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Highlights of this issue:

- Notification - Income-tax (Seventh Amendment) Rules, 2010 — No. 49/2010, dated 09.07.2010
- Computation of Arm Length Price, adjustments, if any made, should be restricted only to International Transactions and not to the entire turnover of the Assessee Company — *DCIT v. Starlite (ITAT Mumbai)*
- Achuthan Committee on Takeover Regulations submits report to SEBI — *Press Release No. 164/2010, dated 19.07.2010*
- International Taxation and Role of Chartered Accountants — An article by *CA Dr. A.L. Saini*

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- In order to claim deduction under Section 36(1)(vii), one of the conditions that is required to be satisfied as laid down under Section 36(2)(i) is that the debt claimed to be deductible as bad or part thereof has been taken into account in computing the income of the Assessee of the relevant previous year or of any earlier previous year — *DCIT v. Shreyas S, Morakhia (ITAT-Mumbai)*
- Notification - Exemption of notified taxable services relating to transmission and distribution of electricity — No. 45/2010, dated 20.07.2010
- Finance Minister on GST and DTC

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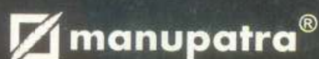

Article

International Taxation and Role of Chartered Accountants

CA Dr. A.L. Saini*

Taxes should play a neutral role in attracting foreign capital and investment. Tax neutrality and tax harmony have become the accepted principles in International Taxation. The treaty, generally applies to residents of the contracting states. Each country retains the power to tax its citizens and residents on their world income (Status Jurisdiction) and taxes others (non-citizens), (non-residents) only on their income in the country (Source jurisdiction). The borderless global economy has certainly put India at the forefront of the global trained resource pool, not only in the information technology arena but also even in traditional areas like taxation, especially International Taxation. Competent and enterprising taxation professionals, like Chartered Accountants are a captive requirement to keep the wheels of corporate businesses turning.

Introduction: With globalisation of the economy and most of the countries in the world accepting it, the fiscal scenario has changed. Any country cannot manipulate fiscal policy to achieve economic development. Earlier foreign companies operating in other countries were taxed at a higher rate than domestic companies. After GATT agreement and in order to facilitate free flow of trade and investment the tax rate have to be the same for both domestic and foreign companies. Taxes should play a neutral role in attracting foreign capital and investment. Tax neutrality and tax harmony have become the accepted principles in International Taxation.

Double Taxation

What is double taxation?: Double taxation means taxing the same income twice, once in the home country and again in host country. It is of relevance to mention here "No rules of international law prohibit international double taxation." So it is for the countries in the international arena to solve double taxation problems.

Double taxation of income is a great disincentive as it

(*i*) hampers free flow of capital and

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(*ii*) becomes a prohibitive burden on taxpayers leading to decline in foreign investments.

Hence, negotiation of tax treaties between different countries became inevitable and these have been entered in large numbers based on OECD and UN models with suitable alterations, where necessary, to meet the special needs of the contracting countries. These agreements are in the nature of contracts between the countries, which have entered into such agreements.

How does double taxation arise?: International double taxation may arise in two ways.

Case 1: The jurisdictional connections used by different countries may overlap with each other.

For example, Mr. X, an ordinary resident under the Indian Income tax Act, 1961, has to pay tax in his world income as citizen in the USA (Residential jurisdiction).

Case 2: The taxpayer or his income may have connections with more than one country.

For example, Mr. X gets income from the U.K. and dividend income from France. "X" has to pay tax on his world income in India, and also tax on income earned in each country mentioned above (Source jurisdiction).

Residence Versus Source Jurisdiction: In the concept of International taxation, there is a link age between Sovereign (Taxing authority), Subject (Taxpayer) and Object (Income generating economic activity). Some countries tax the subject (taxpayer) on his economic activity in the world, while some other countries confine themselves to taxing economic activity in their respective countries. This is called Status or residence jurisdiction and Source jurisdiction respectively.

Scope of the Tax Treaties in Determining Jurisdiction: Normally tax treaty between two countries covers the following:

(1) Persons

(2) Taxes

(3) Territory

(4) Time.

The treaty generally applies to residents of the contracting states. Each country retains the power to tax its citizens and residents on their world income (Status Jurisdiction) and taxes others (non-citizens), (non-residents) only on their income in the country (Source jurisdiction). However, the treaty provisions protect the taxpayers from suffering double taxation on the same income.

