SOLUTION TO CASE STUDY 1

I. ANSWERS TO MCQs (Most appropriate answers)

1. (c)
2. (b)
3. (b)
4. (d)
5. (d)
6. (b)
7. (b)
8. (a)
9. (c)
10. (b)
II. ANSWERS TO DESCRIPTIVE QUESTIONS

Answer to Q.1:

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

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

Third stage: The traditional meaning and understanding of a fixed place PE connotes a physical space which is at the disposal of the non-resident enterprise and through which the latter conducts its business. With respect to a website, it has been held that it is merely a software. In the absence of the server supporting the website being located in India (here, it is in Cayman Islands), there can be no PE liability for Athena Ltd. The server, through which business is carried on, is located in Cayman Islands, a no tax jurisdiction, and not in India. Furthermore, a warehouse in India would not constitute a PE as per Article 5(4) of the India-Country A DTAA.

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

Answer to Q.2(a):

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

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

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

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

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

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

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

- A virtual fixed place of business PE in the concept of PE i.e., creation of a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.

- Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider or imposition of a equalisation levy on consideration for certain digital transactions received by a non-resident from a resident or from a non-resident having PE in other contracting state.

Answer to Q.2(b)

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

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

- if the passive income is not more than 50% of its total income; and

- less than 50% of its total assets are situated in India; and

- less than 50% of total number of employees are situated in India or are resident in India; and

- the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

Passive income is the aggregate of, -

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

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

© The Institute of Chartered Accountants of India
<table>
<thead>
<tr>
<th>Particulars</th>
<th>Country A</th>
<th>Country B</th>
<th>India</th>
<th>Total</th>
<th>% of (4) to total in (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of assets</td>
<td>Rs.400 lakhs</td>
<td>Rs.100 lakhs</td>
<td>Rs.210 lakhs</td>
<td>Rs.710 lakhs</td>
<td>29.58%</td>
</tr>
<tr>
<td>Number of employees</td>
<td>30</td>
<td>10</td>
<td>20</td>
<td>60</td>
<td>33.33%</td>
</tr>
<tr>
<td>Payroll expenses on employees</td>
<td>Rs.160 lakhs</td>
<td>Rs.35 lakhs</td>
<td>Rs.65 lakhs</td>
<td>260</td>
<td>25.00%</td>
</tr>
</tbody>
</table>

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

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

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

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

**Answer to Q.3:**

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

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

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

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

(c) Section 10(50) of the Income-tax Act, 1961 exempts income arising from providing specified service of online advertisement, which are subject to equalization levy, from income-tax.
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 2017, he stayed in India during the P.Y. 2017-18 for 183 days. Therefore, he is a resident in India for the P.Y.2017-18.

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. 2017-18 is 730 days or more.

Thus, Shivam is Resident and Ordinarily Resident in India for the P.Y.2017-18.
As per Country “Q” tax residency rules, Shivam qualifies to be resident for the year 2017-18 in Country “Q”, since he stays for 182 days (more than 180 days) in Country “Q” in the Financial Year 2017-18.

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 2017-18. 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 28 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)(l), 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 Ruling, 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. DTAA’s may, however, provide that business income is taxable only if there is a
permanent establishment in India.

Therefore, in cases covered by DTAA’s, 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 DTAA’s, 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. 2018-19

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INR</th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Salaries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salary from services rendered in India (April - September 2017)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic Salary (INR 70,000 x 6)</td>
<td>4,20,000</td>
<td></td>
</tr>
<tr>
<td>Dearness Allowance (INR 30,000 x 6)</td>
<td>1,80,000</td>
<td></td>
</tr>
<tr>
<td>Special Allowance (INR 5,000 x 6)</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Bonus</td>
<td>3,00,000</td>
<td></td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Income from services rendered in Country “Q” (October 2017 - March 2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Salary [See Note (i)]</td>
</tr>
<tr>
<td>Cost of Living Allowance [See Note (i)]</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td><strong>Salary from services rendered in Country “Q” (October 2017 - March 2018)</strong></td>
</tr>
</tbody>
</table>

Income from House Property at Mumbai

<table>
<thead>
<tr>
<th>Income from House Property at Mumbai</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Annual Value [See Note (iii)]</td>
</tr>
<tr>
<td>Less: Standard deduction @ 30%</td>
</tr>
<tr>
<td><strong>Income from House Property at Mumbai</strong></td>
</tr>
</tbody>
</table>

