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CHARTERED ACCOUNTANTS

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# INTERNATIONAL TAX

## Elimination of Cross border Double Tax

With the Globalisation process gaining momentum, many Companies are expanding their business operations like setting up their offices i.e. Subsidiaries or branch etc. in various countries and earn their income from more geographical locations. These Companies are subject to tax in their Residence country as well as the country where they are operating their business and earn income. Countries, worldover, have entered into bilateral agreements to avoid such double taxation for such Companies. Generally Article 23 of the Double Tax Avoidance Agreements between countries specifies the guidelines of how such double taxation is eliminated.

**Causes of Double Taxation**

- **Judicial Double Tax -** Some income is taxed in two (or more) countries since the income is taxed on "Residence basis" as well as "Source bases". (Eg. Branch or Permanent Establishment in other State, Source of Royalty, Fees for Technical Services income from other State etc.)

- **Economic Double Tax –** Some income are taxed more than once. (Eg. Holding and Subsidiary Company). The Taxes are paid by the Subsidiary Company. The Dividend Distribution tax is paid by Subsidiary Company and thereafter Holding Company is subject to tax on Dividend Income in its Residence State.

**Standard Illustration Case Study:**

| | |
|---|---|
| Income in State R | 100k |
| Income in State S | 20k |
| Global Income | 120k |
| **Tax Rate:** | |
| In State R:<br>- Upto 100k<br>- 120k | <br>30%<br>35% |
| In State S – Case 1 | 20% |
| - Case 2 | 40% |

| | **No Double Tax Relief** | |
|---|---|---|
| | **Case 1** | **Case 2** |
| Tax in State R | 42k<br>(120k x 35%) | 42k<br>(120k x 35%) |
| Tax in State S | 4k<br>(20k x 20%) | 8k<br>(20K X 40%) |

| Total Tax Liability | 46k | 50k |
|---|---|---|
| Total Rate of Tax | 46% | 50% |
| Tax Relief | Nil | Nil |

**Types of Double Taxation Relief**

- Relief under Domestic Law – Section 91 of The Income Tax Act provides for relief from double taxation under domestic law.
- Treaty Relief – Generally Article 23 of the Double Tax Avoidance Agreements provide for relief from double taxation as per the Treaty provisions.

**Methods of elimination of Double Tax**

Various methods of elimination of Double tax have been prescribed under the OECD and UN model. The Rules and methods that are specified and adopted by the countries in the bilateral treaties are to be followed by the country of Residence.

- **Exemption Method**
  - **Full Exemption**
    - ✓ In this method, the amount of income is not included in the Total Income at all. The OECD/UN model treaty states "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, **exempt such income or capital from tax."**
    - ✓ Such method is most beneficial method for the tax payer.
    - ✓ India has adopted this method only with Greece.

| | **Full Exemption Method** | |
|---|---|---|
| | **Case 1** | **Case 2** |
| Tax in State R | 30k<br>(100k x 30%) | 30k<br>(100k x 30%) |
| Tax in State S | 4k | 8k |
| Total Tax Liability | 34k | 38k |
| Total Rate of Tax | 34% | 38% |
| Tax Relief | 12k<br>(46k – 34k) | 12%<br>(50k – 38k) |

- **Exemption with progression:**

  - ✓ In this method, although the income is exempt in the Resident State, the exempt income has to be included in the total income for the purpose of calculation of rate of tax.

  - ✓ The OECD/UN model treaty states "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, **exempt such income or capital from tax."**

  - ✓ The paragraph 3 states "Where in accordance with any provisions of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, **in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital."**

| | **Exemption with Progression Method** | |
|---|---|---|
| | **Case 1** | **Case 2** |
| Tax in State R | 35k<br>(100k x 35%) | 35k<br>(100k x 35%) |
| Tax in State S | 4k | 8k |
| Total Tax Liability | 39k | 43k |
| Total Rate of Tax | 32.5% | 35.83% |
| Tax Relief | 5k<br>(46k – 39k) | 7k<br>(50k – 43k) |

- **Credit Method**

Under the credit method, the Resident State calculates the tax on the basis of the total income including the income from the Source State (excluding the income which shall be taxable only in the Source State). Thereafter it allows a deduction from its own tax for the taxes paid in the Source State. The Principal of Credit may be applied by two main methods:

- **Full Credit Method**

  - ✓ Under this method, the entire tax paid in the source country is allowable as deduction from total tax liability in the Residence country.