The treaty provisions have no fixed duration and can be terminated by a contracting state with six months notice after a treaty has been in effect for five years. (U.S. Model 1981 Act 29). The treaties can lessen the vigor of double taxation and cannot enhance the burden.

Double Tax Relief Versus Double Tax Avoidance: Double tax relief means granting of relief in respect of income on which income tax has been paid under the Indian tax laws and also in the other country. Double tax avoidance means avoidance of double taxation of income under the tax laws of the two countries. The Supreme Court of India has clearly pointed out the distinction between avoidance of double taxation and relief against double taxation. One important feature in this distinction is that in case of avoidance of double taxation the Assessee does not have to pay the tax first and then apply relief in the form of refund, as he would be obliged to do under a provision for relief against double taxation.

Methods of Avoiding Double Taxation: Countries throughout the world are following various methods of avoiding double taxation. They are as follows.

(1) Unilateral relief

(2) Bilateral relief

(3) Multilateral relief

(4) Non-tax treaties

Unilateral relief: Under this system of taxation whether the income is subject to tax abroad or not is immaterial. In Unitary system, relief is given by way of tax credit for the taxes paid abroad. The countries, which follow this method of tax credit, are the U.S., Greece, India, and Japan to name a few. For example, under Section 91 of the Income tax Act, 1961, the method is "tax credit method". A resident in India who has paid income tax in any country with which India does not have a treaty for the relief or avoidance of double taxation is entitled to credit against his Indian Income tax for an amount equal to the Indian coverage rate or the foreign rate whichever is lower applied to the double taxed income. This is done as follows.

(*a*) Where the foreign tax is equal to Indian tax, the full amount of foreign tax will be given credit.

(*b*) Where the foreign tax exceeds the tax payable in India, the liability to Indian tax will be nil. However, no refund in respect of the excess amount is allowed, and

(*c*) Where the foreign tax paid is less than the Indian tax after deducting the foreign tax would be payable by the taxpayer. The principle is that the credit allowable will never exceed the amount of Indian income tax, which becomes due or payable in respect of the doubly taxed income.

Bilateral Relief: Bilateral relief may take any one of the following two forms. Firstly, the treaty may apply exempting method, the country in question refrain from exercising jurisdiction to tax a particular income.

For example, under this exemption method, the country of source in which the Permanent Establishment (PE) is located is assigned an exclusive jurisdiction to tax the profits of the establishment. In turn it may agree to refrain from exercising its jurisdiction to tax the owner on these profits. Alternatively, the treaty may provide relief from double taxation by reducing the tax ordinarily due in one or both of the contracting parties on that income which is subject to double taxation.

For example, the country, which is the source of a dividend, often agrees to reduce the withholding rate normally applicable to dividends paid to non-residents and the country of residence agrees to give a tax credit or similar relief for the tax paid to the country of source. In such a case, both the countries exercise the rights to jurisdiction, while mutually agreeing for adjustments. This helps in avoiding or at least reducing the international double taxation on the income in question. Many treaties combine both the methods of relief.

Multilateral Treaties: These are similar to bilateral treaties. It is achieved through agreement between many countries e.g. European Economic Community.

Non-Tax Treaties: These are not direct treaties of tax, but are treaties of friendship, cooperation, political ties, diplomacy, etc., but which consequently result in tax consequences.

Position in India: The Income-tax Act, 1961, provides unilateral relief under Section 91 of the Act. Besides, the Central Government is empowered under Section 90 of the Act to enter into an agreement with a foreign Government, which may take any one of the above forms discussed, viz., bilateral, multilateral, non-tax treaty basis. It may be entered for any one of the following purposes:

(*a*) Double tax relief

(*b*) Double tax avoidance

(*c*) Exchange of information

(*d*) Recovery of tax

According to Section 90(2) of the Indian Income-tax Act, where the Central Government has entered into any such agreement, then the provisions of that agreement would normally apply to the case of an Assessee who is covered by such agreement. However, if the relevant provisions under the Indian Income-tax Act are more beneficial, then to that extent, the Assessee can seek application of the provisions of the Act as against the provisions of the agreement.

Section 91: Relief if there is no DTAA: According to Section 91 of the Indian Income-tax Act, the following is the relief available if there does not exist an agreement under Section 90 between India and the country in which the income accrues.