Income from Other Sources

<table>
<thead>
<tr>
<th>Income from Other Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest earned from investment of security deposit (INR 1,00,000 @10%)</td>
</tr>
<tr>
<td>Interest earned on saving bank account with Country “Q” [QGD 150 x INR 48.61] [See Rule 115 in Note (i)]</td>
</tr>
<tr>
<td>Interest on Securities of a Country “Q” company [QGD 5000 x INR 48.52] [See Rule 115 in Note (i)]</td>
</tr>
<tr>
<td>Interest on bonds issued by Country “P” Government</td>
</tr>
<tr>
<td>Dividend from a Country “Q” Company (QGD 1000 x INR 48.52) [See Rule 115 in Note (i)]</td>
</tr>
<tr>
<td><strong>(Dividend of foreign Company is taxable in India)</strong></td>
</tr>
</tbody>
</table>

Gross Total Income

<table>
<thead>
<tr>
<th>Gross Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>23,63,292</strong></td>
</tr>
</tbody>
</table>

Less: Deductions under Chapter VI-A

<table>
<thead>
<tr>
<th>Deduction u/s 80DD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>75,000</strong></td>
</tr>
</tbody>
</table>

(Flat deduction of INR 75,000 is allowed in respect of medical treatment of dependent disabled, irrespective of the expenditure incurred)

<table>
<thead>
<tr>
<th>Deduction u/s 80GG [See Note (iii)]</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>60,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>22,28,292</strong></td>
</tr>
</tbody>
</table>

Total Income (rounded off)

<table>
<thead>
<tr>
<th>Total Income (rounded off)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>22,28,290</strong></td>
</tr>
</tbody>
</table>
Computation of tax liability of Shivam for A.Y. 2018-19

<table>
<thead>
<tr>
<th>Particulars</th>
<th>INR</th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on INR 22,28,290</td>
<td></td>
<td>4,80,987</td>
</tr>
<tr>
<td>Add: Education cess @2%</td>
<td></td>
<td>9,620</td>
</tr>
<tr>
<td>Secondary higher education cess @1%</td>
<td></td>
<td>4,810</td>
</tr>
<tr>
<td>Tax Liability</td>
<td></td>
<td>4,95,417</td>
</tr>
<tr>
<td>Less: Foreign Tax Credit [See Note (v)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- on salary income</td>
<td>1,01,232</td>
<td></td>
</tr>
<tr>
<td>- on interest income</td>
<td>36,390</td>
<td>1,37,622</td>
</tr>
<tr>
<td>Net tax liability</td>
<td></td>
<td>3,57,795</td>
</tr>
<tr>
<td>Net tax liability (rounded off)</td>
<td></td>
<td>3,57,800</td>
</tr>
</tbody>
</table>

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 last day of the month immediately preceding the month in the income is due i.e. rate as on 28.02.2018
- **Interest earned on other than securities** i.e. interest on bank deposits- last day of the previous year i.e. rate as on 31.03.2018
- **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 28.02.2018

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

**Overseas salary for the period October 2017 to March 2018:**

<table>
<thead>
<tr>
<th>Month</th>
<th>Basic Salary in QGD (1)</th>
<th>Cost of living Allowance (COLA) (2)</th>
<th>Rate of Exchange (3)</th>
<th>Basic Salary in INR (1 x 3)</th>
<th>COLA in INR (2 x 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct 17</td>
<td>1400</td>
<td>1000</td>
<td>45.95</td>
<td>64,330</td>
<td>45,950</td>
</tr>
<tr>
<td>Nov 17</td>
<td>1400</td>
<td>1000</td>
<td>46.85</td>
<td>65,590</td>
<td>46,850</td>
</tr>
<tr>
<td>Dec 17</td>
<td>1400</td>
<td>1000</td>
<td>45.10</td>
<td>63,140</td>
<td>46,950</td>
</tr>
<tr>
<td>Jan 18</td>
<td>1400</td>
<td>1000</td>
<td>46.95</td>
<td>65,730</td>
<td>46,950</td>
</tr>
<tr>
<td>Feb 18</td>
<td>1400</td>
<td>1000</td>
<td>47.83</td>
<td>66,962</td>
<td>47,830</td>
</tr>
<tr>
<td>Mar 18</td>
<td>1400</td>
<td>1000</td>
<td>48.52</td>
<td>67,928</td>
<td>48,520</td>
</tr>
<tr>
<td>Total</td>
<td>8400</td>
<td>6000</td>
<td></td>
<td>3,93,680</td>
<td>2,81,200</td>
</tr>
</tbody>
</table>

(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 22,88,290 = INR 5,72,073
- Actual rent – 10% of adjusted total income = INR 3,00,000 (25,000*12) – INR 2,28,829 (10% of 22,88,290) = INR 71,171

Adjusted total income = Gross total income after providing for deduction under section 80C to 80U but before deduction under section 80GG = INR 23,63,292 – INR 75,000 = INR 22,88,292 (rounded off to INR 22,88,290).

