PAPER

4

FINAL COURSE
STUDY MATERIAL
GROUP-II

DIRECT TAX LAWS & INTERNATIONAL TAXATION

MODULE 4 OF 4

[Direct Tax Laws as amended by the Finance Act, 2023]
Assessment Year 2024-25
Relevant for May, 2024 and November, 2024 Examinations

Board of Studies (Academic)
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

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Basic draft of this publication was prepared by CA. Vandana D Nagpal.

Edition	:	October, 2023
Committee/Department	:	Board of Studies (Academic)
E-mail	:	bosnoida@icai.in
Website	:	www.icai.org
Price	:	₹ /- (For All Modules)
ISBN No.	:	978-81-19472-92-5
Published by	:	The Publication & CDS Directorate on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002 (India)
Printed by	:	

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CHAPTER 21

NON RESIDENT TAXATION

LEARNING OUTCOMES

After studying this Chapter, you will be able to –

- **determine** the residential status of Individuals, HUF, AOPs/ BOIs, Firms & Companies etc;
- **examine** the scope of income chargeable to tax in respect of different persons, after ascertaining their residential status;
- **examine** when income arising in the hands of non-resident from a transaction is deemed to accrue or arise in India;
- **appreciate** the circumstances when the presence of eligible fund manager in India would not constitute business connection in India for an eligible investment fund;
- **identify** whether a particular income is exempt in the hands of a non-resident based on the provisions of the Income-tax Act, 1961;
- **compute** the profits and gains for non-resident assessees from shipping business, business of operation of aircraft, business of civil construction etc. in certain turnkey power projects applying the presumptive tax provisions under the Income-tax Act, 1961;
- **determine** the quantum of head office expenditure allowable as deduction to non-residents;
- **determine** the tax payable by the non-residents on dividend, royalty and fees for technical service applying the special provisions of Chapter XII;
- **determine** the tax payable by non-residents applying the special provisions relating to certain incomes of non-residents prescribed under Chapter XII-A;
- **examine** the withholding tax provisions to determine the tax, if any, required to be deducted at source on certain payments made to non-residents;
- **compute** the total income of non-residents and tax payable thereon, applying the general provisions and special provisions applicable to non-residents under the Income-tax Act, 1961.

21.1 INTRODUCTION

Taxation of cross-border transactions are generally based on the two concepts:

1. Residence based taxation
2. Source based taxation

Residence based taxation: The concept of residence-based taxation asserts that natural persons or individuals are taxable in the country or tax jurisdiction in which they establish their residence or domicile, regardless of the source of income. In case of companies, the place of incorporation or the place of effective management is generally considered as its place of residence.

Source based taxation: According to this concept, a country considers certain income as taxable income, if such income arises within its jurisdiction. Such income is taxed in the country of source regardless of the residence of the taxpayer.

21.2 RESIDENTIAL STATUS AND SCOPE OF TOTAL INCOME

(1) Residential Status [Section 6]

The incidence of tax on any assessee depends upon his residential status under the Act. For all purposes of income-tax, taxpayers (individuals and HUF) are classified into three broad categories on the basis of their residential status viz.

(1) Resident and ordinarily resident

(2) Resident but not ordinarily resident

(3) Non-resident

Taxpayers (other than individuals and HUF) are classified into two broad categories on the basis of their residential status viz.

(1) Resident

(2) Non-resident

The residential status of an assessee must be ascertained with reference to each previous year. A person who is resident and ordinarily resident in one year may become non-resident or resident but not ordinarily resident in another year or *vice versa.*

The provisions for determining the residential status of assessees are:

(1) Residential status of Individuals

Residential status on the basis of number of days of stay in India

Under section 6(1), an individual is said to be resident in India in any previous year, if he satisfies **any one** of the following conditions:

(i) He has been in India during the relevant previous year for a total period of 182 days or more, or

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

If both the above conditions are not satisfied, the individual is a non-resident.

Notes:

(a) The term "stay in India" includes stay in the territorial waters of India (i.e., 12 nautical miles into the sea from the Indian coastline). Even the stay in a ship or boat moored in the territorial waters of India would be sufficient to make the individual resident in India.

(b) It is not necessary that the period of stay must be continuous or active nor is it essential that the stay should be at the usual place of residence, business or employment of the individual.

(c) For the purpose of counting the number of days stayed in India, both the date of departure as well as the date of arrival are considered to be in India.

(d) The residence of an individual for income-tax purpose has nothing to do with citizenship, place of birth or domicile. An individual can, therefore, be resident in more countries than one even though he can have only one domicile.

Exceptions:

The following categories of individuals will be treated as resident in India only if the period of their stay during the relevant previous year amounts to 182 days or more. The condition of presence in India for 60 days or more in the relevant previous year is not applicable for such individuals.

(i) Indian citizen, who leaves India during the relevant previous year as a member of the crew of an Indian ship or for purposes of employment outside India, or

(ii) Indian citizen or person of Indian origin[1] who, being outside India comes on a visit to India during the relevant previous year.

However, such person having total income, other than the income from foreign sources [i.e., income which accrues or arises outside India (except income from a business controlled from or profession set up in India) and which is not deemed to accrue or arise in India], exceeding ₹ 15 lakhs during the previous year will be treated as resident in India if -

- the period of his stay during the relevant previous year amounts to 182 days or more, or
- he has been in India during the 4 years immediately preceding the previous year for a total period of 365 days or more and has been in India for at least 120 days in the previous year.

Note - Stay in India for 120 days in the relevant P.Y. is not a standalone condition. This condition requires stay in India for 120 days in the relevant P.Y. + 365 days in the 4 years immediately preceding the P.Y.

How to determine period of stay in India for an Indian citizen, being a crew member?

In case of foreign bound ships where the destination of the voyage is outside India, there is uncertainty regarding the manner and the basis of determining the period of stay in India for an Indian citizen, being a crew member.

To remove this uncertainty, *Explanation 2* to section 6(1) provides that in the case of an individual, being a citizen of India and a member of the crew of a foreign bound ship leaving India, the period or periods of stay in India shall, in respect of such voyage, be determined in the prescribed manner and subject to the prescribed conditions.

Accordingly, the CBDT has vide, *Notification No. 70/2015 dated 17.8.2015*, inserted Rule 126 in the Income-tax Rules, 1962 to compute the period of stay in such cases.

According to Rule 126, for the purposes of section 6(1), in case of an individual, being a citizen of India and a member of the crew of a ship, the period or periods of stay in India shall, in respect of an eligible voyage, not include the following period:

[1]A person is said to be of Indian origin if he or either of his parents or either of his grandparents were born in undivided India.

Period to be excluded

Period commencing from		Period ending on
the date entered into the Continuous Discharge Certificate in respect of joining the ship by the said individual for the eligible voyage	**And**	the date entered into the Continuous Discharge Certificate in respect of signing off by that individual from the ship in respect of such voyage.

Meaning of certain terms:

Terms		Meaning
(a)	Continuous Discharge Certificate	This term has the meaning assigned to it in the Merchant Shipping (Continuous Discharge Certificate-cum Seafarer's Identity Document) Rules, 2001 made under the Merchant Shipping Act, 1958.
(b)	Eligible voyage	A voyage undertaken by a ship engaged in the carriage of passengers or freight in international traffic where – (i) for the voyage having originated from any port in India, has as its destination any port outside India; and (ii) for the voyage having originated from any port outside India, has as its destination any port in India.

ILLUSTRATION 1

Mr. Ajay is an Indian citizen and a member of the crew of a Mauritius bound Indian ship engaged in carriage of passengers in international traffic departing from Mumbai port on 16th July, 2023. From the following details for the P.Y.2023-24, determine the residential status of Mr. Ajay for A.Y.2024-25, assuming that his stay in India in the last 4 previous years (preceding P.Y.2023-24) is 415 days and last seven previous years (preceding P.Y.2023-24) is 745 days:

Particulars	*Date*
Date entered into the Continuous Discharge Certificate in respect of joining the ship by Mr. Ajay	*16th July, 2023*
Date entered into the Continuous Discharge Certificate in respect of signing off the ship by Mr. Ajay	*19th January, 2024*

SOLUTION

In this case, since Mr. Ajay is an Indian citizen and leaving India during P.Y. 2023-24 as a member of the crew of an Indian ship, he would be resident in India, only if he stayed in India for 182 days or more.

The voyage is undertaken by an Indian ship engaged in the carriage of passengers in international traffic, originating from a port in India (i.e., the Mumbai port) and having its destination at a port outside India (i.e., the Mauritius port). Hence, the voyage is an eligible voyage for the purposes of section 6(1).

Therefore, the period beginning from 16th July, 2023 and ending on 19th January, 2024, being the dates entered into the Continuous Discharge Certificate in respect of joining the ship and signing off from the ship by Mr. Ajay, an Indian citizen who is a member of the crew of the ship, has to be excluded for computing the period of his stay in India. Accordingly, 188 days [16+31+30+31+30+31+19] have to be excluded from the period of his stay in India. Consequently, Mr. Ajay's period of stay in India during the P.Y.2023-24 would be 178 days [i.e., 366 days – 188 days]. Since his period of stay in India during the P.Y.2023-24 is less than 182 days, he is a non-resident for A.Y.2024-25.

Note *- Since the residential status of Mr. Ajay is "non-resident" for A.Y.2024-25 consequent to his number of days of stay in P.Y.2023-24 being less than 182 days, his period of stay in the earlier previous years become irrelevant.*

Deemed resident [Section 6(1A)]

An individual, being an Indian citizen, having total income, other than the income from foreign sources [i.e., income which accrues or arises outside India (except income from a business controlled from or profession set up in India) and which is not deemed to accrue or arise in India], exceeding ₹ 15 lakhs during the previous year would be deemed to be resident in India in that previous year, if he is not liable to pay tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

However, this provision will not apply in case of an individual who is a resident of India in the previous year as per section 6(1).

Meaning of "liable to tax" – Liable to tax, in relation to a person and with reference to a country, means that there is an income-tax liability on such person under the law of that country for the time being in force. It also includes a person who has subsequently been exempted from such liability under the law of that country [Section 2(29A)].

Notes – (1) Only Indian citizen can be deemed resident. An individual who is not an Indian citizen but a person of Indian Origin cannot be deemed resident u/s 6(1A).

(2) Stay in India is not necessary for being a deemed resident u/s 6(1A).

Resident and ordinarily resident/ Resident but not ordinarily resident

Only individuals and HUF can be resident but not ordinarily resident in India. All other classes of assessees can be either a resident or non-resident. An individual and HUF would be not-ordinarily resident if they satisfy any one of the conditions specified under section 6(6).

(i) If such individual has been non-resident in India in any 9 out of the 10 previous years preceding the relevant previous year, or

(ii) If such individual has during the 7 previous years preceding the relevant previous year been in India for a period of 729 days or less, or

(iii) If such individual is an Indian citizen or person of Indian origin (who, being outside India, comes on a visit to India in any previous year) having total income, other than the income from foreign sources [i.e., income which accrues or arises outside India (other than income derived from a business controlled in or profession set up in India) and which is not deemed to accrue or arise in India], exceeding ₹ 15 lakhs during the previous year, who has been in India for 120 days or more but less than 182 days during that previous year, or

(iv) If such individual is an Indian citizen who is deemed to be resident in India under section 6(1A) [It may be noted that a deemed resident will always be a resident but not ordinarily resident].

ILLUSTRATION 2

Chris Gayle, a West Indies cricket player visits India for 102 days in every financial year. This has been his practice for the past 10 financial years.

(a) Find out his residential status for the A.Y. 2024-25.

(b) Would your answer change if the above facts relate to Srinath, an Indian citizen who resides in West Indies and represents the West Indies cricket team?

(c) What would be your answer if Srinath had visited India for 120 days instead of 102 days every year, including P.Y.2023-24?

SOLUTION

(a) Determination of Residential Status of Mr. Chris Gayle for the A.Y. 2024-25:

Period of stay during the P.Y. 2023-24 = 102 days

Calculation of period of stay during 4 preceding previous years (102 days x 4=408 days)

P.Y. 2022-23	102 days
P.Y. 2021-22	102 days
P.Y. 2020-21	102 days
P.Y.2019-20	102 days
Total	**408 days**

Mr. Chris Gayle has been in India for a period of more than 60 days during P.Y. 2023-24 and for a period of more than 365 days during the 4 immediately preceding previous years. Therefore, since he satisfies one of the basic conditions under section 6(1), he is a resident for the A.Y. 2024-25.

Computation of period of stay during 7 preceding previous years = 102 days x 7=714 days

2022-23	102 days
2021-22	102 days
2020-21	102 days
2019-20	102 days
2018-19	102 days
2017-18	102 days
2016-17	102 days
Total	**714 days**

Since his period of stay in India during the past 7 previous years is less than 730 days, he is a not-ordinarily resident during the A.Y. 2024-25. **(See Note below)**

Therefore, Mr. Chris Gayle is a resident but not ordinarily resident during the previous year 2023-24 relevant to the A.Y. 2024-25.

Note: *An individual, not being an Indian citizen, would be not-ordinarily resident person if he satisfies any one of the conditions specified under section 6(6), i.e.,*

(i) If such individual has been non-resident in India in any 9 out of the 10 previous years preceding the relevant previous year, or

(ii) If such individual has during the 7 previous years preceding the relevant previous year been in India for a period of 729 days or less.

In this case, since Mr. Chris Gayle satisfies condition (ii), he is a not-ordinary resident for the A.Y. 2024-25.

(b) If the above facts relate to Mr. Srinath, an Indian citizen, who residing in West Indies, comes on a visit to India, he would be treated as non-resident in India for previous year 2023-24, irrespective of his total income (excluding income from foreign sources), since his stay in India in the current financial year is, in any case, less than 120 days.

(c) In this case, if Mr. Srinath's total income (excluding income from foreign sources) exceeds ₹ 15 lakh, he would be treated as resident but not ordinarily resident in India for P.Y.2023-24, since his stay in India is 120 days in the P.Y.2023-24 and 480 days (i.e., 120 days x 4 years) in the immediately four preceding previous years.

If his total income (excluding income from foreign sources) does not exceed ₹ 15 lakh, he would be treated as non-resident in India for the P.Y.2023-24, since his stay in India is less than 182 days in the P.Y.2023-24.

(2) Residential status of HUF

Resident: A HUF would be resident in India if the control and management of its affairs is situated wholly or partly in India.

Non-resident: If the control and management of the affairs is situated wholly outside India it would become a non-resident.