- ✓ The OECD/UN model states "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State **shall allow as a deduction from the tax on the total income of that resident, an amount equal to the income tax/capital tax paid in that other State."**

- ✓ Such full credit method is more beneficial where the Rate of Tax in the Source State is higher than that of the Resident State.

| | **Full Credit Method** | |
|---|---|---|
| | **Case 1** | **Case 2** |
| Tax in State R | 42k<br>(120k x 35%) | 42k<br>(120k x 35%) |
| Tax in State S | 4k | 8k |
| Total Tax Liability | 46k | 50k |
| Less: Credit available | 4k | 8k |
| Net Tax Liability | 42k | 42k |
| Total Rate of Tax | 35% | 35% |
| Tax Relief | 4k<br>(46k – 42k) | 8k<br>(50k – 42k) |

- **Ordinary Credit Method**

  - ✓ Under hits method, credit for the taxes paid in Source country is allowable as set-off against the total income by the Residence country. However, the amount of such credit shall not exceed that part of the tax in Resident country which is proportionate to that income.

  - ✓ The OECD/UN model states "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident, an amount equal to the income tax/capital tax paid in that other State. **Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or capital which may be taxed in that other State."**

  - ✓ Most of the Indian treaties follow this Ordinary Credit Method.

| | Ordinary Credit Method | |
|---|---|---|
| | **Case 1** | **Case 2** |
| Tax in State R | 42k<br>(120k x 35%) | 42k<br>(120k x 35%) |
| Tax in State S | 4k | 8k |
| Total Tax Liability | 46k | 50k |
| Less: Credit available | 4k<br>(20k x 20%) | 7k<br>(20k x 35%) |
| Net Tax Liability | 42k | 43k |
| Total Rate of Tax | 35% | 35.83% |
| Tax Relief | 4k<br>(46k – 42k) | 7k<br>(50k – 43k) |

- ✓ In the case 1, the entire amount of tax paid is allowable as deduction since the rate of tax is only 20% (ie. Less than 35% of the tax rate in Residence State). However in the case 2, the credit allowable is restricted to only 35% since the tax rate in Source State (40%) exceeds the tax rate in Residence State (35%).

**Underlying Tax Credit (UTC):**

The UTC is available to avoid 'Economic Double Taxation'. This is beneficial to Holding Companies or Companies having specified substantial shareholding with regards to their Dividend Income. The credit is available for the taxes paid on their profits by the Subsidiary Company. The UTC is in addition to the credit available for Dividend Distribution Tax paid by the Company in the Source State.

$$\textbf{UTC} = \textbf{Tax paid in India} \times \frac{\textbf{Dividend paid to FCO}}{\textbf{Profit after Tax}}$$

India has UTC clause in Treaties with countries like Australia, Germany, Japan, Singapore, UK, USA and a few others.

Para 1(b) of the Article 24 of the India UK Treaty states "In the case of a dividend paid by a Company which is a resident of India to a Company which is a resident of UK and which **controls directly or indirectly at least 10% of the voting power in the Company paying dividend**, the credit shall take into account (in addition to any Indian Tax for which credit may be allowed under the provisions of sub-para (a)) the **Indian tax payable by the Company in respect of the profits** out of which such dividend is paid."

