prescribed in the Act or the rates in force, whichever is highest.

The Central Government invoked the provisions of section 94A of the Act and notified Cyprus as a NJA in November, 2013 owing to inadequate exchange of

information by Cyprus tax authorities. However, in December 2016, the Central Government has rescinded the said Notification, thereby removing Cyprus as a NJA with retrospective effect from the date of original notification. Therefore, since the provisions of section 94A will not be applicable in respect of payment made to a person located in Cyprus, A Ltd. is justified in deducting tax at the rate of 10% being the most beneficial rate contained in the DTAA between India and Cyprus.

(b) Safe Harbour Rules specified under Section 92CB(2) may be opted by an assessee in respect of an ***eligible international transaction***. Advancing of loan is covered within the definition of eligible international transactions. However, receipt of intra - group loans by the Indian entity do not form part of eligible international transactions and hence, A Ltd shall not be eligible to opt for safe harbor rules in respect of the loans taken from its AEs.

(c) Indian Transfer Pricing regulations provide that any income arising from an international transaction shall be computed having regard to arm's length price. However, section 92(3) provides that transfer pricing provisions shall not apply in cases where such application results an increase in the expenditure or decrease in the revenue of the Indian entity. In the given case, as interest payment to the AE would only result in an increase in the expenditure of A Ltd. and subsequent reduction of profits, transfer pricing provisions under the Income-tax Act, 1961 shall not apply.

Answer to case study 3:

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".

(b) 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.

(c) 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.*