IMPORTANT QUESTIONS ON INTERNATIONAL TAXATION

Question 1:
Explain briefly the significant differences between the UN and OECD Model Tax Convention.

Answer:
OECD Model is essentially a model treaty between **two developed nations** whereas **UN Model** is a model treaty between a **developed country and a developing country**.

Further, **OECD Model advocates the Residence Rule,** i.e., it lays emphasis on the right of state of residence to tax the income, whereas the **UN Model is a compromise between the Source Rule and Residence Rule,** giving **more weight to the Source Rule** as against the Residence Rule.

Residence Rule means that income is taxable in hands of receiver in the country of which he is a resident. Therefore, as on per Residence Rule, royalty income received by a USA company from Indian company shall be taxable in USA i.e. the country in which receiver is a resident.

As per Source Rule, the income is taxable in hands of receiver in the country where services are used. Therefore, as per Source Rule, royalty income received by a USA company from Indian company shall be taxable in India, i.e. the country in which knowhow is used.

Question 2:
When does it become necessary to apply the tie-breaker rule? Discuss the manner of application of the tie-breaker rule.

Answer:
DTAA provides that certain incomes are taxable in the hands of recipient in the country of which he is a resident.

Every jurisdiction, in its domestic tax law, prescribes the mechanism to determine residential status of a person. If a person is considered to be resident of both the Contracting States, a series of tie-breaker rules are provided in Model Convention to determine single state of residence for an individual.

The tie-breaker rule would be applied in the following manner:

(i) **The first test is based on where the individual has a permanent home.** Therefore, he shall be deemed to be resident of the state in which he has a permanent home available to him. Permanent home would mean a dwelling place available to him at all times continuously and not occasionally and includes place taken on rent for a prolonged period of time. Any place taken for a short duration of stay or for temporary purpose, may be for reasons such as short business travel, or a short holiday etc. is not regarded as a permanent home.

(ii) **If that test is inconclusive for the reason that the individual has permanent home available to him in both Contracting States,** he will be considered a resident of the Contracting State **where his personal and economic relations are closer (centre of vital interests)**. Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the individual.

(iii) In case,

- where the individual has a permanent home available to him in both Contracting States and it is **not possible to determine** in which State he has his **centre of vital interests**; or
- where the individual has **no permanent home available** to him in both the Contracting State.

preference is given to the Contracting State where the individual has an habitual abode.

(iv) If the individual has **habitual abode in both Contracting States** or in neither of them, he shall be treated as a **resident of the Contracting State of which he is a national.**

(v) If the individual is a **national of both or neither of the Contracting States,** the matter is left to be **considered by the competent authorities** of the respective Contracting States.

Question 3:
Explain the meaning of the term "Royalty" under the UN Model Tax Convention. Is it different from the definition contained in OECD Model? Discuss.

Answer:
Article 12 of the UN Model Convention and OECD Model Convention contains the definition of the term "Royalty".

UN Model Convention defines "Royalty" as under:

"Royalty means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films, or **films or tapes used for radio or television broadcasting,** any patent, trade mark, design or model, plan, secret formula or process, or for the use of, **or the right to use, and industrial, commercial or scientific equipment,** or for information concerning industrial, commercial or scientific experience".

The definition of Royalty in OECD Model is **identical** to UN Model except **that the OECD Model specifically excludes the following from "royalties":**

- Rentals for "films or tapes used for radio or television broadcasting";

- Equipment rentals live rental for industrial, commercial or scientific equipment

Rentals for Film tapes used for radio/television broadcasts and Rentals of equipment are taxable under UN Model under Article 12 at a flat concessional rate say 10%. Whereas the above rentals are taxable under OECD Model under Article 7 as business profits (expenses are allowed and normal tax rate is applied).

Question 4:
What do you understand by base erosion and profit shifting? Describe briefly its adverse effects.

Answer:
Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to make **profits 'disappear'** for tax purposes or to **shift profits to locations where there is little or no real activity** but the taxes are low, resulting in little or no overall corporate tax being paid.

Adverse Effects of BEPS:

(1) **Governments** have to cope with **less revenue and a higher cost** to ensure compliance.

(2) In developing countries, the lack of tax revenue leads to significant **under-funding of public investment** that could help foster economic growth.