Illustration

| **ICO (Subsidiary) tax structure in India** | |
|---|---|
| Income before taxation | 100k |
| Tax @ 34% | 34k |
| Income after tax | 66k |
| Dividend Distributed | 40k |
| Dividend paid to FCO (Holding Co.) | 30k |
| Dividend Distribution Tax thereon (@ 17%) (Total A) | 5.1k |
| FCO tax structure in India: | |
| Dividend income exempt from tax in India | Nil |
| FCO tax structure in Residence State: | |
| Tax on Dividend (assuming tax rate 40%) | 12k (30k x 40%) |
| Underlying tax credit (34k x 40k/66k) = (Total B) | 20.60 |
| Total Tax Credit available (A + B) | 25.70 |
| | |

**Tax Sparing:**

The meaning of tax credit is sometimes restricted to the tax actually paid vis-à-vis tax payable. Where the Domestic Law in the Source State provides certain tax incentives, there arises certain difference between the tax paid and tax payable. Such incentives may be due to setting up of industry in backward area, setting up unit in Special Economy Zone etc. The Tax Sparing is understood as giving credit to Tax Payable.

The language of the Treaty has to be seen in such context as to whether it contemplates credits for tax paid or tax payable. The Treaty would specify the provisions in the domestic law of the respective countries for which the relief should be granted. Usually the State of Residence would provide for deemed tax exemption or deemed tax credit.

Para 3(a) of the Article 24 of the India UK Treaty states that "the term **'Indian tax payable' shall be deemed to include**: **any amount which would have been payable as Indian tax but for a deduction allowed** in computing the taxable income or an exemption or reduction of tax granted for that year in question under the provisions of the Income Tax Act, referred to in para 4(a) or (b) of this Article;" The para 4(a) and (b) refers to all the sections under which various deductions or exemptions (Sec. 10(4), 10(4b),…. Chapter VI-A) are granted from the total income of Companies satisfying certain conditions.

$$\textbf{TSC (Tax Sparing Credit)} = \textbf{Tax deemed to be paid} \times \frac{\textbf{Dividend paid to FCO}}{\textbf{Profit after Tax}}$$

| **Taxation of PE of FCO in India** | **Without Incentive** | **With Incentive** |
|---|---|---|
| Business profits in India | 100k | 100k |
| Deduction Under Chapter VI-A | Nil | 60k |
| Net Taxable Income in India | 100k | 40k |
| Tax Paid @ 34% | 34k | 14k |

| Taxation of FCO in UK | **Without Incentive** | **With Incentive** |
|---|---|---|
| Business Profits (excluding PE profits) | 80k | 80k |
| Profits of PE in India | 100k | 100k |
| Total Business Profits | 180k | 180k |
| Tax Payable (assuming @ 40%) | 72k | 72k |
| Less: Tax Credit | 34k | 14k |
| Less: Tax Sparing credit (Tax deemed to be paid ie 60k x 34%) | Nil | 20k |
| Balance Tax Payable | 38k | 38k |
| | | |

Note: If there was no tax sparing credit available, FCO would have paid tax of Rs. 58k (72k – 14k) in UK. In that case, the advantage of tax incentive available in India gets nullified by paying tax in the Residence State ie. UK.

Para 3(b) of the Article 24 of the India UK Treaty further states that " the term 'Indian tax payable' shall be deemed to include: **that proportion of any amount which would have been payable as Indian tax be a resident of India but for a deduction allowed** in computing the taxable income or an exemption or reduction granted for the year in question under the provisions of the Income Tax Act, referred to in para 4(c) of this article which corresponds to the proportion of that resident's total ………" The para 4(c) refers specifically to Sections 10A and 10B of the Income Tax Act.

| Profit before tax | 1000 |
|---|---|
| Less: Deduction under Section 10A/10B | 400 |
| Taxable Profits | 600 |
| Tax paid in India @ 34% | 204 |
| Profit after tax available for distribution | 796 |
| Total dividend declared | 400 |
| Dividend paid to FCO in UK ( FCO holds 50% shares in ICO) | 200 |
| Dividend Distribution tax paid thereon @ 17% (A) | 34 |
| Underlying Credit available 204 x 200/796 (B) | 51.25 |
| Tax sparing credit available 136 x 200/796 (C) | 34.17 |
| Total Tax credit available to FCO in UK (Total A + B + C) | 119.42 |
| | |