If any person resident in India in any previous year establishes that he has paid income tax by deduction or otherwise, in any country in respect of his income which accrued or arose outside India, he shall be entitled to the deduction from the Indian income tax payable by him such a sum calculated on such doubly taxed income at the Indian rate of tax or at the rate of tax of the said country, whichever is lower. Where the tax rates are equal, the Indian rate shall apply.

Foreign Tax Credit of the USA: The United States has chosen the foreign tax credit method—the method of allowance of a credit against its own income tax for the income tax paid by the U.S. taxpayer to the country of source—as

the principal method of accommodation to be used in its international tax relations. The credit is given unilaterally in the Internal Revenue Code and is thus the key factor in the code provisions relating to foreign income. These Foreign Tax Credits (FTCs) are of two types called direct or indirect.

Direct Foreign Tax Credit: A direct tax is one imposed directly on a U.S. taxpayer. Direct taxes include the tax paid on the earnings of a foreign branch of a U.S. company and any foreign withholding taxes deducted from remittances to a U.S. Investor. Under Section 901 of the U.S. Internal Revenue Code, a direct foreign tax credit can be taken for these direct taxes paid to a foreign government. Taxes that are allowable in computing foreign tax credits must be based on income. These taxes would include foreign income taxes paid by an overseas branch of a U.S. corporation and taxes withheld from passive income (i.e. dividends, rents, and royalties). Credit is not granted for non income-based taxes such as sales tax or VAT.

Indirect Foreign Tax Credit: U.S. corporate shareholders owning at least 10% of a foreign corporation are also permitted under Section 902 to claim an indirect foreign tax credit or deemed paid credit on dividends received from that foreign unit, based on an appointment of the foreign income taxes already paid by the affiliate. This indirect credit is in addition to the direct tax credit allowed for any dividend withholding taxes imposed.

$$\text{Indirect tax credit} = \frac{\text{Dividend (including withholding tax)} \times \text{Foreign tax}}{\text{Earnings net of foreign income taxes}}$$

The foreign dividend included in U.S. income is the dividend received grossed up to include both withholding and deemed paid taxes.

In no case can the credit for taxes paid abroad in a given year exceed the U.S. tax payable on total foreign-source income for the same year. This rule is called the overall limitation on tax credit.

In calculating the overall limitation, total credits are limited to the U.S. tax attributable to foreign-source income (interest income is excluded). Losses in one country are setoff against profits in others, thereby reducing foreign income and the total tax credit permitted.

Thus,

$$\text{Maximum total tax credit} = \frac{\text{Consolidated foreign profits and losses} \times \text{Amount of tax liability}}{\text{Worldwide taxable income}}$$

If the overall limitation applies, the excess foreign tax credit may be carried back two years and forward five years. The result of the carry back and carry forward provisions is that taxes paid by an MNC to a foreign country may be averaged over an eight-year period in calculating the firm's tax liability.

OECD's Project on Improving the Solutions for Cross-Border Tax Disputes: As global trade and investment increases, the possibility of cross-border tax disputes necessarily increases as well. Left unresolved, these disputes can result in double taxation and a corresponding impediment to the free flow of

goods and services in a global economy. Both governments and business need effective procedures to keep such disputes to a minimum and to resolve them satisfactorily when they arise. The OECD's Center for Tax Policy and Administration (CTPA) has been actively involved in developing procedures to deal with these issues. Looking to resolve tax disputes before they start, the OECD has helped establish internationally accepted procedures for so-called "Advance Pricing Agreements (APAs)" in which governments and taxpayers can agree in advance the appropriate approach to determine the "arm's length" price to be charged in transactions between related entities. Bilateral APAs (i.e. APAs involving the competent authorities of the tax administrations affected by the transactions) create an assurance in advance for taxpayers that a consistent approach will be taken by the governments involved in a cross border transaction, thus avoiding the possibility of costly later disputes. The work on avoiding disputes culminated in the publication of the Annex to the OECD Transfer Pricing Guidelines on conducting APAs under the Mutual Agreement Procedure of Article 25 of the OECD Model Tax Convention (MAP APAs).

Abuse of Double Taxation Avoidance Agreements: The objectives of double taxation avoidance/credit agreements are only to avoid double taxation on the same income. But it assumes that a taxpayer pays at least one tax in a country. Taxpayers across the globe indulge in a number of methods to reduce the tax by intelligence and sometimes by illegality.