Meaning of the term "control and management"

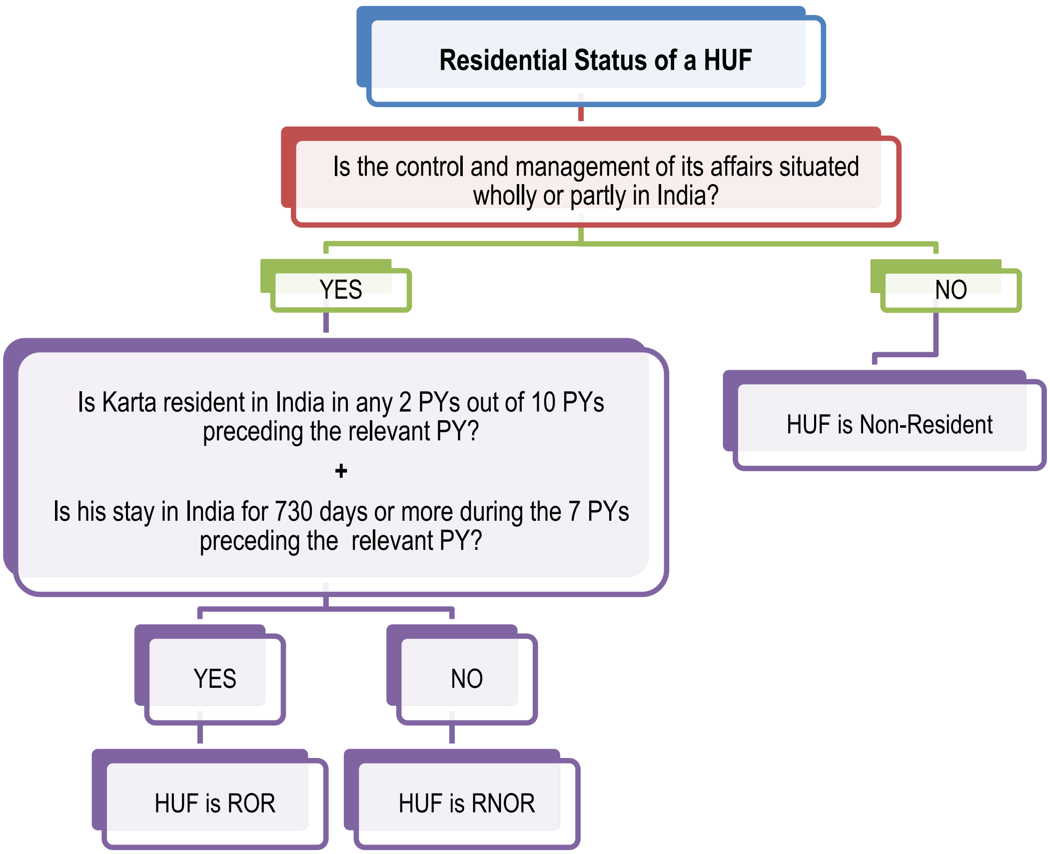
- The expression 'control and management' referred to under section 6 refers to the central control and management and not to the carrying on of day-to-day business by servants, employees or agents.
- Control and management means de facto control and management and not merely having the right to control or manage.
- The business may be done from outside India and yet its control and management may be wholly within India. Therefore, control and management of a business is said to be situated at a place where the head and brain of the adventure is situated. Merely because the family has a house in India, where some of the members reside in the previous year, does not constitute that place as the seat of control and management of the affairs of the HUF unless important decisions concerning the affairs of the HUF are taken at that place.

Resident and ordinarily resident/ Resident but not ordinarily resident

If Karta of resident HUF satisfies both the following additional conditions (as applicable in case of individual) then, resident HUF will be "Resident and ordinarily resident" (ROR), otherwise it will be "Resident but not ordinarily resident" (RNOR).

Additional conditions:

1. Karta of resident HUF should be resident in at least 2 previous years out of 10 previous years immediately preceding relevant previous year.
2. Stay of Karta during 7 previous years immediately preceding relevant previous year should be 730 days or more.



(3) Residential status of firms, AoPs and BoIs

Resident: A firm, AoP and BoI would be resident in India if the control and management of its affairs is situated wholly or partly in India.

Non-resident: Where the control and management of the affairs is situated wholly outside India, the firm, AoP and BoI would become a non-resident.

Note - The residential status of the partners/ members is immaterial while determining the residential status of a Firm/AOP/BOI.

The term "Non-resident" is defined under section 2(30) of the Income-tax Act, 1961 as a person who is not a "resident". However, for the purposes of sections 92B, 93 and 168, non-resident would include a person who is not ordinarily resident within the meaning of section 6(6).

(4) Residential status of local authorities and artificial juridical persons

Resident: Local authorities and artificial juridical persons would be resident in India if the control and management of its affairs is situated wholly or partly in India.

Non-resident: Where the control and management of the affairs is situated wholly outside India, they would become non-residents.

(5) Residential status of a Company

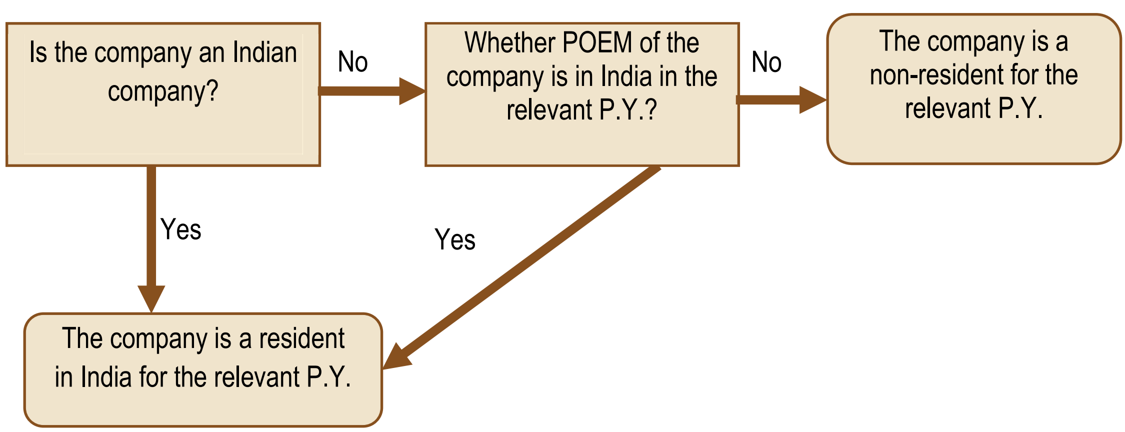
A company would be resident in India in any previous year, if-

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India.

"Place of effective management *"means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made [Explanation to section 6(3)].*

DETERMINATION OF RESIDENTIAL STATUS OF A COMPANY



Guiding Principles for determination of Place of Effective management ('POEM') of a Company, other than an Indian company – [Circular No. 6/2017, dated 24.01.2017 & Circular No. 8/2017, dated 23-02-2017]:

Place of effective management' (POEM) is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognises the concept of 'place of effective management' for determination of residence of a company as a tie-breaker rule for avoidance of double taxation.

The CBDT has laid down the following guiding principles to be followed for determination of POEM.

Concept of Substance over form

The determination of the POEM will depend upon the facts and circumstances of a given case. The POEM concept is one of substance over form. It may be noted that an entity may have more than one place of management, but it can have only one place of effective management at any point of time. Since "residence" is to be determined for each year, POEM will also be required to be determined on year to year basis.

Whether the company is engaged in active business outside India? - An important criterion for determination of POEM

The process of determination of POEM would be 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 passive income is not more than 50% of its total income, and
- less than 50% of its total asset 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.

Meaning of certain terms:

Term	Meaning
Income	(a) As computed for tax purpose in accordance with the laws of the country of incorporation; or (b) As per books of account, where the laws of the country of incorporation does not require such a computation.

Value of assets	**(a) In case of an individually depreciable asset**	The average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the previous year; and
	(b) In case of pool of fixed asset, being treated as a block for depreciation	The average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the year;
	(c) In case of any other asset	Value as per books of account
Number of employees	The average of the number of employees as at the beginning and at the end of the year and shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees.	
Payroll	This term includes the cost of salaries, wages, bonus, and all other employee compensation including related pension and social costs borne by the employer.	
Passive income	It 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; However, any income by way of interest shall not be considered to be passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation	

Place of Effective Management:

(i) In case of Companies engaged in Active Business outside India

POEM of a company engaged in active business shall be presumed to be outside India if the majority of the board meeting are held outside India.

However, in case the Board is not exercising its powers of management and such powers are being exercised by either the holding company or any other person, resident in India, then POEM shall be considered to be in India.

For this purpose, merely because the Board of Directors (BOD) follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of Payroll functions, Accounting, Human resource (HR) functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; would not constitute a case of BoD of companies standing aside.

CBDT Circular No. 25/2017, dated 23.10.2017 clarifies that so long as the Regional Headquarter operates for subsidiaries/ group companies in a region within the general and objective principles of global policy of the group laid down by the parent entity in the field of Payroll functions, Accounting, HR functions, IT infrastructure and network platforms, Supply chain functions, Routine banking operational procedures, and not being specific to any entity or group of entities per se; it would, in itself, not constitute a case of BoD of companies standing aside and such activities of Regional Headquarter in India alone will not be a basis for establishment of POEM for such subsidiaries/ group companies.

It is further mentioned in the said Circular that the provisions of General Anti-Avoidance Rule contained in Chapter X-A of the Income-tax Act, 1961 may get triggered in such cases where the above clarification is found to be used for abusive/ aggressive tax planning.

For the purpose of determining whether the company is engaged in active business outside India, the average of the data of the previous year and two years prior to that shall be considered. In case the company has been in existence for a shorter period, then data of such period shall be considered. Where the accounting year for tax purposes, in accordance with laws of country of incorporation of the company, is different from the previous year, then, data of the accounting year that ends during the relevant previous year and two accounting years preceding it shall be considered.

It has been clarified that mere following of global policies laid down by the Indian holding company would not constitute that Board is standing aside.

(ii) In case of Companies not engaged in active business outside India

The guidelines provide a two-stage process for determination of POEM in case of companies not engaged in active business.

(a) **First stage**: Identifying the person(s) who actually make the key management and commercial decisions for the conduct of the company as a whole.

(b) **Second stage**: Determine the place where these decisions are, in fact, being made.

The place where these management decisions are taken would be more important than the place where such decisions are implemented. For the purpose of determination of POEM, it is the substance which would be conclusive rather than the form.

The conditions specified in the circular are depicted in the flow charts below:

The determination of POEM is based on the following categorization of foreign companies:

Active Business Outside India (Business Test)

Companies fulfilling the test of ABOI

- *POEM outside India, if majority BOD meetings are held outside India*
- *If de facto decision making authority is not BOD but Indian parent or resident, POEM shall be in*

Companies other than those fulfilling the test of ABOI

Stage 1: *Identification of persons who actually make the key management and commercial decision for conduct of the company's business as a whole*

Stage 2: *Determination of place where*

What is ABOI test?

A company is said to be engaged in ABOI, if it fulfills the cumulative conditions of:

- Its passive income* (wherever earned) is 50% or less of its total income
- Less than 50% of its total assets situated in India
- Less than 50% of the total number of employees are situated in India or are residents in India
- Payroll expenses incurred on such employees are less than 50% of its total payroll expenditure

** Passive income of a company shall be 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 (except for banking companies and public financial institutions) or rental income whether or not involving associated enterprises.

Some of the guiding principles which may be taken into account for determining the POEM are as follows:

(a) Location where the Board of Directors meet and makes decisions: This location may be the place of effective management of a company provided, the Board –

(i) retains and exercises its authority to govern the company; and

(ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's 'business as a whole'.

It may be mentioned that mere formal holding of board meetings at a place would by itself not be conclusive for determination of POEM being located at that place. If the key decisions by the directors are in fact being taken in a place other than the place where the formal meetings are held then such other place would be relevant for POEM.

As an example this may be the case where the board meetings are held in a location distinct from the place where head office of the company is located or such location is unconnected with the place where the predominant activity of the company is being carried out.

If a Board has *de facto* delegated the authority to make the key management and commercial decisions for the company to the senior management or any other person including a shareholder, promoter, strategic or legal or financial advisor etc. and does nothing more than routinely ratifying the decisions that have been made, the company's place of effective management will ordinarily be the place where these senior managers or the other person make those decisions.

"Senior Management" in respect of a company means the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis. While designation may vary, these persons may include:

(i) Managing Director or Chief Executive Officer;

(ii) Financial Director or Chief Financial Officer;

(iii) Chief Operating Officer; and

(iv) The heads of various divisions or departments (for example, Chief Information or Technology Officer, Director for Sales or Marketing).

(b) Location of Executive Committee in case powers are delegated by the Board: A company's board may delegate some or all of its authority to one or more committees such as an executive committee consisting of key members of senior management. In these situations, the location where the members of the executive committee are based and where that committee develops and formulates the key strategies and policies for mere formal approval by the full board will often be considered to be the company's place of effective management.

The delegation of authority may be either *de jure* (by means of a formal resolution or Shareholder Agreement) or *de facto* (based upon the actual conduct of the board and the executive committee).

(c) Location of Head Office: The location of a company's head office will be a very important factor in the determination of the company's place of effective management because it often represents the place where key company decisions are made. The following points need to be considered for determining the location of the head office of the company: -

If the company's senior management and their support staff are based in a single location and that location is held out to the public as the company's principal place of business or headquarters then that location is the place where head office is located.

If the company is more decentralized (for example where various members of senior management may operate, from time to time, at offices located in the various countries) then the company's head office would be the location where these senior managers,-

(i) are primarily or predominantly based; or

(ii) normally return to following travel to other locations; or

(iii) meet when formulating or deciding key strategies and policies for the company as a whole.

Members of the senior management may operate from different locations on a more or less permanent basis and the members may participate in various meetings via telephone or video conferencing rather than by being physically present at meetings in a particular location. In such situation the head office would normally be the location, if any, where the highest level of management (for example, the Managing Director and Financial Director) and their direct support staff are located.

In situations where the senior management is so decentralized that it is not possible to determine the company's head office with a reasonable degree of certainty, the location of a company's head office would not be of much relevance in determining that company's place of effective management.

"Head Office" of a company would be the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office is not necessarily the same as the place where the majority of its employees work or where its board typically meets.

(d) **Use of modern technology:** The use of modern technology impacts the place of effective management in many ways. It is no longer necessary for the persons taking decision to be physically present at a particular location. Therefore, physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases the place where the directors or the persons taking the decisions or majority of them usually reside may also be a relevant factor.

(e) **Decision *via* circular resolution or round robin voting:** In case of circular resolution or round robin voting the factors like, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc. are to be considered. It cannot be said that proposer of decision alone would be relevant but based on past practices and general conduct; it would be required to determine the person who has the authority and who exercises the authority to take decisions. The place of location of such person would be more important.

(f) **Decisions made by shareholders are not relevant factor in determination of POEM:** The decisions made by shareholder on matters which are reserved for shareholder decision under the company laws are not relevant for determination of a company's place of effective management. Such decisions may include sale of all or substantially all of the company's assets, the dissolution, liquidation or deregistration of the company, the modification of the rights attaching to various classes of shares or the issue of a new class of shares etc. These decisions typically affect the existence of the company itself or the rights of the shareholders as such, rather than the conduct of the company's business from a management or commercial perspective and are therefore, generally not relevant for the determination of a company's place of effective management.

However, the shareholder's involvement can, in certain situations, turn into that of effective management. This may happen through a formal arrangement by way of shareholder agreement etc. or may also happen by way of actual conduct. As an example if the shareholders limit the authority of board and senior managers of a company and thereby remove the company's real authority to make decision then the shareholder guidance transforms into usurpation and such undue influence may result in effective management being exercised by the shareholder.

Therefore, whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only.

(g) **Day to day routine operational decisions are not relevant for determination of POEM:** It may be clarified that day to day routine operational decisions undertaken by junior and middle management shall not be relevant for the purpose of determination of POEM. The operational decisions relate to the oversight of the day-to-day business operations and activities of a company whereas the key management and commercial decision are concerned with broader strategic and policy decision. For example, a decision to open a major new manufacturing facility or to discontinue a major product line would be examples of key commercial decisions affecting the company's business as a whole. By contrast, decisions by the plant manager appointed by senior management to run that facility, concerning repairs and maintenance, the implementation of company-wide quality controls and human resources policies, would be examples of routine operational decisions. In certain situations, it may happen that person responsible for operational decision is the same person who is responsible for the key management and commercial decision. In such cases it will be necessary to distinguish the two type of decisions and thereafter assess the location where the key management and commercial decisions are taken.