**Compiled by: Malay Damania**

***CASE LAW:*** ***Ashapura Minichem Ltd.v.ADIT***
***REFERENCE:*** ***[ITA No.2508/Mum/08]***
***DATE:*** ***21 May, 2010***

***SUBJECT:*** ***Fee for technical services may be taxable in India even if completely rendered outside India***

## FACTS OF THE CASE

- Assessee, an Indian company entered into an agreement with a Chinese company for availing bauxite testing services.
- The bauxite samples were sent by Indian company for testing in the laboratories of the Chinese company located in China.
- The Testing reports consequent to the test on bauxite samples were prepared in China and provided to the assessee from outside India.
- At the time of making the remittance to the Chinese company, the assessee made an application under section 195 of the Income Tax Act, 1961 (the Act) for obtaining a NIL withholding tax order from the Assessing Officer ("AO").

## CONTENTION OF THE ASSESSEE

- The assessee submitted that the fees to be paid to Chinese company is in the nature of business income and in the absence of any Permanent Establishment ("PE") of the Chinese company in India in terms of India- China tax treaty (Tax Treaty), the said fee is not taxable in India.

## CONTENTION OF THE ASSESSING OFFICER

- The AO held that the services rendered by the Chinese company were in the nature of Fee for Technical Services ("FTS") under the provisions Sec 9 (1) (vii) of the Act as well as under the Tax Treaty between India and China.
- Therefore the remittance is liable to withhold tax at the rate of 10% of the gross amount under the aforesaid Tax Treaty.

## ISSUE BEFORE THE TRIBUNAL

- Whether the service rendered by the Chinese company from outside India is FTS under the provisions of the Act and under the Tax Treaty?

**DECISION OF THE TRIBUNAL**

- The fees payable to the Chinese company is covered within the scope of fees for technical services under explanation 2 to section 9(1) (vii) of the provisions of the Act.

- As per the landmark judgments laid down by the Courts in the case of **Clifford Chance V DCIT** and **Ishikawajima Harima Heavy Industries Ltd v DIT.** that under section 9(1)(vii) of the Act services should be
  (i) utilised in India, and
  (ii) rendered in India in order to be taxable in India,

- But the above judgments no longer hold good in view after the retrospective amendment made in section 9 of the Act. As the law stands now, utilization of the services India is enough to attract taxability in India. Thus there is no requirement that services must be rendered in India.

- The definition of fees for technical services under India-China Tax Treaty is wider in scope. It provides for provision of services instead of provision of rendering of services. Therefore, it will cover the services even when these are not rendered in the other contracting state, i.e. India.

- Article 12(6) of India - China tax treaty provides that fee for technical services arises in a country where the payer is a resident. In case it is accepted that FTS as defined under Article 12(4) will cover only such services which are rendered in a contracting state i.e. India, then the deeming provision of Article 12(6) will be unworkable.

- A literal interpretation to a Tax Treaty which renders treaty provisions unworkable and which is contrary to the clear and unambiguous scheme of the treaty has to be avoided.

- The technical services are clearly covered under Article 12(4) and under deeming fiction of Article 12(6) of the Tax Treaty. Consequently, the payment made to the Chinese company by the assessee is subject to withholding of tax in India.

**CONCLUSION**

- The decision of tribunal reaffirms amendment to section 9 of the Act that the services should be utilized in India in order to be taxable in India irrespective of the situs (location) of rendering of the services.