They use tax avoidance devices generally by trying to exploit the double taxation avoidance treaties. This kind of tax avoidance takes place in any one of the following manner:

1. Transfer pricing
2. Treaty shopping
3. Misuse of DTAA's in tax havens

1. Transfer Pricing: One of the tax avoidance methods, frequently adopted by the MNCs, are manipulation of price in intra-firm exchange. The basic objective in this method is to maximise the company's overall after-tax profit rather than the profit of individual subsidiaries. The prices charged by the subsidiary on sale to another located in different countries is popularly known as transfer of pricing; prices are fixed not according to the market principles, i.e. interaction of demand and supply principles, but artificially by the parent company with a view to desire maximum benefits, comparative labour cost and comparative tax advantages. The following example will make the position clear. "A" parent company in a developed country (A) floats a subsidiary company in B country where raw materials and labour are cheap much cheaper than in "A" country. Manufacturing takes place in country and then the manufactured goods are transferred to "C", country where another subsidiary of "A" company is formed. The tax rate in C country is low and number of tax concessions are available. Therefore, the final goods are sold in this country. In this process the after tax profit of "A" the parent company will be maximum. Secondly, the MNC, to minimise its tariff payments to the country that imports components and intermediate goods, by under-pricing the exported

components and involving shifting profits from the supplying to the Importing country subsidiary.

2.Treaty Shopping: Under this method, the tax treaty agreements are misused by taking advantage in investing in low tax countries. MNCs shop for DTA agreements signed by countries to obtain fiscal advantages.

Treaty Shopping in India. The most important treaty shopping in which the Indian Government is losing considerable revenue is in the Mauritius route. Indo-Mauritius DTA agreement came into effect from 6.12.1983. As per the agreement corporate entity if resident in Mauritius has the choice to pay income tax in Mauritius at Mauritius tax rates even if the taxable income accrues in India. India can only impose a law withholding tax of 5 per cent of 15 per cent on the dividend income paid by the Indian subsidiary to the foreign corporation. A foreign corporation, incorporated in Mauritius, can repatriate dividend income received from an Indian joint venture subsidiary with option to pay tax in Mauritius at Mauritius rates of income tax instead of the very high corporate rate of income tax for foreign corporations in India.

Under the Mauritius Offshore Act, a corporation known as the MOBA entity has the privilege to pay income tax on dividend income (from India) repatriated into Mauritius on a voluntary basis in the sense of paying at a rate choosing from 0 per cent to 35 per cent. The following illustration will reveal how fiscal advantage of the Mauritius route will be availed by the MNCs.

Modus Operandi of MNCs: MNC channels investment into India via subsidiary incorporated in Mauritius as an MOBA corporation is issued a tax residence certificate by the Mauritius if such corporation

(*a*) has local directors

(*b*) holds board meetings in Mauritius

(*c*) Maintains a bank account in Mauritius and

(*d*) Maintains books of account in that country.

Thus, a Mauritius residents in the MOBA subsidiary of the foreign company can choose to pay tax on dividend income, repatriated out of India, under the Mauritius tax laws at Mauritius tax rates. This is by virtue of Clause 13(4) of the Indo-Mauritius DTA treaty.

3. Misuse of DTAA in Tax Havens: *Tax Haven Countries*. A tax-haven nation means a nation with nil or moderate level of taxation and/or liberal tax incentives for undertaking specific activities such as exporting.

Types of tax haven countries:

(*a*) *Nil tax haven countries*. These have no taxation at all on income of any sort accrued from these nations.

This type encompasses many of the tax havens in the Carribean, such as the Bahamas, Bermudas and the Cayman islands. For example, Bahamas levies a flat tax of 100$ per year on all Bahamian companies. It has no tax treaty with any country require it to disclose any information.

(b) *Nil tax outside haven countries.* These impose tax on any income accruing from within its territory but exempt from tax any income brought into the tax haven from outside.

A country whose tax benefits are characteristic of this type is Hong Kong. Although Hong Kong imposes a nominal tax of 15 per cent on Hong Kong sourced income, foreign source income is completely exempt. Panama is another good example of nil tax outside haven countries.

(c) *Low tax haven countries.* Here, income is not exempted but taxed at lower rates. A good example for a country representing this type of tax haven is The British Virgin Islands. It has a 12 per cent income tax rate. Another example is the Netherlands Antilles, a colony of the Netherlands located few miles off the coast of Venezuela. Income taxes in these countries are very low and there are special tax privileges to shipping, aviation and holding companies.