If the above factors do not lead to clear identification of POEM, then the final guidelines provide that following secondary factors may be considered:

- Place where main and substantial activity of the company is carried out; or

- Place where the accounting records of the company are kept.

It needs to be emphasized that the determination of POEM is to be based on all relevant facts related to the management and control of the company, and is not to be determined on the basis of isolated facts that by itself do not establish effective management, as illustrated by the following examples:

(i) The fact that a foreign company is completely owned by an Indian company will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(ii) The fact that there exists a Permanent Establishment of a foreign entity in India would itself not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iii) The fact that one or some of the Directors of a foreign company reside in India will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

(iv) The fact of, local management being situated in India in respect of activities carried out by a foreign company in India will not, by itself, be conclusive evidence that the conditions for establishing POEM have been satisfied.

(v) The existence in India of support functions that are preparatory and auxiliary in character will not be conclusive evidence that the conditions for establishing POEM in India have been satisfied.

It is reiterated that the above principles for determining the POEM are for guidance only. No single principle will be decisive in itself. The above principles are not to be seen with reference to any particular moment in time rather activities performed over a period of time, during the previous year, need to be considered.

In other words, a “snapshot” approach is not to be adopted. Further, based on the facts and circumstances if it is determined that during the previous year the POEM is in India and also outside India then POEM shall be presumed to be in India if it has been mainly /predominantly in India

The CBDT also clarified that the Assessing Officer (AO) shall, before initiating any proceedings for holding a company incorporated outside India, on the basis of its POEM, as being resident in India, seek prior approval of the Principal Commissioner or the Commissioner, as the case may be.

Further, in case the AO proposes to hold a company incorporated outside India, on the basis of its POEM, as being resident in India then any such finding shall be given by the AO after seeking prior approval of the collegium of three members consisting of the Principal Commissioners or the Commissioners, as the case may be, to be constituted by the Principal Chief Commissioner of the region concerned, in this regard. The collegium so constituted shall provide an opportunity of being heard to the company before issuing any directions in the matter.

Example 1: *Company A Co. is a sourcing entity, for an Indian multinational group, incorporated in country X and is 100% subsidiary of Indian company (B Co.). The warehouses and stock in them are the only assets of the company and are located in country X. All the employees of the company are also in country X. The average income wise breakup of the company's total income for three years is, -*

(i) *30% of income is from transaction where purchases are made from parties which are non-associated enterprises and sold to associated enterprises.*

(ii) *30% of income is from transaction where purchases are made from associated enterprises and sold to associated enterprises.*

(iii) *30% of income is from transaction where purchases are made from associated enterprises and sold to non-associated enterprises. and*

(iv) *10% of the income is by way of interest.*

Interpretation: In this case, passive income is 40% of the total income of the company. The passive income consists of, -

(i) 30% income from the transaction where both purchase and sale is from/to associated enterprises; and

(ii) 10% income from interest.

The A Co. satisfies the first requirement of the test of active business outside India. Since no assets or employees of A Co. are in India the other requirements of the test is also satisfied. Therefore, company is engaged in active business outside India.

Example 2: *The other facts remain same as that in Example 1 with the variation that A Co. has a total of 50 employees. 47 employees, managing the warehouse, storekeeping, and accounts of the company, are located in country X. The Managing Director (MD), Chief Executive Officer (CEO) and sales head are resident in India. The total annual payroll expenditure on these 50 employees* *is of ₹ 5 crore. The annual payroll expenditure in respect of MD, CEO and sales head is of ₹ 3 crore.*

Interpretation: Although the first limb of active business test is satisfied by A Co. as only 40% of its total income is passive in nature. Further, more than 50% of the employees are also situated outside India. All the assets are situated outside India. However, the payroll expenditure in respect of the MD, the CEO and the sales head being employee's resident in India exceeds 50% of the total payroll expenditure. Therefore, A Co. is not engaged in active business outside India.

Example 3: *The basic facts are same as in Example 1. Further facts are that all the directors of the A Co. are Indian residents. During the relevant previous year 5 meetings of the Board of Directors is held of which two were held in India and 3 outside India with two in country X and one in country Y.*

Interpretation: The A Co. is engaged in active business outside India as the facts indicated in Example 1 establish. The majority of board meetings have been held outside India. Therefore, the POEM of A Co. shall be presumed to be outside India.

Example 4:*The facts are same as in Example 3 but it is established by the Assessing Officer that although A Co.'s senior management team signs all the contracts, for all the contracts above ₹ 10 lakh the A Co. must submit its recommendation to B Co. and B Co. makes the decision whether or not the contract may be accepted. It is also seen that during the previous year more than 99% of the contracts are above ₹ 10 lakh and over past years also the same trend in respect of value contribution of contracts above ₹ 10 lakh is seen.*

Interpretation: These facts suggest that the effective management of the A Co. may have been usurped by the parent company B Co. Therefore, POEM of A Co. may in such cases be not presumed to be outside India even though A Co. is engaged in active business outside India and majority of board meeting are held outside India.

Example 5: *An Indian multinational group has a local holding company A Co. in country X. The A Co. also has 100% downstream subsidiaries B Co. and C Co. in country X and D Co. in country Y. The A Co. has income only by way of dividend and interest from investments made in its subsidiaries. The Place of Effective Management of A Co. is in India and is exercised by ultimate parent company of the group. The subsidiaries B, C and D are engaged in active business outside India. The meetings of Board of Director of B Co., C Co. and D Co. are held in country X and Y respectively.*

Interpretation: Merely because the POEM of an intermediate holding company is in India, the POEM of its subsidiaries shall not be taken to be in India. Each subsidiary has to be examined separately. As indicated in the facts since B Co., C Co., and D Co. are independently engaged in active business outside India and majority of Board meetings of these companies are also held outside India. The POEM of B Co., C Co., and D Co. shall be presumed to be outside India.

Further, the CBDT vide Circular no. 8/2017 dated 23.02.2017 also clarified that POEM guidelines shall not apply to a company having turnover or gross receipts of ₹ 50 crores or less in a financial year.

ILLUSTRATION 3

ABC Inc., a Swedish company headquartered at Stockholm, not having a permanent establishment in India, has set up a liaison office in Mumbai in April, 2023 in compliance with RBI guidelines to look after its day to day business operations in India, spread awareness about the company's products and explore further opportunities. The liaison office takes decisions relating to day to day routine operations and performs support functions that are preparatory and auxiliary in nature. The significant management and commercial decisions are, however, in substance made by the Board of Directors at Sweden. Determine the residential status of ABC Inc. for A.Y. 2024-25.

SOLUTION

Section 6(3) provides that a company would be resident in India in any previous year, if-

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India.

In this case, ABC Inc. is a foreign company. Therefore, it would be resident in India for P.Y.2023-24 only if its place of effective management, in that year, is in India.

Explanation to section 6(3) defines "place of effective management" to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. In the case of ABC Inc., its place of effective management for P.Y.2023-24 is not in India, since the significant management and commercial decisions are, in substance, made by the Board of Directors outside India in Sweden.

ABC Inc. has only a liaison office in India through which it looks after its routine day to day business operations in India. The place where decisions relating to day to day routine operations are taken and support functions that are preparatory or auxiliary in nature are performed are not relevant in determining the place of effective management.

Hence, ABC Inc., being a foreign company is a non-resident for A.Y.2024-25, since its place of effective management is outside India in the P.Y.2023-24.

Transition Mechanism for a company incorporated outside India and has not been assessed to tax earlier [Chapter XII-BC – Section 115JH]

A transition mechanism has been provided in Chapter XII-BC comprising of section 115JH for a company which is incorporated outside India, which has not been assessed to tax in India earlier and has become resident in India for the first time due to application of POEM,.

(a) Section 115JH empowers the Central Government to notify exception, modification and adaptation subject to which, the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation, set-off or carry forward and set off of losses, special provision relating to avoidance of tax and the collection and recovery of taxes shall apply in a case where a foreign company is said to be resident in India due to its POEM being in India for the first time and the said company has never been resident in India before.

(b) In a case where the determination regarding foreign company to be resident in India has been made in the assessment proceedings relevant to any previous year, then, these transition provisions would also cover any subsequent previous year, if the foreign company is resident in India in that previous year and the previous year ends on or before the date on which such assessment proceeding is completed. In effect, the transition provisions would also cover any subsequent previous year upto the date of determination of POEM in an assessment proceeding. However, once the transition is complete, then, normal provisions of the Act would apply.

(c) In the notification issued by the Central Government, certain conditions including procedural conditions subject to which these adaptations shall apply can be provided for and in case of failure to comply with the conditions, the benefit of such notification would not be available to the foreign company.

    Accordingly, where in a previous year, any benefit, exemption or relief has been claimed and granted to the foreign company in accordance with the notification, and subsequently, there is failure to comply with any of the conditions specified therein, then –

    (i) the benefit, exemption or relief shall be deemed to have been wrongly allowed.

    (ii) the Assessing Officer may re-compute the total income of the assessee for the said previous year and make the necessary amendment as if the exceptions, modifications, and adaptations as per the notification does not apply; and

    (iii) the provisions of section 154 shall, so far as may be, apply thereto and the period of four years for rectification of mistake apparent from the record has to be reckoned from the end of the previous year in which the failure to comply with the condition stipulated in the notification takes place.

(d) Every notification issued in exercise of this power by the Central Government shall be laid before each house of the Parliament.

(e) Accordingly, in exercise of the power under section 115JH(1) of the Income-tax Act, 1961,the Central Government has, vide notification No. 29/2018, dated 22nd June, 2018, specified the exceptions, modifications and adaptions subject to which, the provisions of the Act relating to computation of income, treatment of unabsorbed depreciation, set-off or carry forward and set off of losses, special provision relating to avoidance of tax and the collection and recovery of taxes shall apply in a case where a foreign company is said to be resident in India in any previous year on account of its POEM being in India and the such foreign company has not been resident in India before the said previous year.

Particulars	Provisions
Determination of opening WDV	**If the foreign company is assessed to tax in the foreign jurisdiction** **Where depreciation is required to be taken into account for the purpose of computation of its taxable income**, the WDV of the depreciable asset as per the tax record in the foreign country on the 1st day of the previous year shall be adopted as the opening WDV for the said previous year. **Where WDV is not available as per tax records,** the WDV shall be calculated assuming that the asset was installed, utilised and the depreciation was actually allowed as per the provisions of the laws of that foreign jurisdiction. The WDV so arrived at as on the 1st day of the previous year shall be adopted to be the opening WDV for the said previous year. **If the foreign company is not assessed to tax in the foreign jurisdiction** WDV of the depreciable asset as appearing in the books of account as on the 1st day of the previous year maintained in accordance with the laws of that foreign jurisdiction shall be adopted as the opening WDV for the said previous year.
Brought forward loss and unabsorbed depreciation	**If the foreign company is assessed to tax in the foreign jurisdiction** Brought forward loss and unabsorbed depreciation as per the tax record shall be determined year wise on the 1st day of the said previous year. **If the foreign company is not assessed to tax in the foreign jurisdiction** Brought forward loss and unabsorbed depreciation as per the books of account prepared in accordance with the laws of that country shall be determined year wise on the 1st day of the said previous year.

	Other provisions Such brought forward loss and unabsorbed depreciation shall be deemed as loss and unabsorbed depreciation brought forward as on the 1st day of the said previous year and shall be allowed to be set off and carried forward in accordance with the provisions of the Act for the remaining period calculated from the year in which they occurred for the first time taking that year as the first year. However, the losses and unabsorbed depreciation of the foreign company shall be allowed to be set off only against such income of the foreign company which has become chargeable to tax in India on account of it becoming resident in India due to application of POEM. In cases where the brought forward loss and unabsorbed depreciation originally adopted in India are revised or modified in the foreign jurisdiction due to any action of the tax or legal authority, the amount of the loss and unabsorbed depreciation shall be revised or modified for the purposes of set off and carry forward in India.
Period of profit and loss account and balance sheet in cases where accounting year of foreign company does not end on 31st March	The foreign company is required to prepare profit and loss account and balance sheet for the period starting from the date on which the accounting year immediately following said accounting year begins, upto 31st March of the year immediately preceding the period beginning with 1st April and ending on 31st March during which the foreign company has become resident. The foreign company is also required to prepare profit and loss account and balance sheet for succeeding periods of twelve months, beginning from 1st April and ending on 31st March, till the year the foreign company remains resident in India on account of its POEM. **Examples:** **Example 1:** If the accounting year of the foreign company is a calendar year and the company becomes resident in India during P.Y. 2023-24 for the first time due to its POEM being in India, then, the company is required to prepare profit and loss account and balance sheet for the period 1st January, 2023 to 31st March, 2023. It is also required to prepare profit and loss account and balance sheet for the period 1st April, 2023 to 31st March, 2024. For the purpose of carry forward of loss and unabsorbed depreciation in this case, since the period 1st January, 2023 to 31st March, 2023 is less than 6 months, it is to be included in the accounting year immediately preceding the accounting year in which the foreign company is held to be resident in India for the first time. Accordingly, the profit and loss and balance sheet of the Fifteen (15) month period from 1st January, 2022 to 31st March, 2023 is to be prepared.