(3) BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. When tax laws permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, **other taxpayers, especially individual taxpayers in that jurisdiction bear a greater share of the burden.** This gives rise to tax fairness issues on account of individuals having to bear a higher tax burden.

(4) **Enterprises that operate only in domestic markets,** including family-owned businesses or new innovative businesses, may have **difficulty competing with MNEs that have the ability to shift their profits** across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS.

Question 5:
Describe the three-tier structure for transfer pricing documentation mandated by BEPS Action Plan 13.

Answer:
Action 13 contains a three-tiered standardized approach to transfer pricing documentation which consists of:

(a) **Local file:** Local file requires maintaining of transactional information specific to each country in detail covering related-party transactions and the amounts involved in those transactions. In addition, relevant financial information regarding specific transactions, a comparability analysis and analysis of the selection and application of the most appropriate transfer pricing method should also be captured. The local file is to be delivered by MNEs directly to tax administrations, if it is demanded by tax authorities. If the tax authorities demand local files and the assessee fails to produce them, then there is a penalty of 2% of value of international transactions.

(b) **Master file:** Master file requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies. The master file is to be delivered by MNEs directly to local tax administrations. **Master file (PART A) needs to be filed even if there is no international transaction during the previous year. Penalty for not filing master report is ₹ 5,00,000/-**

(c) **Country-by-country (CBC) report:** CBC report requires MNEs to provide an annual report of economic indicators viz. the amount of revenue, profit before income tax, income tax paid and accrued in relation to the tax jurisdiction in which they do business. CBC reports are required to be filed in the jurisdiction of tax residence of the ultimate parent entity, being subsequently shared between other jurisdictions through automatic exchange of information mechanism. Penalty for not filing CBC report is:

i. **₹ 5,000 for every day for which the failure continues, if the period of failure does not exceed one month; or**

ii. **₹ 15,000 for every day for which the failure continues beyond the period of one month.**

Question 6:
What is the difference between "Monist Views" and "Dualist Views"?

Answer:
The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAAs which are applicable to the taxpayers, then the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer. Internationally this situation is known as "**Monist View**" wherein International and National laws are part of the same system of law, where **DTAA overrides domestic law if DTAA is more beneficial than domestic tax laws.** Some other countries which follow such a system are: Argentina. Italy, the Netherlands, Belgium and Brazil.

The other prevalent view is known as "**Dualistic View**" wherein International Law and National Law are separate systems and DTAA becomes part of the national legal system by specific incorporation/legislation. In case of Dualistic View, DTAAs may be made subject to provisions of the National Law. **The domestic law prevails over DTAA**. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

Question 7:
Explain the exemption method for elimination of double taxation under UN Model Convention.
Answer:

The exemption method for elimination of double taxation under UN Model is, by either of the following methods:

1. **Exemption of Income from Tax:**
   If income has been taxed in one of the Contracting State, applying the Source Rule, then the other Contracting State (i.e. state of Residence) shall exempt such income from tax.

2. **Tax Credit Method:**
   If income has been taxed in one of the Contracting State applying the Source Rule, then the other Contracting State (i.e. State of Residence) shall provide the credit of taxes paid in the first Contracting State. Such credit shall not exceed the tax computed on such income in the other Contracting State as per Tax Laws of the other Contracting State.

Question 8:

What are the significant OECD Recommendations under Action Plan 1 of BEPS? Which recommendation has been adopted in Indian tax laws?

Answer:
The OECD has recommended under Action Plan 1, several options to tackle the direct tax challenges which include:

(1) Modifying the existing Permanent Establishment (PE) rule to provide that 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.

(2) 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.

(3) 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 permanent establishment in other contracting state.

In order to address these challenges, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy", provides for an equalisation levy of 6% of the amount of consideration for specified services received or receivable by a non-resident not having permanent establishment in India, from a resident in India who carries out business or profession, or from a non-resident having permanent establishment in India.