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.2018-19 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.

With reference to Article 25 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:

<table>
<thead>
<tr>
<th>Calculation of foreign tax credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Doubly taxed Salary Income</td>
</tr>
<tr>
<td>Basic Salary</td>
</tr>
<tr>
<td>Cost of Living Allowance</td>
</tr>
<tr>
<td>Doubly taxed salary income</td>
</tr>
</tbody>
</table>

Computation of foreign tax credit on doubly taxed salary income:

Lower of:

- Tax withheld in Country Q on salary income at 15% = 1,01,232
- Tax payable in India on salary income@22.23% = 1,50,046

Foreign tax credit = 1,01,232
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:**

<table>
<thead>
<tr>
<th>Description</th>
<th>INR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower of:</td>
<td></td>
</tr>
<tr>
<td>Tax withheld in Country Q on interest income at 15%, which is also the rate as per the DTAA</td>
<td>36,390</td>
</tr>
<tr>
<td>Tax payable in India on interest income@22.23%</td>
<td>53,930</td>
</tr>
<tr>
<td><strong>Foreign tax credit</strong></td>
<td><strong>36,390</strong></td>
</tr>
</tbody>
</table>

*Note – Questions based on interpretation of articles of a DTAA may have alternate views.*
SOLUTION 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 articles of the DTAA. These conditions have to be fulfilled including the condition that the entity has to be a person and resident of the either of the contracting states.

(a) As per Article 3(1)(d) of the India-Country Y DTAA, the term 'person' includes any entity which is treated as a taxable unit under the tax laws in force in the respective States.

In order to be eligible for the DTAA, it has to be seen whether the partnership firm is a resident of the Contracting State. Article 4(1) of the India-Country Y DTAA defines a “resident of a Contracting State” to mean a person “liable to tax in that State by reason of his domicile, residence, place of management or any other criterion of similar nature”.

As per Article 2 of the India-Country Y DTAA, the scope of the DTAA extends to both income-tax and trade tax as may be levied under the laws of Country Y. Since trade tax is being levied on the Gryffindors Y partnership firm, it can held that the firm is “liable to tax” and therefore the requirement in Article 4 gets satisfied. Accordingly, Gryffindors Y partnership firm shall be eligible to access the India-Country Y DTAA based on this line of reasoning.
(b) As per Article 3(1)(d) of the India-Country Z DTAA, the term ‘person’ includes any other entity which is taxable under the laws in force in the either Contracting States.

Article 4(1) of the India-Country Z DTAA defines a “resident of a Contracting State” to mean any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. Further, in the case of income derived or paid by a partnership, this term applies only to the extent that the income derived by such partnership, is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners.

Thus, Article 4(1) of the treaty clearly provides that in the case of income derived or paid by a partnership, the term “resident of a contracting state”, in case of a firm, applies to the extent that the income derived by such partnership, is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners. The article clearly permits a firm to be treated as a resident of a contracting state in respect of income which is either liable to tax in its hands or in the hands of the partners. Therefore, Gryffindors Z partnership firm would be entitled to the benefits of the India-Country Z tax treaty, even though it is a fiscally transparent entity as per the tax laws of Country Z.

(ii) Article 14 of the India-Country Y and India-Country Z tax treaties deal with Independent Personal Services. Professional services rendered by independent professionals like lawyers, doctors, engineers, accountants etc. are covered by the provisions of this article.

It may be noted that the India-Country Y DTAA restricts the scope of Article 14 to income derived by an individual who is a resident of the Contracting State. Consequently, Article 14 of the DTAA with Country Y cannot be invoked in the case of income derived by a firm.

However, the India-Country Z DTAA does not restrict the scope of Article 14 to income derived by a resident individual and includes within its scope, a resident firm as well. Therefore Article 14 of the India-Country Z DTAA can be invoked in respect of income derived from such services by Gryffindors Z firm, which is resident in Country Z.

(iii) Article 2 of the DTAs specifies the ‘taxes covered’ under the DTAA entered into between the Contracting States. In the DTAs 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 DTAs, 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 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 calculation 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.