	Example 2: If the accounting year of the foreign company is from 1st July to 30th June and the company becomes resident in India during P.Y. 2023-24 for the first time due to its POEM being in India, then, the company is required to prepare profit and loss account and balance sheet for the period 1st July, 2022 to 31st March, 2023. It is also required to prepare profit and loss account and balance sheet for the period 1st April 2023 to 31st March 2024. For the purpose of carry forward of loss and unabsorbed depreciation in this case, since the period is more than 6 months, it is to be treated as a separate accounting year. The loss and unabsorbed depreciation as per tax record or books of account, as the case may be, of the foreign company shall, be allocated on proportionate basis.
Applicability of provisions of Chapter XVII-B (TDS provisions)	Where more than one provision of Chapter XVII-B of the Act applies to the foreign company as resident as well as foreign company, the provision applicable to the foreign company alone shall apply. Compliance to those provisions of Chapter XVII-B of the Act as are applicable to the foreign company prior to it becoming Indian resident shall be considered sufficient compliance to the provisions of said Chapter. The provisions of section 195(2) relating to application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax shall apply in such manner so as to include payment to the foreign company.
Availability of deduction under section 90 or 91 (Foreign tax credit)	The foreign company shall be entitled to relief or deduction of taxes paid in accordance with the provisions of section 90 or section 91 of the Act. Where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India in respect of the income to which it relates and shall be in accordance with the provisions of rule 128 of the Income-tax Rules, 1962.
Non applicability of the notification	The above exceptions, modifications and adaptations shall not apply in respect of such income of the foreign company which otherwise would have been chargeable to tax in India, even if the foreign company had not become Indian resident.
Applicability of the notification where foreign company becomes resident in the subsequent	In a case where the foreign company is said to be resident in India during a previous year, immediately succeeding a previous year during which it is said to be resident in India; the exceptions, modifications and adaptations shall apply to the said previous year subject to the condition that the WDV, the brought forward loss and the unabsorbed depreciation to be adopted on the 1st day of the previous year shall be those which have been arrived at on the last

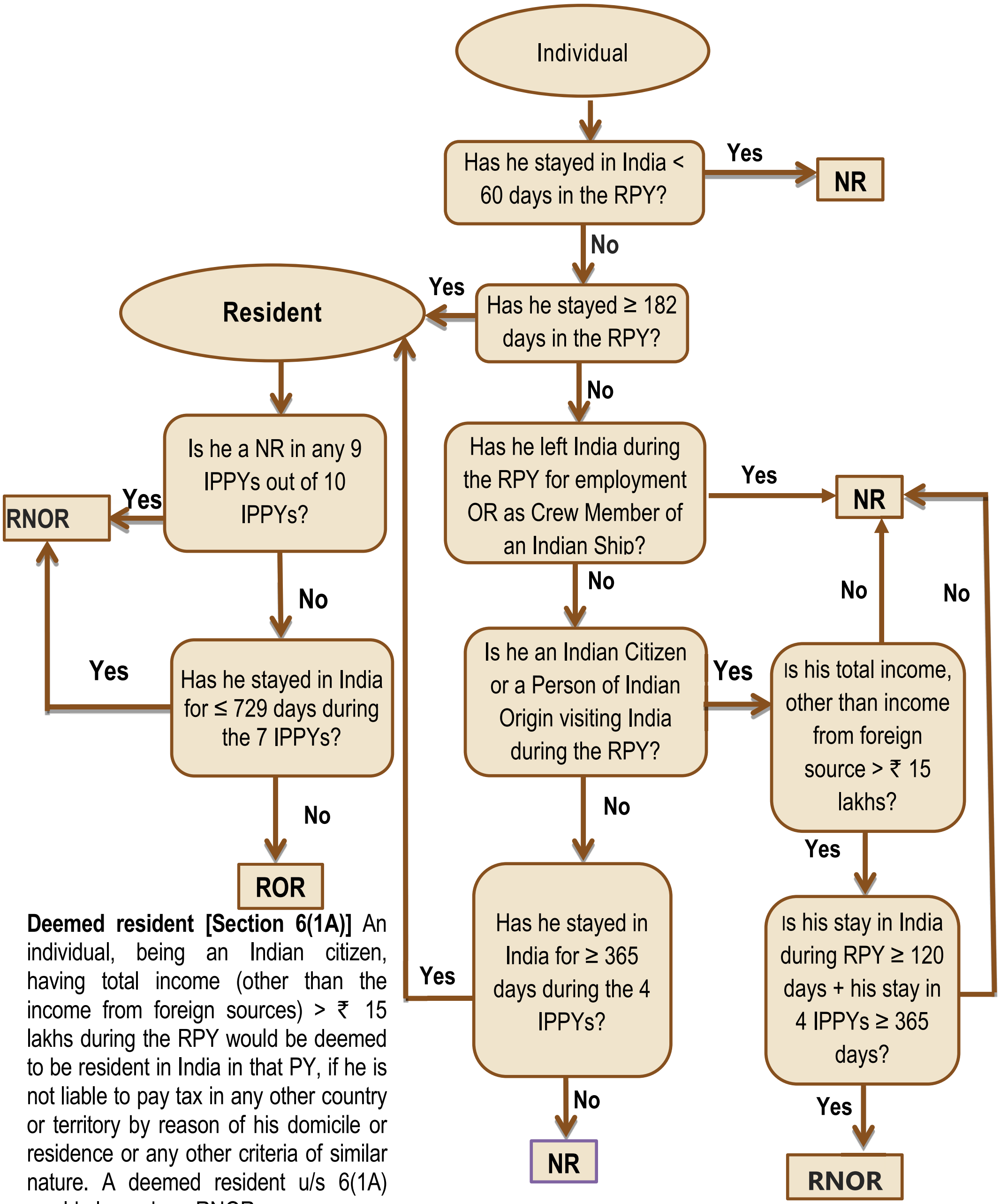
previous year also	day of the preceding previous year in accordance with the provisions of this notification.
No effect on other transactions	Any transaction of the foreign company with any other person or entity under the Act shall not be altered only on the ground that the foreign company has become Indian resident.
Applicability of other provisions relating to foreign company	Subject to the above exceptions, modifications and adaptions specifically provided vide this notification, the foreign company shall continue to be treated as a foreign company even if it is said to be resident in India and all the provisions of the Act shall apply accordingly. Consequently, the provisions specifically applicable to— (i) a foreign company, shall continue to apply to it; (ii) non-resident persons, shall not apply to it; and (iii) the provisions specifically applicable to resident, shall apply to it.
Applicability of tax rate on foreign company	In case of conflict between the provision applicable to the foreign company as resident and the provision applicable to it as foreign company, the later shall generally prevail. Therefore, the rate of tax in case of foreign company i.e., 40% shall remain the same, i.e., rate of income-tax applicable to the foreign company even though residency status of the foreign company changes from non-resident to resident on the basis of POEM.
Applicability of notification	This notification shall be deemed to have come into force from 1st April 2017.
Meaning of foreign jurisdiction	The place of incorporation of the foreign company.
Applicability of rule 115 of the Income-tax Rules, 1962.	The rate of exchange for conversion into rupees of value expressed in foreign currency, wherever applicable, shall be in accordance with provision of Rule 115 of the Income-tax Rules, 1962. [Rule 115 is given as Annexure 1 at the end of this module]

Determination of Residential Status: A summary

Abbreviations used in the Flow Charts in pages 21.29 & 21.30

IC	=	**Indian Citizen**	**RPY**	=	**Relevant Previous Year**
R	=	**Resident**	**NR**	=	**Non-resident**
IPPYs	=	**Immediately Preceding Previous Years**	**AOP**	=	**Association of Persons**
N & OR	=	**Resident but Not Ordinarily Resident**	**HUF**	=	**Hindu Undivided Family**
ROR	=	**Resident and Ordinarily Resident**			

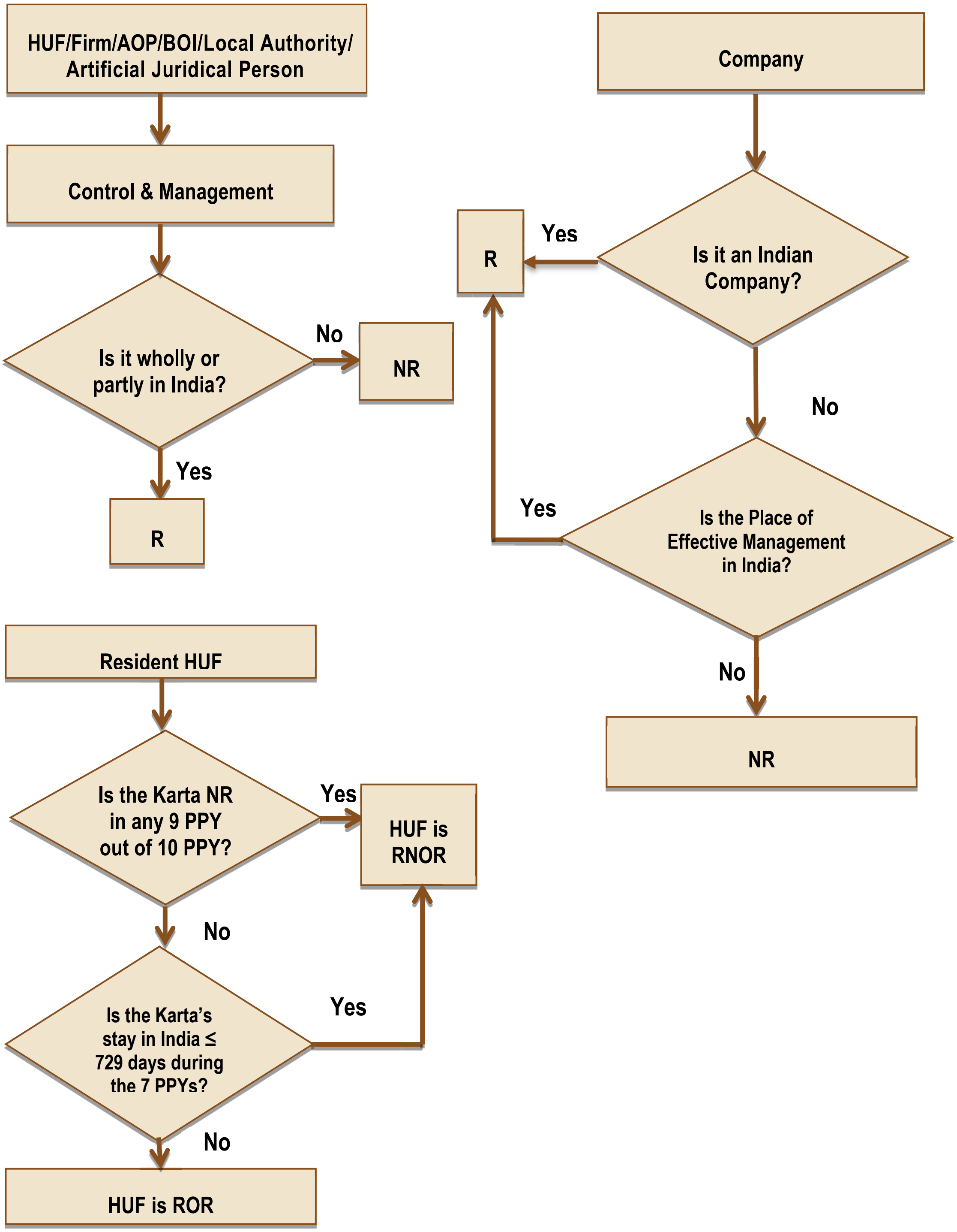
Determination of Residential Status of Individual



Deemed resident [Section 6(1A)] An individual, being an Indian citizen, having total income (other than the income from foreign sources) > ₹ 15 lakhs during the RPY would be deemed to be resident in India in that PY, if he is not liable to pay tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature. A deemed resident u/s 6(1A) would always be a RNOR.

***Note** – If an individual is a resident in India in the PY as per section 6(1), then, the provision of deemed resident u/s 6(1A) would not apply to him.*

Determination of Residential Status of HUF/ Firm/ AOP/ BOI/Local Authority/ Artificial Juridical Person/Company



(2) Scope of Total Income [Section 5]

Section 5 provides the scope of total income which depends on the residential status of the assessee. The scope of total income of an assessee depends upon the following three important considerations:

(i) the residential status of the assessee;

(ii) the place of accrual or receipt of income, whether actual or deemed; and

(iii) the point of time at which the income had accrued to or was received by or on behalf of the assessee.

The ambit of total income of the three classes of assessees would be as follows:

(1) Resident and ordinarily resident (ROR)

The total income of an ROR would, under section 5(1), consist of:

(i) income received or deemed to be received in India during the previous year;

(ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year; and

(iii) income which accrues or arises outside India even if it is not received or brought into India during the previous year.

In simpler words, the global income of a ROR is chargeable to tax in India.

(2) Resident but not ordinarily resident (RNOR)

Under section 5(1), the total income of an RNOR would consist of –

(i) income received or deemed to be received in India during the previous year;

(ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year; and

(iii) income derived from a business controlled in or profession set up in India, even though it accrues or arises outside India.

Note – All other income accruing or arising outside India which is not received or deemed to be received or deemed to accrue or arise in India would not be included in his total income.

(3) Non-resident

A non-resident's total income under section 5(2) includes:

(i) income received or deemed to be received in India in the previous year; and

(ii) income which accrues or arises or is deemed to accrue or arise in India during the previous year.

Note: All assessees, whether resident or not, are chargeable to tax in respect of their income accrued, arisen, received or deemed to accrue, arise or to be received in India whereas a resident alone (resident and ordinarily resident in the case of individuals and HUF) is chargeable to tax in respect of income which accrues or arises outside India.

Clarification regarding liability to income-tax in India of a non-resident seafarer receiving remuneration in NRE (Non-Resident External) account maintained with an Indian Bank [Circular No.13/2017, dated 11.04.2017 and Circular No.17/2017, dated 26.04.2017]

Income by way of salary, received by non-resident seafarers, for services rendered outside India on foreign ships, is being subjected to tax in India for the reason that the salary has been received by the seafarer into the NRE bank account maintained in India by the seafarer. On receiving representations in this regard, the CBDT examined the matter and noted that section 5(2)(a) of the Income-tax Act, 1961 provides that only such income of a non-resident shall be subjected to tax in India that is either received or is deemed to be received in India.

Accordingly, the CBDT has, vide this circular, clarified that salary accrued to a non-resident seafarer for services rendered outside India on a foreign going ship (with Indian flag or foreign flag) shall not be included in the total income merely because the said salary has been credited in the NRE account maintained with an Indian bank by the seafarer.

.**Summary of scope of Total Income**

Particulars	Resident and Ordinarily Resident	Not ordinarily Resident	Non-Resident
Income received or deemed to be received in India whether earned in India or elsewhere	Yes	Yes	Yes
Income which accrues or arises or is deemed to accrue or arise in India during the previous year whether received in India or elsewhere	Yes	Yes	Yes

Income which accrues or arises outside India and received outside India from a business controlled from India	Yes	Yes	No
Income which accrues or arises outside India and received outside India in the previous year from any other source	Yes	No	No
Income which accrues or arises outside India and received outside India during the year(s) preceding the relevant previous year and remitted to India during the relevant previous year	No	No	No

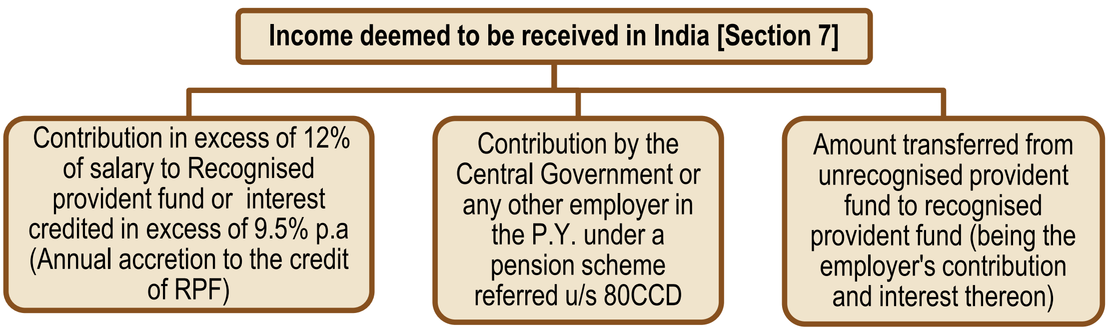
Meaning of "Income received or deemed to be received"

All assessees are liable to tax in respect of the income received or deemed to be received by them in India during the previous year irrespective of -

(i) their residential status, and

(ii) the place of its accrual.

Income is to be included in the total income of the assessee immediately on its actual or deemed receipt. The receipt of income refers to only the first occasion when the recipient gets the money under his control. Therefore, when once an amount is received as income, remittance or transmission of that amount from one place or person to another does not constitute receipt of income in the hands of the subsequent recipient or at the place of subsequent receipt.



<u>Meaning of income 'accruing' and 'arising'</u>

Accrue refers to the right to receive income, whereas due refers to the right to enforce payment of the same. For e.g. salary for work done in December will accrue throughout the month, day to day, but will become due on the salary bill being passed on 31st December or 1st January.