Meaning of "Specified Service":
(1) Online advertisement;
(2) Any provision for digital advertising space or any other facility or service for the purpose of online advertisement;

The Finance Act, 2020 has imposed an Equalisation Levy of 2% on the Non-Resident E-Commerce Operator not having a Permanent Establishment in India. The Non-Resident E-Commerce Operator has to pay Equalisation Levy of 2% on the consideration received by him for the making sales of goods and services to the following persons provided the total consideration received by him for the same is ₹ 2 crores or more:

a) A person resident in India

b) A person who buys such goods and/or services using internet protocol address located in India

c) A non-resident from sale of advertisement which targets a customer
- **Who is resident in India or**
- **Who accesses the advertisement through internet protocol address located in India**

d) A non-resident from sale of data collected from a person
- **Who is resident in India or**
- **Who uses internet protocol address located in India.**

Note: Consideration received/ receivable from e-commerce supply or services shall include:

Consideration for sale of goods/ provision of services irrespective of whether goods/ services are owned/ provided or facilitated by e-commerce operator so, however that it shall not include consideration for such sale/ provision by

- **a resident in India or**
- **a permanent establishment of a non-resident where such sale/ provision is effectively connected with such permanent establishment.**

Question 9:
What do you mean by double taxation? Discuss the connecting factors which lead to Double taxation.

Answer:
The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country.** Internationally, the term used to determine the jurisdiction for taxation is "connecting factors". There are two types of connecting factors, namely, "Residence" and "Source". It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business **with** another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business in a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link.

- **Jurisdictional double taxation:** Accordingly, when source rules overlap, double taxation may arise i.e. tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise. in their respective jurisdictions. This is known as "jurisdictional double taxation".

  In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91 of the Income-tax Act, 1961, providing unilateral relief in the event of double taxation.

- **Economic double taxation:** 'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different person (because of lack of subject identity)

Question 10:
Discuss the provision incorporated in the Income-tax Act, 1961 in line with the OECD recommendations under Action Plan 4 of BEPS.

Answer:

The OECD is concerned that multinational groups are able to erode their tax base (i.e., reduce their taxable profits) with interest expense, for example by:

- Locating third party debt in high tax countries;
- Using intra-group loans to achieve interest deductions in excess of the group's actual third party interest expense;

- Using related party or third party debt to finance the production of exempt or deferred income.

BEPS Action Plan 4 calls for the development of recommendations for the design of domestic rules to prevent tax base erosion through the use of interest expense and other financial payments that are economically equivalent to interest.

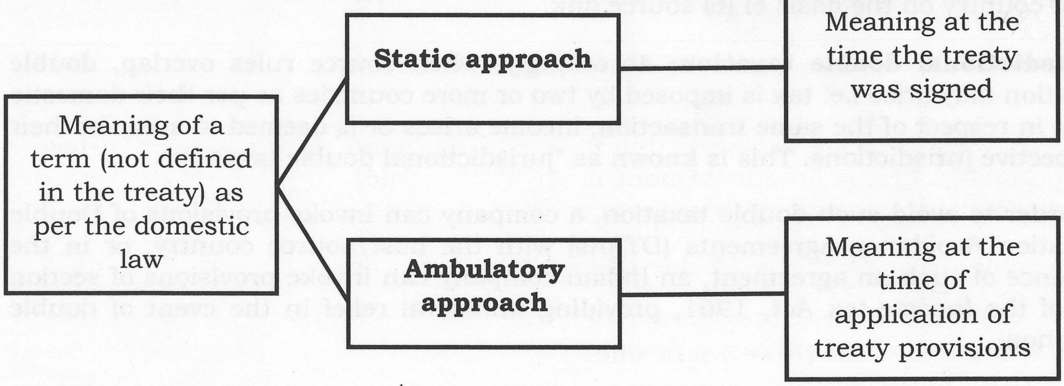
In line with the recommendations of OECD BEPS Action Plan 4, new section 94B has been inserted in the Income-tax Act, 1961, to provide a cap on the interest expense that can be claimed by an entity to its associated enterprise. The total interest paid in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise for that previous year, whichever is less, shall not be deductible.

Question 11:
What is "Ambulatory Approach" and "Static Approach"?

Answer:

AMBULATORY V. STATIC APPROACH

Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, a question often arises what meaning to be assigned to the said term – the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two views on the subject, namely, Static and Ambulatory.



In general, Model Commentaries favor ambulatory approach, however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the term.