**Compiled by: Yogendra Jain**

# INTERNATIONAL FINANCIAL REPORTING STANDARDS

## FOREIGN EXCHANGE TRANSACTIONS:

### Major items of GAAP differences (IFRSs vis a vis Indian GAAP)

| Sr No | Particulars | As per IFRSs | As per Indian GAAP |
|---|---|---|---|
| | **Relevant Text** | **IAS 21** | **AS 11** |
| | | **Effects of changes in foreign exchange rates** | **Effects of changes in foreign exchange rates** |
| | | | |
| 1 | Functional and Presentation currency | Three concepts of currency's are defined as follows:<br>• Functional currency- Currency of the primary economic environment in which entity operates.<br>• Presentation currency- Reporting currency of financial statements.<br>• Foreign currency: Currency other than functional currency. | No concept of functional and Presentation currency. Foreign currency is termed as currency other than reporting currency in which financial statements are presented. |
| | | | |
| 2 | Initial recognition | Foreign currency transactions shall be recorded on initial recognition in functional currency. | No concept of functional currency and hence Foreign currency transactions shall be recorded on initial recognition in reporting currency. |
| | | | |
| 3 | **Exchange difference**: Assets and Revenue (during and at the end of reporting period) | All exchange difference (Assets / Revenue) arising on translation/ settlement of foreign currency monetary items are recognized in profit and loss account. | All exchange difference (Assets / Revenue) arising on translation/ settlement of foreign currency monetary items are recognized in profit and loss account except otherwise entity (Companies) opts for treatment of exchange rate difference suggested in notification on AS-11 issued by ICAI. |
| | | | |

| Sr No | Particulars | As per IFRSs | As per Indian GAAP |
|---|---|---|---|
| | **Relevant Text** | **IAS 21** | **AS 11** |
| | | **Effects of changes in foreign exchange rates** | **Effects of changes in foreign exchange rates** |
| | **Exchange difference:** Net investment in foreign operation | Exchange difference on monetary items , in substance, forming part of net investment in a foreign operation are recognized in profit and loss account in case of separate financial statements and in other comprehensive income in consolidated financial statements as separate component of equity. | Exchange difference on monetary items, in substance, forming part of net investment in a foreign operation are recognized in foreign currency translation reserve in separate financial statements as well as in consolidated financial statements. |
| | | | |
| 4 | Change in functional currency | To be applied prospectively | No disclosure required in case of change in reporting currency. |
| | | | |
| 5 | **Exchange difference:** On translation of financial statements from functional currency to presentation currency | • Assets and Liabilities- closing rate<br>• Income and Expenses- Actual/ Average rate<br>• Resulting Exchange Rate Difference: Other comprehensive Income | No concept of functional currency. |
| | | | |
| 6 | **Exchange difference:** On translation of foreign operation (Respective Functional currency to Presentation currency) | • Assets and Liabilities- closing rate<br>• Income and Expenses- Actual/ Average rate<br>• Resulting Exchange Rate Difference: Other comprehensive Income and accumulated in a separate component of equity.<br>• **Elimination of Intra Group transactions- Profit and loss account**<br>• On disposal: Exchange rate difference recognized till date in other comprehensive income to be transferred to Profit and Loss Account with respect to concerned foreign operation. | In case of Integral operation:<br>• Monetary Assets and Liabilities- closing rate<br>• Non Monetary items- At historical rates<br>• Income and Expenses- Actual/ Average rate<br>• Resulting Exchange Rate Difference: Profit and Loss Account |

| Sr. No | Particulars | As per IFRSs | As per Indian GAAP |
|---|---|---|---|
| | **Relevant Text** | **IAS 21** | **AS 11** |
| | | **Effects of changes in foreign exchange rates** | **Effects of changes in foreign exchange rates** |
| | | | In case of Non-Integral operation:<br><br>• Assets and Liabilities- closing rate<br>• Income and Expenses- Actual/ Average rate<br>• Resulting Exchange Rate Difference: Foreign Currency Translation Reserve<br>• **Elimination of Intra Group transactions- Profit and loss account**<br>• On disposal- Exchange rate difference recognized in Foreign Currency Translation Reserve till date to be transferred to Profit and Loss Account with respect to concerned foreign operation. |
| | | | |
| 7 | Tax effect- Gains/ losses on foreign currency transactions and exchange differences on translating of foreign operations | To be dealt as per IAS 12 "Income Taxes". | No specific guideline referred in the concerned AS. |
| | | | |
| 8 | Forward contracts | Treated as derivatives and accounted as per guideline given in IAS 39 (Replaced by IFRS 9). | Specific guideline given in AS based on the nature of contracts i.e. speculative/ non speculative. With applicability of AS 30/31/32, treatment of forward contracts would be par with IFRSs. |

**Compiled by: Bharat Jain**