Similarly, on Government securities, interest payable on specified dates arise during the period of holding, day to day, but will become due for payment on the specified dates.

Example:

Interest on Government securities is usually payable on specified dates, say on 1st January and 1st July. In all such cases, the interest would be said to accrue from 1st July to 31st December and on 1st January, it will fall due for payment.

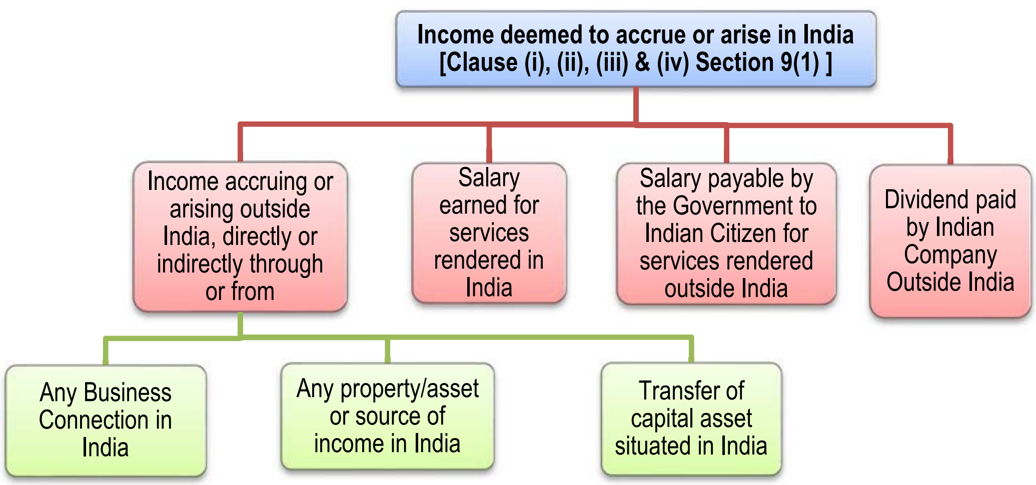
It must be noted that income which has been taxed on accrual basis cannot be assessed again on receipt basis, as it will amount to double taxation.

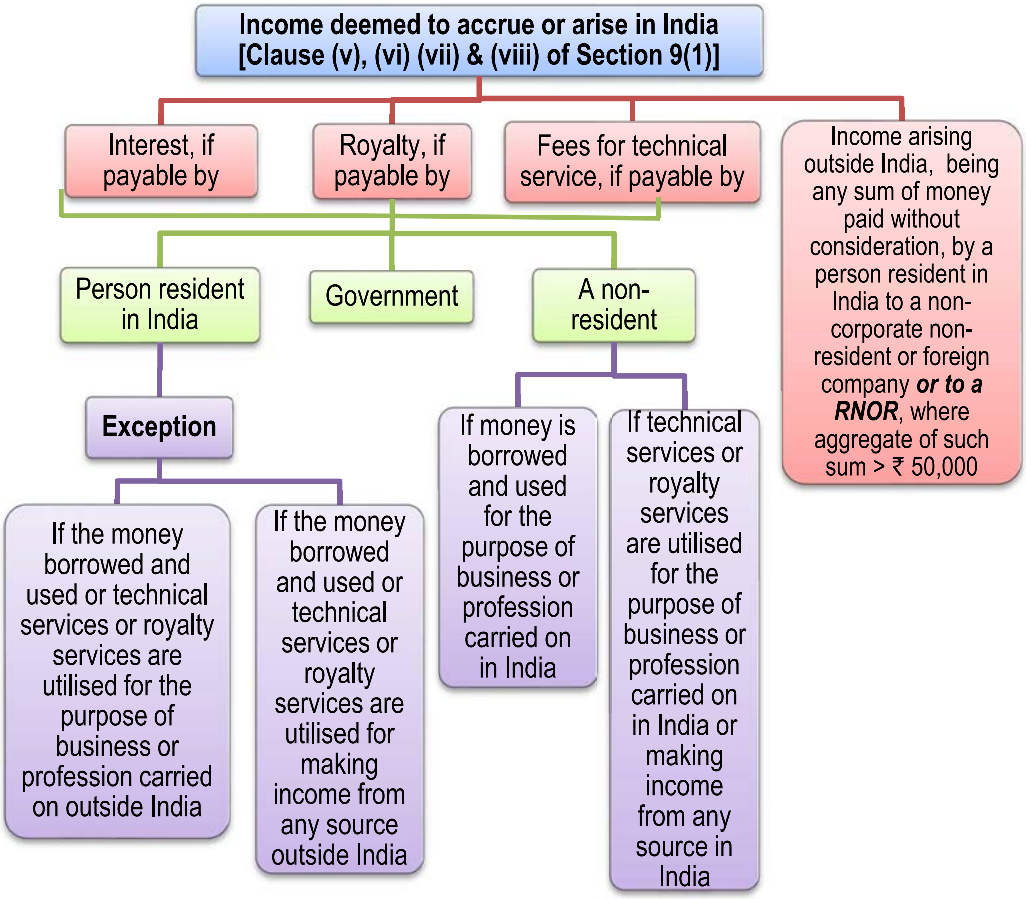
Explanation 1 to section 5 specifically provides that an item of income accruing or arising outside India shall not be deemed to be received in India merely because it is taken into account in a balance sheet prepared in India.

Further, *Explanation 2* to section 5 makes it clear that once an item of income is included in the assessee's total income and subjected to tax on the ground of its accrual/ deemed accrual, it cannot again be included in the person's total income and subjected to tax either in the same or in a subsequent year on the ground of its receipt - whether actual or deemed.

Income deemed to accrue or arise in India [Section 9]

Under section 9, certain types of income are deemed to accrue or arise in India even though they may actually accrue or arise outside India.





The categories of income which are deemed to accrue or arise in India are:

(1) Any income accruing or arising to an assessee in any place outside India whether directly or indirectly

(i) through or from any business connection in India,

(ii) through or from any property in India,

(iii) through or from any asset or source of income in India or

(iv) through the transfer of a capital asset situated in India

would be deemed to accrue or arise in India **[Section 9(1)(i)].**

(i) What is Business Connection?

'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident [*Explanation 2* to section 9(1)(i)]

For a business connection to be established, the person acting on behalf of the non-resident –

(a) must have an authority, which is habitually exercised in India, to conclude contracts on behalf of the non-resident or

habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and such contracts are

- in the name of the non-resident; or
- for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
- for the provision of services by that non-resident, or

Note - This amendment in the definition of "business connection" is for the purpose of alignment with the provisions of the Double Taxation Avoidance Agreement (DTAA) as modified by Multilateral Instrument (MLI) so as to make the provisions in the treaty effective.

(b) in a case, where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or

(c) habitually secures orders in India, mainly or wholly for the non-resident.

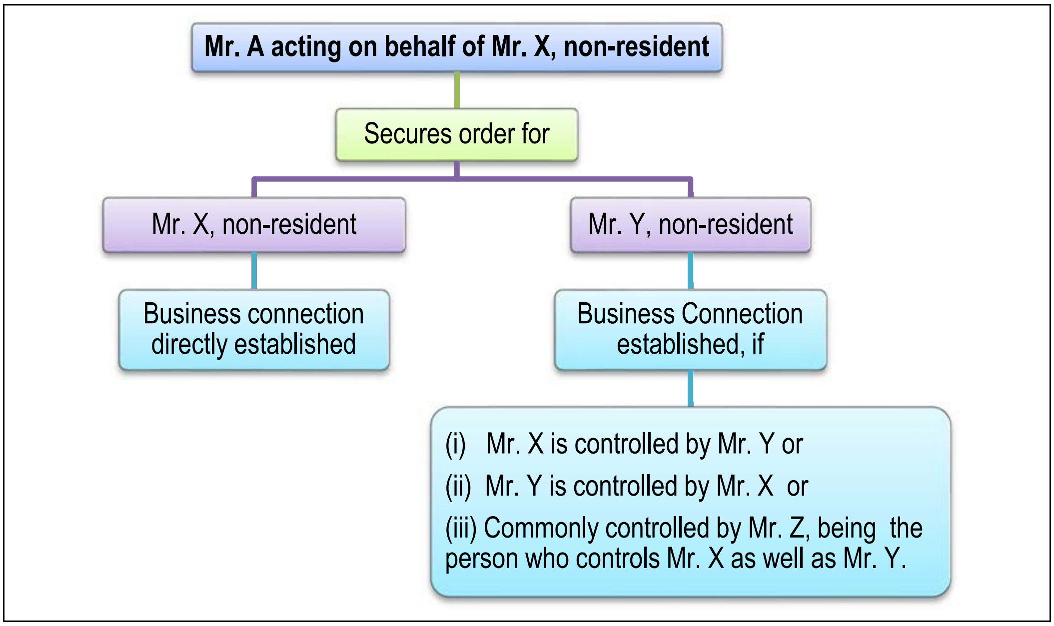
Further, there may be situations when the person acting on behalf of the non-resident secure order for other non-residents. In such situation, business connection for other non-residents is established if,

i. such other non-resident controls the non-resident or

ii. such other non-resident is controlled by the non-resident or

iii. such other non-resident is subject to same control as that of non-resident.

In all the three situations, business connection is established, where a person habitually secures orders in India, mainly or wholly for such non-residents.



Agents having independent status are not included in Business Connection: Business connection, however, shall not be established, where the non-resident carries on business through a broker, general commission agent or any other agent having an independent status, if such a person is acting in the ordinary course of his business.

A broker, general commission agent or any other agent shall be deemed to have an independent status where he does not work mainly or wholly for the non-resident.

Where a business is carried on in India through a person referred to in (a), (b) or (c) of (i) above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India *[Explanation 3 to Section 9(1)(i)]*.

Significant economic presence [Explanation 2A to section 9(1)(i)]

Significant economic presence of a non-resident in India shall also constitute business connection in India.

Significant economic presence means-

	Nature of transaction	Condition
(a)	in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India	Aggregate of payments arising from such transaction or transactions during the previous year should exceed **₹ 2 crores.**

(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India	The number of users should be atleast **3 lakhs**.

Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;

(ii) the non-resident has a residence or place of business in India; or

(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

In the case of a non-resident the following shall not, however, be treated as business connection in India *[Explanation 1* to section 9(1)(i)*]:*

(a) In the case of a business, in respect of which all the operations are not carried out in India [*Explanation 1(a)* to section 9(1)(i)]: In the case of a business, other than the business having business connection in India on account of significant economic presence, of which all the operations are not carried out in India, the income of the business deemed to accrue or arise in India shall be only such part of income as is reasonably attributable to the operations carried out in India. Therefore, it follows that such part of income which cannot be reasonably attributed to the operations in India, is not deemed to accrue or arise in India.

Income attributable to the operations carried out in India includes:

- Income from advt. targetting customers residing in India or accessing advt. thro IPA located in India
- Income from sale of data collected from persons residing in India or using IPA located in India
- Income from sale of goods and services using data collected from persons residing in India or using IPA located in India

IPA – Internet Protocol Address

The above provisions would also apply to the income attributable to the transactions or activities referred to in Explanation 2A to section 9(1)(i).

(b) **Purchase of goods in India for export [Explanation *1(b)* to section 9(1)(i)]:** In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

(c) **Collection of news and views in India for transmission out of India [*Explanation 1(c)* to section 9(1)(i)]:** In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

(d) **Shooting of cinematograph films in India [*Explanation 1(d)* to section 9(1)(i)]:** In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, if such non-resident is :

- an individual, who is not a citizen of India or
- a firm which does not have any partner who is a citizen of India or who is resident in India; or
- a company which does not have any shareholder who is a citizen of India or who is resident in India.

(e) **Activities confined to display of rough diamonds in SNZs [*Explanation 1(e)* to section 9(1)(i)]**: In case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unassorted diamonds in any special zone notified by the Central Government in the Official Gazette in this behalf.

(ii) & (iii) Income from property, asset or source of income in India

Any income which arises from any property in India (movable, immovable, tangible and intangible property) would be deemed to accrue or arise in India.

Examples:

- *Hire charges or rent paid outside India for the use of the machinery or buildings situated in India*
- *deposits with an Indian company for which interest is received outside India etc.*

(iv) Income through transfer of a capital asset situated in India

Capital gains arising through or from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether

- The capital asset is movable or immovable, tangible or intangible;
- The place of registration of the document of transfer etc., is in India or outside; and
- The place of payment of the consideration for the transfer is within India or outside.

Accordingly, the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of" ***[Explanation 4* to section 9(1)(i)*]*.**

Further, an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India ***[Explanation 5* to section 9(1)(i)*]*.**

Cases where an asset or capital asset held by a non-resident is not deemed to be situated in India

(1) An asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly, in Category-I or Category-II foreign portfolio investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 prior to their repeal, made under the Securities and Exchange Board of India Act, 1992, shall not deemed to be or deemed to have been situated in India [Second proviso to *Explanation 5* to section 9(1)(i)]

(2) An asset or a capital asset, which is held by a non-resident by way of investment, directly or indirectly, in Category-I foreign portfolio investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019, made under the Securities and Exchange Board of India Act, 1992 shall also not deemed to be or deemed to have been situated in India [Third proviso to *Explanation 5* to section 9(1)(i)]

The CBDT has, vide Circular No. 28/2017, dated 07.11.2017, clarified that the provisions of section 9(1)(i) read with *Explanation 5*, shall not apply in respect of income accruing or arising to a non-resident on account of redemption or buyback of its share or interest held indirectly (i.e. through upstream entities registered or incorporated outside India) in the specified funds (namely, investment funds, venture capital company and venture capital funds) if such income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds and such income is chargeable to tax in India.

However, the above benefit shall be applicable only in those cases where the proceeds of redemption or buyback arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realized by the specified funds from the said transfer of shares or securities in India. It is further clarified that a non-resident investing directly in the specified funds shall continue to be taxed as per the extant provisions of the Act.

Declaration of dividend by a foreign company outside India does not have the effect of transfer of any underlying assets located in India. *Circular No. 4/2015, dated 26-03-2015*, therefore, clarifies that, the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would **NOT** be deemed to be income accruing or arising in India by virtue of the provisions of section 9(1)(i).

***Explanation 6* to section 9(1)(i)** provides that the share or interest in a company or entity registered or incorporated outside India, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets, -

- exceeds the amount of ₹ 10 crore; and
- represents at least 50% of the value of all the assets owned by the company or entity, as the case may be;

Meaning of certain terms:

Term	Meaning
Value of an asset	The **fair market value as on the specified date**, of such asset **without reduction of liabilities**, if any, in respect of the asset, determined in prescribed manner.
Specified date	The date on which the **accounting period** of the company or, as the case may be, the entity **ends** preceding the date of transfer of a share or an interest. However, the date of transfer shall be the specified date of valuation, in a case where the book value of the assets of the company or entity on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer.
Accounting period	Each period of 12 months ending with 31st March. However, where a company or an entity, referred to in *Explanation 5*,

	regularly adopts a period of 12 months ending on a day other than 31st March for the purpose of— (a) complying with the provisions of the tax laws of the territory, of which it is a resident, for tax purposes; or (b) reporting to persons holding the share or interest, then, the period of twelve months ending with the other day shall be the accounting period of the company or, as the case may be, the entity:
First Accounting Period	First accounting period of the company or, as the case may be, the entity shall **begin from the date of its registration or incorporation** and **end with the 31st March** or such other day, as the case may be, following the date of such registration or incorporation.
Later accounting period	Later accounting period shall be the **successive periods of twelve months**
Accounting period of an entity which ceases to exist	If the company or the entity ceases to exist before the end of accounting period, as aforesaid, then, the accounting period shall end immediately before the company or, as the case may be, the entity, ceases to exist.