(d) *Special Exemption tax haven countries.* These are special exemptions, which are given in the form of a special act or concessions to attract investment by MNCs. This group includes those countries that are trying to promote development in certain regions or encourage industrialisation within the country. The most notable example here is the Republic of Ireland, which exempts from taxation the export earnings of corporations that setup manufacturing operations in certain regions.

Factors that are to be considered by companies while choosing a tax haven: Before analysing the type of tax haven to use, the MNC must develop a framework to evaluate its projected needs against the advantages of the various tax havens. Factors that are usually considered in choosing a tax haven include the following.

(a) The political and economic stability of the country and the integrity of its Government.

(b) The attitude of the country towards tax haven business.

(c) The other taxes, aside from income taxes, it imposes.

(d) Tax treaties. (Some tax havens owe their very existence to the fact that they are parties to advantageous tax treaty agreements.)

(e) The lack of exchange controls.

(f) Liberal incorporation laws that minimise both the cost of incorporation and the length of time it takes to incorporate.

(g) Banking facilities.

(h) Infrastructure facilities such as roads, telecommunication etc.

(i) The long range prospects for continued freedom from taxation.

Forms of tax avoidance in tax havens: Multinational corporations face a perennial charge for their misuses of tax havens to shield income from the local tax collector. The tax avoidance in tax havens takes palace broadly by two methods: profit diversion and profit extraction.

Profit Diversion. Under this, profit is diverted away from high tax jurisdiction into the tax haven thereby avoiding income tax on the money thus diverted.

For example, Company X, which is an MNC, sells at a low price to a subsidiary in a tax-haven country that in turn sells worldwide the same product at high prices.

Profit Extraction: In this method, a company in a tax haven country renders services to a company in a high tax jurisdiction and extracts money from that jurisdiction in the form of consultancy fees, licensing fees, technology fees, royalty etc as being gross by inflated so that effectively money is brought into the tax haven while the high tax jurisdiction subsidiary claims these fees as deductible expenses. The OECD publishes from time to time a list of tax havens based on their cooperation or non-co operation. OECD feels that the tax havens have distorted the natural flow of international tax and funds. It is for this reason that it has asked the tax havens to match their tax rates with those of the OECD members. The 2000 Progress Report identified 35 other jurisdictions as meeting the OECD criteria for being considered a tax haven. The 2000 Progress Report established a procedure by which jurisdictions wishing to co-operate in addressing harmful tax practices could avoid being listed as Uncooperative Tax Havens by making commitments to address harmful tax practices. The requirements for making such commitments were modified in the 2001 Progress Report. Commitments are now only being sought with respect to transparency and effective exchange of information. Since the publication of these reports, the OECD has accepted commitments from a number of the jurisdictions that were named in the 2000 Progress Report. These jurisdictions are not included in the List of Uncooperative Tax Havens issued on 18.4.2002 and revised on 20 May 2003 to remove the Republic of Vanuatu.

Role of Chartered Accountants: An Upcoming Area of Practice: The borderless global economy has certainly put India at the forefront of the global trained resource pool not only in the information technology arena but also even in traditional areas like taxation, especially International Taxation. Competent and enterprising taxation professionals are a captive requirement to keep the wheels of corporate businesses turning.

Here is an opportunity for Chartered Accountants to explore a lot of professional opportunities.

1. According to Section 92E every person who has entered into an international transaction during a previous year shall obtain a report from a chartered accountant and furnish such report on or before 31st October of the relevant assessment year. The report shall be in Form No. 3CEB duly signed and verified in the prescribed manner and setting forth the prescribed particulars.

2. In the context of International Tax planning, following are the avenues opened up for Indian chartered accountants.

(*a*) Advisory role in the matter of choosing a tax haven nation by an MNC.

(*b*) In the area of transfer pricing regarding determination of arm's length price etc.

(c) Consultancy to multinational and other non-residents with regard to proper and optimum utilisation of the DTAAs those are currently available with various nations.

(d) Appearance before the Advance Ruling Authorities in respect of non-resident clients.

(e) International tax planning avenues in the background of various tax incentives available among nations.

(f) Investment consultancy to companies that are planning expansion across the globe with regard to tax regulatory framework and investment concessions and allowances provided by various countries.

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