Note - The manner of determination of fair market value of the assets of the foreign company is given in Rule 11UB. Determination of income attributable to assets in India is given in Rule 11UC[2].

***Explanation* 7 to section 9(1)(i)** provides that **no income shall be deemed** to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, in the following cases;

(1)	Foreign company or entity **directly** owns the assets situated in India	**AND**	**the transferor** (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, **does not hold** • the right of management or control in relation to foreign company or entity; or • the voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the foreign company or entity; or
(2)	Foreign company or entity **indirectly** owns the	**AND**	**the transferor** (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, **does not hold** • the right of management or control in relation to foreign company or entity; or

[2] For detailed reading of Rule 11UB and 11UC of the Income-tax Rules, 1962, students may visit https://incometaxindia.gov.in/Pages/rules/income-tax-rules-1962.aspx

	assets situated in India		• any right in, or in relation to, such foreign company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India; or • such percentage of voting power or share capital or interest in foreign company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;

In effect, the exemption shall be available to the transferor of a share of, or interest in, a foreign entity if he along with its associated enterprises, -

- neither holds the right of control or management,
- nor holds voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest,

in the foreign company or entity directly holding the Indian assets (direct holding company).

In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly then the exemption shall be available to the transferor if he along with its associated enterprises,-

- neither holds the right of management or control in relation to such company or the entity,
- nor holds any rights in such company which would entitle it to either exercise control or management of the direct holding company or entity or entitle it to voting power or share capital or total interest exceeding 5% in the direct holding company or entity.

Further, where all the assets owned, directly or indirectly, by a company or, as the case may be, an entity registered or incorporated outside India, are not located in India, the income of the non-resident transferor, from transfer outside India of a share of, or interest in the foreign company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in the prescribed manner.

"Associated enterprise", in relation to another enterprise, means an enterprise—

- which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or

- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

(2) Income from salaries earned in India [Section 9(1)(ii)]

Income, which falls under the head "Salaries", deemed to accrue or arise in India, if it is earned in India. Salary payable for service rendered in India would be treated as earned in India.

Further, any income under the head "Salaries" payable for rest period or leave period which is preceded and succeeded by services rendered in India, and forms part of the service contract of employment, shall be regarded as income earned in India.

(3) Income from salaries payable by the Government for services rendered outside India [Section 9(1)(iii)]

Income from 'Salaries' which is payable by the Government to a citizen of India for services rendered outside India would be deemed to accrue or arise in India.

However, allowances and perquisites paid or allowed outside India by the Government to an Indian citizen for services rendered outside India is exempt, by virtue of section 10(7).

ILLUSTRATION 4

J, a citizen of India, employed in the Indian Embassy at Tokyo, Japan. He received salary and allowances at Tokyo from the Government of India for the year ended 31.3.2024 for services rendered by him in Tokyo. Besides, he was allowed perquisites by the Government. He is a non-resident for the assessment year 2024-25. Examine the taxability of salary, allowances and perquisites in the hands of J for the assessment year 2024-25.

SOLUTION

As per section 9(1)(iii), salaries payable by the Government to a citizen of India for services rendered outside India shall be deemed to accrue or arise in India. As such, salary received by J is chargeable to tax, even though he was a non-resident for A.Y. 2024-25.

As per section 10(7), all allowances or perquisites paid or allowed as such outside India by the Government to a citizen of India for rendering services outside India is exempt from tax. Therefore, the allowances and perquisites received by J are exempt as per section 10(7).

(4) Dividend paid by an Indian company outside India [Section 9(1)(iv)]

Dividend paid by an Indian company outside India is deemed to be accrue or arise in India and would be taxable in India in the hands of non-resident shareholders.

(5) Interest [Section 9(1)(v)]

Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by -

(i) the Government;

(ii) a person resident in India;

Exception: Where it is payable in respect of any debt incurred or money borrowed and used, for the purposes of a business or profession carried on by him outside India or for the purposes of making or earning any income from any source outside India, it will not be deemed to accrue or arise in India.

(iii) a non-resident, when it is payable in respect of any debt incurred or moneys borrowed and used, for the purpose of a business or profession carried on in India by him.

Exception: Interest on money borrowed by the non-resident for any purpose other than a business or profession, will not be deemed to accrue or arise in India.

Example: *If a non-resident 'A' borrows money from a non-resident 'B' and invests the same in shares of an Indian company, interest payable by 'A' to 'B' will not be deemed to accrue or arise in India.*

Meaning of interest: Interest means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.

Taxability of interest payable by the Permanent Establishment of a non-resident engaged in banking business to the head office

In order to provide clarity and certainty, on the issue of taxability of interest payable by the PE of a non-resident engaged in banking business to the head office, an Explanation has been inserted in section 9(1)(v). Accordingly, in the case of a **non-resident, being a person engaged in the business of banking,** any interest payable by the **PE in India of such non-resident to the head office** or any PE or any other part of such non-resident outside India, shall be deemed to accrue or arise in India.

Such interest shall be chargeable to tax in addition to any income attributable to the PE in India.

Further, the PE in India shall be deemed to be a person separate and independent of the non-resident person of which it is a PE and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery would apply accordingly.

Also, the PE in India has to deduct tax at source on any interest payable to either the head office or any other branch or PE, etc. of the non-resident outside India. Non-deduction would result in disallowance of interest claimed as expenditure by the PE and may also attract levy of interest and penalty in accordance with relevant provisions of the Act.

Permanent establishment includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

(6) Royalty [Section 9(1)(vi)]

Royalty will be deemed to accrue or arise in India when it is payable by -

(i) the Government;

(ii) a person who is a resident in India

Exception: Where it is payable for the transfer of any right or the use of any property or information or for the utilization of services 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, or

(iii) a non-resident only when the royalty is payable in respect of any right, property or information used or services utilised for purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

Important points:

(A) Lumpsum royalty not deemed to accrue arise in India: Lumpsum royalty payments made by a resident for the transfer of all or any rights (including the granting of a license) in respect of **computer software** supplied by a non-resident manufacturer along with computer hardware under any scheme approved by the government under the policy on computer software export, software development and training, 1986 shall not be deemed to accrue or arise in India.

(B) Meaning of Computer software: "Computer software" means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customised electronic data.

(C) Meaning of Royalty: The term 'royalty' means consideration (including any lumpsum consideration but excluding any consideration which would be the income of the recipient chargeable under the head 'capital gains') for:

(i) the transfer of all or any rights (including the granting of license) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(v) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

(vi) the transfer of all or any rights (including the granting of license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting.

Note - Consideration for sale, distribution or exhibition of cinematographic films is covered within the scope of royalty.

(vii) the rendering of any service in connection with the activities listed above.

The definition of 'royalty' for this purpose is wide enough to cover both industrial royalties as well as copyright royalties. The definition specially excludes income which should be chargeable to tax under the head 'capital gains'.

(D) Consideration for use or right to use of computer software is royalty within the meaning of section 9(1)(vi)

The consideration for use or right to use of computer software is royalty by clarifying that, transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a license) irrespective of the medium through which such right is transferred *[Explanation 4].*

Consequently, the provisions of tax deduction at source under section 194J and section 195 would be attracted in respect of consideration for use or right to use computer software since the same falls within the definition of royalty as per the provisions of the Income-tax Act, 1961.

The Central Government has, vide *Notification No. 21/2012 dated 13.6.2012* to be effective from 1st July, 2012, exempted certain software payments from the applicability of tax deduction under section 194J. Accordingly, where payment is made by the transferee for acquisition of software from a resident-transferor, the provisions of section 194J would not be attracted if –

(1) the software is acquired in a subsequent transfer without any modification by the transferor;

(2) tax has been deducted either under section 194J or under section 195 on payment for any previous transfer of such software; and

(3) the transferee obtains a declaration from the transferor that tax has been so deducted along with the PAN of the transferor.

The issue of whether the amounts paid by resident Indian end-users/ distributors to non-resident computer software manufacturers/ suppliers, as consideration for the use/resale of the computer software through End-User Licence Agreement (EULAs) /distribution agreements, be considered as payment of royalty for the use of copyright in the computer software came up before the Supreme Court in Engineering Analysis Centre of Excellence P. Ltd v. CIT and Another (2021) ITR 471.

The Apex Court observed that as per the definition given in Explanation 2(v) to section 9(1)(vi) of the Income-tax Act, 1961, "royalty" means consideration for, inter alia, the transfer of all or any rights (including the granting of a licence), in respect of any copyright, literary, artistic or scientific work. As per Explanation 4 thereto, such transfer of all or any rights includes transfer of all or any right for use or right to use a computer software (including the granting of a licence). As per the meaning of royalties as assigned in the DTAA with Singapore, "royalty" means payment of any kind received as consideration for "the use of, or the right to use, any copyright" of a literary, artistic or scientific work. The meaning of royalty in India's DTAA with other countries like Australia, Canada, France, *Italy, USA, Netherlands, Sweden, Taiwan, Japan, China etc. is also similar if not identical. The definition of the royalties under the DTAA does not include transfer of right for use or right to use a computer software.*

The scope of definition of royalties under the Act is wider as compared to the definition of royalties under India's DTAA with these countries.

The Apex Court observed the following four categories of cases, in which the distribution agreements and end-user licence agreements did not create any interest or right to such distributors or end-users, which could amount to the use of or right to use any copyright:

(i) where computer software is purchased directly by an end-user, resident in India, from a foreign, non-resident supplier or manufacturer.

(ii) where resident Indian companies acting as distributors or resellers, purchase computer software from foreign, non-resident suppliers or manufacturers and then, resell the same to resident Indian end-users.

(iii) where the distributor happens to be a foreign, non-resident vendor, who, after purchasing software from a foreign, non-resident seller, resells the same to resident Indian distributors or end-users.

(iv) where computer software is affixed onto hardware and is sold as an integrated unit/equipment by foreign, non-resident suppliers to resident Indian distributors or end-users.

Therefore, in the specified cases mentioned above, the Apex Court held that the amount paid by resident Indian end-users or distributors to non-resident computer software manufacturers or suppliers, as consideration for the resale or use of the computer software through end-user licence agreements or distribution agreements, is not royalty. Consequently, the consideration paid to the non-resident computer software manufacturers or suppliers would not be chargeable to tax India. Hence, no tax is required to be deducted at source u/s 195.

(E) Consideration in respect of any right, property or information – Is it royalty?

Royalty includes and has always included consideration in respect of any right, property or information, whether or not,

(a) the possession or control of such right, property or information is with the payer;

(b) such right, property or information is used directly by the payer;

(c) the location of such right, property or information is in India *[Explanation 5].*

(F) Meaning of Process

The term "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret *[Explanation 6].*

(7) Fees for technical services [Section 9(1)(vii)]

Any fees for technical services will be deemed to accrue or arise in India if they are payable by -

(i) the Government.

(ii) a person who is resident in India

Exception: Where the fees is payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India.

(iii) a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India.

Fees for technical services mean any consideration (including any lumpsum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

Income deemed to accrue or arise in India to a non-resident by way of interest, royalty and fee for technical services to be taxed irrespective of territorial nexus [*Explanation* to section 9]

Income by way of interest, royalty or fee for technical services which is deemed to accrue or arise in India by virtue of clauses (v), (vi) and (vii) of section 9(1), shall be included in the total income of the non-resident, whether or not –

(i) the non-resident has a residence or place of business or business connection in India; or

(ii) the non-resident has rendered services in India.

In effect, the income by way of fee for technical services, interest or royalty, from services utilized in India would be deemed to accrue or arise in India in case of a non-resident and be included in his total income, whether or not such services were rendered in India.

ILLUSTRATION 5

Miss Vivitha paid a sum of 5000 USD to Mr. Kulasekhara, a management consultant practising in Colombo, specializing in project financing. The payment was made in Colombo. Mr. Kulasekhara is a non-resident. The consultancy is related to a project in India with possible Ceylonese collaboration. Is this payment chargeable to tax in India in the hands of Mr. Kulasekhara?

SOLUTION

A non-resident is chargeable to tax in respect of income received outside India only if such income accrues or arises or is deemed to accrue or arise to him in India.

The income deemed to accrue or arise in India under section 9 comprises, *inter alia*, income by way of fees for technical services, which includes any consideration for rendering of any managerial, technical or consultancy services. Therefore, payment to a management consultant relating to project financing is covered within the scope of "fees for technical services".

The *Explanation* below section 9(2) clarifies that income by way of, *inter alia*, fees for technical services, from services utilized in India would be deemed to accrue or arise in India in case of a non-resident and be included in his total income, whether or not such services were rendered in India or whether or not the non-resident has a residence or place of business or business connection in India.

In the instant case, since the services were utilized in India, the payment received by Mr. Kulasekhara, a non-resident, in Colombo is chargeable to tax in his hands in India, as it is deemed to accrue or arise in India.

(8) Any sum of money paid by a resident Indian to a non-corporate non-resident or foreign company or to a resident but not ordinarily resident in India [Section 9(1)(viii)]

Income arising outside India, being any sum of money paid without consideration, by a Indian resident person to a non-corporate non-resident or foreign company ***or to a RNOR*** would be deemed to accrue or arise in India if the same is chargeable to tax under section 56(2)(x) i.e., if the aggregate of such sum received by a non-corporate non-resident or foreign company exceeds ₹ 50,000.

It may be noted that this deeming provision applies to only sum of money paid outside India to a non-corporate non-resident or foreign company ***or to a RNOR***, and not in respect of property, movable or immovable, transferred outside India without consideration or for inadequate consideration to a non-corporate non-resident or foreign company ***or to a RNOR***.

ILLUSTRATION 6

Compute the total income in the hands of an individual, aged 55 years, being a resident and ordinarily resident, resident but not ordinarily resident, and non-resident for the A.Y. 2024-25 if he has shifted out of the default tax regime and pays tax under normal provisions of the Act:

Particulars	*Amount (₹)*
Interest on UK Development Bonds, 50% of interest received in India	*10,000*
Income from a business in Chennai (50% is received in India)	*20,000*
Short term capital gains on sale of shares of an Indian company received in London	*20,000*
Dividend from British company received in London	*5,000*
Long term capital gains on sale of plant at Germany, 50% of profits are received in India	*40,000*
Income earned from business in Germany which is controlled from Delhi (₹ 40,000 is received in India)	*70,000*
Profits from a business in Delhi but managed entirely from London	*15,000*
Income from house property in London deposited in an Indian Bank at London, brought to India (Computed)	*50,000*
Interest on debentures in an Indian company received in London	*12,000*
Fees for technical services rendered in India but received in London	*8,000*
Profits from a business in Bombay managed from London	*26,000*
Pension for services rendered in India but received in London (Computed)	*4,000*
Income from property situated in Pakistan, received there (Computed)	*16,000*
Past foreign untaxed income brought to India during the previous year	*5,000*
Income from agricultural land in Nepal received there and then brought to India	*18,000*
Income from profession in Kenya which was set up in India, received there but spent in India	*5,000*
Gift received on the occasion of his wedding	*20,000*
Interest on savings bank deposit in State Bank of India	*12,000*

Income from a business in Russia, controlled from Russia	*20,000*
Dividend from Reliance Petroleum Limited, an Indian Company	*5,000*
Agricultural income from a land in Rajasthan	*15,000*

SOLUTION

Computation of total income for the A.Y. 2024-25

Particulars	Resident and ordinarily resident ₹	Resident but not ordinarily resident ₹	Non-resident ₹
Interest on UK Development Bonds, 50% of interest received in India	10,000	5,000	5,000
Income from a business in Chennai (50% is received in India)	20,000	20,000	20,000
Short term capital gains on sale of shares of an Indian company received in London	20,000	20,000	20,000
Dividend from British company received in London	5,000	-	-
Long term capital gain on sale of plant at Germany, 50% of profits are received in India	40,000	20,000	20,000
Income earned from business in Germany which is controlled from Delhi, out of which ₹ 40,000 is received in India	70,000	70,000	40,000
Profits from a business in Delhi but managed entirely from London	15,000	15,000	15,000
Income from property in London deposited in a Bank at London, later on remitted to India	50,000	-	-
Interest on debentures in an Indian company received in London	12,000	12,000	12,000
Fees for technical services rendered in India but received in London	8,000	8,000	8,000
Profits from a business in Bombay managed from London	26,000	26,000	26,000
Pension for services rendered in India but received in London	4,000	4,000	4,000

Income from property situated in Pakistan, received there	16,000	-	-
Past foreign untaxed income brought to India during the previous year	-	-	-
Income from agricultural land in Nepal received there and then brought to India	18,000	-	-
Income from profession in Kenya which was set up in India, received there but spent in India	5,000	5,000	-
Gift received on the occasion of his wedding **[not taxable]**	-	-	-
Interest on savings bank deposit in SBI	12,000	12,000	12,000
Income from a business in Russia, controlled from Russia	20,000	-	-
Dividend from Reliance Petroleum Limited, an Indian Company	5,000	5,000	5,000
Agricultural income from a land in Rajasthan **[Exempt under section 10(1)]**	-	-	-
Gross Total Income	**3,56,000**	**2,22,000**	**1,87,000**
Less: Deduction u/s 80TTA			
[Interest on savings bank account subject to a maximum of ₹ 10,000]	10,000	10,000	10,000
Total Income	**3,46,000**	**2,12,000**	**1,77,000**

(3) Presence of Eligible Fund Manager in India not to constitute Business Connection in India of such Eligible Investment Fund on behalf of which he undertakes Fund Management Activity [Section 9A]

(i) **Fund Management Activity through an eligible fund manager not to constitute business connection [Section 9A(1)]:** In the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund, subject to fulfillment of certain conditions.

(ii) **Location of Fund Manager in India not to affect residential status of an eligible investment fund [Section 9A(2)]:** An eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf, is located in India.

(iii) **Conditions to be fulfilled by an Eligible Investment Fund [Section 9A(3)]:** The eligible investment fund means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit. Further, it should fulfill the following conditions:

(a) the fund should not be a person resident in India;

(b) the fund should be a resident of a country or a specified territory with which an agreement referred to in section 90(1) or section 90A(1) has been entered into or should be established or incorporated or registered, outside India in a country or a specified territory notified by the Central Government in this behalf;

(c) the aggregate participation or investment in the fund, directly or indirectly, by 0persons being resident in India should not exceed 5% of the corpus of the fund;

However, for the purposes of calculation of aggregate participation or investment in the fund, any contribution made by the eligible fund manager during the first 3 years of operation of the fund, not exceeding ₹ 25 crore, would not be taken into account.

(d) the fund and its activities should be subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;

(e) the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;

(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50%;

(h) the investment by the fund in any entity shall not exceed 20% of the corpus of the fund;

(i) no investment shall be made by the fund in its associate entity;

(j) the monthly average of the corpus of the fund shall not be less than ₹ 100 crore. If the fund has been established or incorporated in the previous year, the corpus of fund should not be less than ₹ 100 crore at the end of a period of twelve months from the last day of the month of its establishment or incorporation;

However, this condition shall not be applicable to a fund which has been wound up in the previous year.

(k) the fund shall not carry on or control and manage, directly or indirectly, any business in India;

(l) the fund should neither be engaged in any activity which constitutes a business connection in India nor should have any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf.

(m) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken on its behalf should not be less than the amount calculated in the prescribed manner.

(iv) **Certain conditions not to apply to investment fund set up by the Government or the Central Bank of a foreign State or a Sovereign Fund or other notified fund [Proviso to Section 9A(3)]:** The following conditions would, however, not be applicable in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund or such other fund notified by the Central Government [i.e., an investment fund set up by a Category-I or Category-II Foreign Portfolio Investor registered under the SEBI (Foreign Portfolio Investors) Regulations, 2014, made under the SEBI Act, 1992 and an investment fund set up by a Category-I foreign portfolio investor registered under the SEBI (Foreign Portfolio Investors) Regulations, 2019, made under the SEBI Act, 1992]:

(e) the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;

(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50%.

(v) **Eligible Fund Manager [Section 9A(4)]:** The eligible fund manager, in respect of an eligible investment fund, means any person who is engaged in the activity of fund management and fulfills the following conditions:

(a) the person should not be an employee of the eligible investment fund or a connected person of the fund;

(b) the person should be registered as a fund manager or investment advisor in accordance with the specified regulations;

> The CBDT has, vide **Circular No.8/2019 dated 10.5.2019**, clarified that a fund manager includes an Asset Management Company (AMC) approved by SEBI under the SEBI (Mutual Funds) Regulations, 1996. This is because AMCs are engaged in the activity of fund management of Mutual Funds and hence are, in substance, Fund Managers.

(c) the person should be acting in the ordinary course of his business as a fund manager;

(d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than 20% of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through such fund manager.

(vi) **Furnishing of Statement in prescribed form [Section 9A(5)]:** Every eligible investment fund shall, in respect of its activities in a financial year, furnish within 90 days from the end of the financial year, a statement in the prescribed form to the prescribed income-tax authority. The statement should contain information relating to –

(a) the fulfillment of the above conditions; and

(b) such other relevant information or document which may be prescribed.

If any eligible investment fund fails to furnish such statement or information or document within 90 days from the end of the financial year, the income-tax authority prescribed under the said sub-section may direct that such fund shall pay, by way of penalty, a sum of ₹ 5,00,000 [Section 271FAB].

(vii) **Non-applicability of special taxation regime under section 9A [Section 9A(6)/(7)]:** This special taxation regime would not have any impact on taxability of any income of the eligible investment fund which would have been chargeable to tax irrespective of whether the activity of the eligible fund manager constituted business connection in India of such fund or not.

Further, the said regime shall not have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

(viii) CBDT to prescribe guidelines for the manner of application of the provisions of this section.

(ix) Certain conditions not to apply or apply with modification to investment fund and its fund manager, if such fund manager is located in an IFSC and has commenced its operation on or before 31.3.2024 [Section 9A(8A)]: The Central Government may, by notification, specify that any one or more of the conditions specified in point (iii) and (v) above would not be applicable or applicable with such modifications, as may be specified in such notification in case of an eligible investment fund and its eligible fund manager, if such fund manager is located in an IFSC as defined in section 80LA and has commenced its operation on or before 31.3.2024:

Accordingly, the Central Government has, vide Notification No. 59/2022 dated 6.6.2022, specified that in case of –

I. An eligible investment fund -

(i) the following conditions mentioned under section 9A(3) would not be applicable

(e) the fund should have a minimum of 25 members who are, directly or indirectly, not connected persons;

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding 10%;

(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50%.

(ii) the condition mentioned above in clause (k) of section 9A(3) would apply after the following modification -

"the fund shall not carry on, or participate in, the day to day operations of any person in India and for this purpose the monitoring mechanism to protect the investment in such person including the right to appoint directors or executive director shall not be considered as participation in day to day operations of such person in India"

II. **Eligible fund manager –**

The condition specified in section 9A(4)(b) would apply after the following modification:

"the person is registered as a portfolio manager or an investment advisor in accordance with the IFSC Authority (Capital Market Intermediaries) Regulation 2021 as notified under the IFSC Authority Act, 2019 or such other regulations made under the IFSC Authority Act, 2019".

(x) **Meaning of certain terms:**

Term	Meaning
Associate	An entity in which a director or a trustee or a partner or a member or a fund manager of the investment fund or a director or a trustee or a partner or a member of the fund manager of such fund, holds, either individually or collectively, share or interest, being more than 15% of its share capital or interest, as the case may be.
Corpus	The total amount of funds raised for the purpose of investment by the eligible investment fund as on a particular date.
Connected person	Any person who is connected directly or indirectly to another person and includes,— (a) any relative of the person, if such person is an individual; (b) any director of the company or any relative of such director, if the person is a company; (c) any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member, if the person is a firm or association of persons or body of individuals; (d) any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family; (e) any individual who has a substantial interest in the business of the person or any relative of such individual; (f) a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member;

	(g) a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member has a substantial interest in the business of the person, or family or any relative of such director, partner or member; (h) any other person who carries on a business, if - (i) the person being an individual, or any relative of such person, has a substantial interest in the business of that other person; or (ii) the person being a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person;

21.3 EXEMPTED INCOME OF NON RESIDENTS

Section 10 of the Income-tax Act, 1961 exempts from tax various incomes including the following in the hands of a non-resident:

(1) Interest on moneys standing to the credit of individual in his NRE A/c [Section 10(4)(ii)]

As per section 10(4)(ii), in the case of an individual, any income by way of interest on moneys standing to his credit in a **Non-resident (External) Account (NRE A/c)** in any bank in India in accordance with the Foreign Exchange Management Act, 1999 (FEMA, 1999), and the rules made thereunder, would be exempt, provided such individual;

- is a person resident outside India, as defined in FEMA, 1999, or
- is a person who has been permitted by the Reserve Bank of India to maintain such account.

The benefit of exemption under section 10(4)(ii) will be available to joint account holders, subject to fulfilment of other conditions contained in that section by each of the individual joint account holders.

Example: Mrs. Neena Kansal, is resident of Singapore since year 2000. She holds an NRE account with Bank of Baroda, New Delhi Branch. Interest of ₹ 10,000 was credited to such account during financial year 2023-24. Such interest income earned by her shall be exempt from income-tax while she files her tax return for A.Y 2024-25.

(2) Interest income of a non-corporate non-resident or foreign company on specified off-shore Rupee Denominated Bonds issued by an Indian company or business trust [Section 10(4C)]

Interest payable by an Indian company or business trust to a non-corporate non-resident or a foreign company in respect of money borrowed from a source outside India by way of issue of rupee denominated bond during the period from 17.9.2018 to 31.3.2019 would be exempt.

(3) Income of a specified fund on transfer of certain asset [Section 10(4D)]

Following income accrued or arising to or received by specified fund would be exempt -

- any income from transfer of a capital asset, being a bond of an Indian Company or a public sector company (sold by the Government and purchased by the specified fund in foreign currency), GDR or rupee denominated bond of an Indian company or derivative or any other notified security, on a recognized stock exchange located in any IFSC and where the consideration is paid or payable in convertible foreign exchange or
- any income from transfer of securities (other than shares in a company resident in India) or
- any income from securities issued by a non-resident (not being a permanent establishment of a non-resident in India) and where such income otherwise does not accrue or arise in India or
- any income from a securitisation trust which is chargeable under the head "Profits and gains of business or profession",

to the extent such income accrued or arisen to, or is received is attributable to units held by non-resident (not being the permanent establishment of a non-resident in India) or is attributable to the investment division of offshore banking unit, as the case may be, computed in the prescribed manner.

Condition for exemption - The income attributable to units held by non-resident (not being the permanent establishment of a non-resident in India) in a specified fund would not be exempt under section 10(4D) unless the specified fund furnish the annual statement of exempt income on or before the due date u/s 139(1).

The income of a specified fund attributable to an eligible investment division would not be exempt under section 10(4D) unless it furnishes the annual statement of exempt income and the report of audit on or before the said due date. *[Notification no. 64/2022 dated 16.6.2022]*

Meaning of certain terms:

S.No.	Term	Meaning
1	**Securities**	Securities includes (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate; (ii) derivative; (iii) units or any other instrument issued by any collective investment scheme to the investors in such schemes; (iv) security receipt; (v) units or any other such instrument issued to the investors under any mutual fund scheme; (vi) Government securities; (vii) such other instruments as may be declared by the Central Government to be securities; and (viii) rights or interest in securities It shall also include such other securities or instruments as may be notified by the Central Government.
2	**Investment division of offshore banking unit**	An investment division of a banking unit of a non-resident located in an IFSC, as referred to in section 80LA(1A) and which has commenced its operations on or before 31.3.2024
3	**Specified fund**	(i) A fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate, – (a) which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Fund) Regulation, 2012, made under the SEBI Act, 1992 or ***regulated under the IFSC Authority (Fund Management) Regulations, 2022 made under the*** IFSC Authority Act, 2019; (b) which is located in any IFSC; and (c) of which all the units are held by non-residents other than units held by a sponsor or manager

		However, this condition would not apply where any unit holder or holders, being non-resident during the previous year when such unit or units were issued, becomes resident under section 6(1) or (1A) in any previous year subsequent to that year, if the aggregate value and number of the units held by such resident unit holder or holders do not exceed 5% of the total units issued and fulfill such other conditions as may be prescribed. (ii) investment division of an offshore banking unit, which has been (a) granted a certificate of registration as a Category-I foreign portfolio investor under the SEBI(Foreign Portfolio Investors) Regulations, 2019 made under the SEBI Act, 1992 and which has commenced its operations on or before 31.3.2024; and (b) fulfils such conditions including maintenance of separate accounts for its investment division, as may be prescribed.
4	**Trust**	A trust established under the Indian Trust Act, 1882 or under any other law for the time being in force.
5	**Unit**	Unit means beneficial interest of an investor in the fund and shall include shares or partnership interests.
6	**Manager**	Any person or entity who is appointed by the Alternative Investment Fund to manage its investment by whatever name called. Manager may also be same as the sponsor of the Fund.
7	**Sponsor**	Any person or persons who set up the Alternative Investment Fund and includes promoter in case of a company and designated partner in case of LLP.

(4) Income of a non-resident as a result of transfer of non-deliverable forward contracts/ offshore derivative instruments/ over the counter derivatives entered into with an offshore banking unit of an IFSC [Section 10(4E)]

Any income accrued or arisen to, or received by a non-resident as a result of

- transfer of non-deliverable forward contracts or offshore derivative instruments or over-the-counter derivatives, ***or***
- ***distribution of income on offshore derivative instruments,***

entered into with an offshore banking unit of an IFSC as referred to in section 80LA(1A), which fulfils prescribed conditions would be exempt.

Accordingly, Rule 21AK specifies the following conditions to be fulfilled for claiming such exemption -

- *the non-deliverable forward contract or offshore derivative instruments or over-the-counter derivatives is entered into by the non-resident with an offshore banking unit of an IFSC which holds a valid certificate of registration granted under IFSC Authority (Banking) Regulations, 2020 by the IFSC Authority; and*
- *such contract or instrument or derivative is not entered into by the non-resident through or on behalf of its permanent establishment in India [The offshore banking unit (i.e., a banking branch unit located in an IFSC) has to ensure that this condition is complied with].*

Meaning of Certain terms:

Term	*Meaning*
Non-deliverable forward contract	*A contract for the difference between an exchange rate agreed before and the actual spot rate at maturity, with the spot rate being taken as the domestic rate or a market determined rate and such contract being settled with a single payment in a foreign currency.*
Offshore banking unit	*A banking branch Unit located in an IFSC, as referred to in section 80LA(1A).*
Offshore derivative instrument	*Any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it in India, as its underlying [Regulation 2(1)(o) of the SEBI Foreign Portfolio Investor Regulations, 2019];*
Over-the-counter derivatives	*A derivative contract that is not traded on an exchange but instead is privately negotiated between a purchaser and a seller.*

(5) Income of a non-resident by way of royalty or interest, on account of lease of an aircraft or a ship in a previous year, paid by a unit of an IFSC [Section 10(4F)]

Income of a non-resident by way of royalty or interest, on account of lease of an aircraft or a ship in a previous year, paid by a unit of an IFSC referred to in section 80LA(1A), if the unit has commenced its operations on or before 31.3.2024 would be exempt.

"Aircraft", here, means an aircraft or a helicopter, or an engine of an aircraft or a helicopter, or any part thereof.

“Ship” means a ship or an ocean vessel, engine of a ship or ocean vessel, or any part thereof.

(6) Income received by a non-resident in an account maintained with an offshore banking unit in any IFSC [Section 10(4G)]

Any income received by a non-resident from

- ***portfolio of securities or financial products or funds, managed or administered by any portfolio manager on behalf of such non-resident, or***
- ***such activity carried out by such person as may be notified by the Central Government,***

in an account maintained with an Offshore Banking Unit in any IFSC, as referred to in section 80LA(1A) would be exempt, to the extent such income accrues or arises outside India and is not deemed to accrue or arise in India.

"Portfolio manager" shall have the same meaning as assigned to it in regulation 2(1)(z) of the IFSC Authority (Capital Market Intermediaries) Regulations, 2021, made under the IFSC Authority Act, 2019. Accordingly, "Portfolio manager" means a person who pursuant to a contract with a client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or financial products or funds of the client, as the case may be.

(7) Income received by a non-resident or a Unit of an IFSC [Section 10(4H)]

Any income of a non-resident or a Unit of IFSC, as referred to in section 80LA(1A) engaged primarily in the business of leasing of an aircraft, by way of capital gains on transfer of equity shares of domestic company, being a Unit of an IFSC, as referred to in section 80LA(1A), engaged primarily in the business of lease of an aircraft which has commenced operations on or before 31.3.2026 would be exempt.

The exemption from capital gains on transfer of equity shares of such domestic company is available for a period of ten assessment years -

(i) from A.Y. relevant to the P.Y. in which the domestic company has commenced its operations or

(ii) from A.Y. 2024-25, where the period of 10 A.Ys. under (i) above ends before 1.4.2034.

"Aircraft" means an aircraft or a helicopter, or an engine of an aircraft or a helicopter, or any part thereof.

(8) Remuneration received by individuals, who are not citizens of India [Section 10(6)]

(i) **Remuneration received by officials of Embassies etc. of Foreign States [Section 10(6)(ii)]**: The remuneration received by an individual, who is **not** a citizen of India, for services as an official by whatever name called of an embassy, high commission, legation, commission, consulate or trade representation of foreign state, or a member of staff of any of these official, for service in such capacity is exempt.

Conditions

(a) The remuneration received by our corresponding Government officials resident in such foreign countries should be exempt.

(b) The above-mentioned member of the staff of such officials should be the subjects of the respective countries and should not be engaged in any other business or profession or employment in India.

Examples:

- *Mr. A, a citizen of India but resident of USA since year 2012, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2023-24.* ***Being an Individual who is a citizen of India, though fulfilling other conditions of the section, such remuneration shall not be exempt in his hands for A.Y. 2024-25.***

- *Mr. Vikram Kohli, an Indian born person but currently a resident and Citizen of USA, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2023-24.* ***Being an Individual who is not a citizen of India and also fulfilling other conditions of the section, such remuneration shall be exempt in his hands for A.Y. 2024-25, subject to fulfilment of conditions.***

- *Mr. Frank D'Souza, an Irish Citizen but currently the resident of USA, was appointed as a senior official of the US embassy in India. He earned a remuneration of ₹ 10 lakhs during F.Y. 2023-24.* ***Being an Individual who is not a citizen of India, such remuneration shall be exempt in his hands for A.Y. 2024-25, subject to fulfilment of the conditions.***

(ii) **Remuneration received for services rendered in India by a Foreign National employed by foreign enterprise [Section 10(6)(vi)]**: The remuneration received by a foreign national as an employee of a foreign enterprises, for services rendered by him during his stay in India is exempt from tax.

Conditions

(a) The foreign enterprise is not engaged in any business or trade in India:

(b) The employee's stay in India does not exceed in the aggregate a period of 90 days in such previous year, and

(c) The remuneration is not liable to be deducted from the income of the employer chargeable under the Income-tax Act, 1961.

Examples:

- *Mr. A, citizen of India but resident of USA since year 2012, was appointed in India in October, 2022 as an employee of a US enterprise. Such US enterprise is not engaged in any business in India. A's job requires him to visit his US office every twenty five (25) days for reporting purposes.*
  During F.Y. 2023-24, Mr. A earned a remuneration of ₹ 10 lakhs for his India related assignment and his stay in India in aggregate was 85 days. Further, such US enterprise has not claimed any deduction of such remuneration under the Income-tax Act, 1961.

  Being an Individual who is a citizen of India, such remuneration shall not be exempt in his hands for A.Y. 2024-25 under this section i.e., section 10(6)(vi), though he may get exemption under any other provision of the Income-tax Act, 1961, subject to fulfilment of conditions stipulated thereunder.

- *In the above case, let's consider that Mr. A is a citizen of USA. All other facts remaining same, his* ***remuneration shall be exempt from tax in his hands for A.Y. 2024-25 under this section.***

- *Let's take another variation, Mr. A is a citizen of USA but the remuneration paid to him is borne by the permanent establishment of such US enterprise in India. ₹ 10 lakhs paid to A is cross charged by the US enterprise to its Indian permanent establishment (PE).*

  In this case, the remuneration shall not be exempt from taxation in the hands of Mr. A as the same is getting deducted from the income of the Indian PE of such foreign enterprise.

(iii) **Salary received by a non-citizen for services rendered in connection with employment on foreign ship [Section 10(6)(viii)]**: Any income chargeable under the head "Salaries" received by or due to, non-citizen of India who is also a non-resident as remuneration for services rendered in connection with his employment on a foreign ship is exempt provided his total stay in India does not exceed 90 days during the previous year.

(iv) **Remuneration received by Foreign Government employees during their stay in India for specified training [Section 10(6)(xi)]**: Any remuneration received by employee of the Government of a foreign state from their respective Government during his stay in India, is exempt from tax, if remuneration is received in connection with training in any establishment or office of or in any undertaking owned by,-

(a) the Government; or

(b) any company owned by the Central Government or any State Government or partly by the Central Government and partly by one or more State Government; or

(c) any company which is subsidiary of a company referred to in (b) above, or

(d) any statutory corporation; or

(e) any society registered under Societies Registration Act, 1860 or under any law and wholly financed by the Central Government or any State Government(s) or partly by the Central Government and partly by one or more State Governments.

It may be carefully noted that exemption is available under section 10(6) only to an individual who is not a citizen of India.

(9) Income accruing or arising to or received by a unit holder from a specified fund or on transfer of units in a specified fund [Section 10(23FBC)]

(i) **Nature of income exempted:** Any income accruing or arising to or received by a unit holder from a specified fund or on transfer of units in a specified fund would be exempt.

(ii) **Meaning of specified Fund:**

(a) A fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate, –

- which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, made under the SEBI Act, 1992 or ***regulated under the IFSC Authority (Fund Management) Regulations, 2022, made under the*** IFSC Authority Act, 2019;

- which is located in any IFSC and
- of which all the units are held by non-residents other than units held by a sponsor or manager

  However, this condition would not apply where any unit holder or holders, being non-resident during the previous year when such unit or units were issued, becomes resident under section 6(1) or (1A) in any previous year subsequent to that year, if the aggregate value and number of the units held by such resident unit holder or holders do not exceed 5% of the total units issued and fulfill such other conditions as may be prescribed

(b) Investment division of an offshore banking unit, which has been

- granted a certificate of registration as a Category-I foreign portfolio investor under the SEBI(Foreign Portfolio Investors) Regulations, 2019 made under the SEBI Act, 1992 and which has commenced its operations on or before 31.3.2024; and
- fulfils such conditions including maintenance of separate accounts for its investment division, as may be prescribed;

(iii) **Meaning of Unit:** It means beneficial interest of an investor in the fund and shall include shares or partnership interests.

(10) Certain incomes of wholly owned subsidiary of Abu Dhabi Investment Authority, Sovereign Wealth Fund and specified pension fund [Section 10(23FE)]

(i) **Nature of income exempted:** Any income of a specified person in the nature of

- dividend,
- interest
- ***any sum referred to in section 56(2)(xii) i.e. any specified sum received by a unit holder from a business trust during the previous year, with respect to a unit held by him at any time during the previous year or***
- long-term capital gains

arising from an investment made by it in India, whether in the form of debt or share capital or unit would be exempt, if such investment –

(a) is made on or after 1st April, 2020 but on or before 31st March, 2024; and

(b) is held for at least three years.

(ii) **Eligible investment:** Such investment should be in

(a) a business trust; or

(b) a company or enterprise or an entity carrying on the business of developing, or operating and maintaining, or developing, operating and maintaining any infrastructure facility as defined in Explanation to section 80-IA(4)(i) or such other business as notified by the Central Government in this behalf; or

(c) a Category-I or Category-II AIF regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, made under the SEBI Act, 1992, having not less than 50% investment in one or more of the company or enterprise or entity referred to in (b) or (d) or (e) or in an Infrastructure Investment Trust; or

(d) a domestic company, set up and registered on or after 1.4.2021, having minimum 75% investments in one or more of the companies or enterprises or entities referred to in (b); or

(e) a non-banking financial company registered as an Infrastructure Finance Company as referred to in notification number RBI/2009-10/316 issued by the RBI or in an Infrastructure Debt Fund, a non-banking finance company, as referred to in the Infrastructure Debt Fund - NBFC (Reserve Bank) Directions, 2011, issued by the RBI, having minimum 90% lending to one or more of the companies or enterprises or entities referred to in (b).

The Central Government may prescribe the method of calculation of "50%" referred to in (c) or "75%" referred to in (d) or "90%" referred to in (e).

(iii) **Power of CBDT to issue guidelines:** In case any difficulty arises regarding interpretation or implementation of the provisions of this clause, the CBDT may issue guidelines for the purpose of removing the difficulty with the approval of the Central Government.

Every guideline issued by the CBDT has to be laid before each House of Parliament, and shall be binding on the income-tax authorities and specified person.

(iv) **Taxability on failure to satisfy the conditions:** Where any income has not been included in the total income of the specified person due to the aforesaid provisions, and subsequently during any previous year the specified person fails to satisfy any of the conditions mentioned so that the said income would not have been eligible for such non-inclusion, such income shall be chargeable to income-tax as the income of the specified person of that previous year.

(v) **Proportionate exemption of income attributable to investment in Category-I or Category-II AIF, domestic companies or NBFC referred to in (c), (d) or (e) of (ii) above if they are not having 100% investment in specified companies or entities:**

(a) In case a Category-I or Category-II AIF referred to in (c) of (ii) above has investment of less than 100% in one or more of the companies or enterprises or entities referred to in (b) or (d) or (e) of (ii) above or in an Infrastructure Investment Trust referred to in (c) of (ii) above, income accrued or arisen or received or attributable to such investment, directly or indirectly, which is exempt under this section shall be calculated proportionately to that investment made in one or more of the companies or enterprises or entities referred to in (b) or (d) or (e) of (ii) above or in the Infrastructure Investment Trust referred to in (c) of (ii) above, in such manner as may be prescribed.

(b) In case a domestic company referred to in (d) of (ii) above has investment of less than 100% in one or more of the companies or enterprises or entities referred to in (b) of (ii) above, income accrued or arisen or received or attributable to such investment, directly or indirectly, which is exempt under this section shall be calculated proportionately to that investment made in one or more of the companies or enterprises or entities referred to in (b) of (ii) above, in such manner as may be prescribed.

(c) In case a non-banking finance company registered as an Infrastructure Finance Company or Infrastructure Debt Fund referred to in (e) of (ii) above has lending of less than 100% in one or more of the companies or enterprises or entities referred to in (b) of (ii) above, income accrued or arisen or received or attributable to such lending, directly or indirectly, which is exempt under this section shall be calculated proportionately to the lending made in one or more of the companies or enterprises or entities referred to in (b) of (ii) above, in such manner as may be prescribed.

(vi) **Non applicability of exemption under section:** In case a sovereign wealth fund or pension fund has loans or borrowings, directly or indirectly, for the purposes of making investment in India, such fund shall be deemed to be not eligible for exemption under this section.

In order to address the concern with regard to the term "indirect borrowings" which have not been defined in the section and the consequent eligibility or otherwise of the exemption to the specified fund, where the loan and borrowings have been taken by the specified fund or its holding or any other entity in the chain of holding or any associate thereof, the CBDT has, vide Circular No. 19/2021 dated 26.10.2021, issued the guidelines and clarified the following:

- if the loans and borrowings have been taken by the specified fund or any of its group concern, specifically for the purposes of making investment by the specified fund in India, such fund shall not be eligible for exemption under section 10(23FE); and

- if the loans and borrowings have been taken by the specified fund or any of its group concern, not specifically for the purposes of making investment in India, it shall not be presumed that the investment in India has been made out of such loans and borrowings and such specified fund shall be eligible for exemption under section 10(23FE), subject to the fulfilment of all other stipulated conditions, provided that the source of the investment in India is not from such loans and borrowings.

(vii) Meaning of certain terms:

S. No.	Term	Meaning
(i)	Investee	A business trust, or a company, or an enterprise, or an entity, or a Category I or Category II AIF, or an Infrastructure Investment Trust or a domestic company, or an Infrastructure Finance Company or an Infrastructure Debt Fund referred to in (e) of (ii) above, in which the sovereign wealth fund or the pension fund, as the case may be, has made the investment, directly or indirectly, under the provisions of this section.
(ii)	Loan and borrowing	(a) Any loan taken or borrowing by a sovereign wealth fund from, or any deposit or investment made in a sovereign wealth fund by, any person other than the Government of the country in which the sovereign wealth fund is set up; (b) Any loan taken or borrowing by a pension fund from or any deposit or investment made in a pension fund by, any person. However, it shall not include the deposit or investment which represents statutory obligations and defined contributions of one or more funds or plans established for providing retirement, social security, employment, disability, death benefits or any similar compensation to the participants or beneficiaries of such funds or plans, as the case may be.

(viii) ***Meaning of specified person:***

Specified Person

- **A wholly owned subsidiary of the Abu Dhabi Investment Authority**
  - It should be a resident of the United Arab Emirates
  - It makes investment, directly or indirectly, out of the fund owned by the Government of the Abu Dhabi
- **A sovereign wealth fund**
  - It should be wholly owned and controlled, directly or indirectly, by the Government of a foreign country
  - It should be set up and regulated under the law of such foreign country
  - The earnings of the fund are credited either to the account of the Government of that foreign country or to any other account designated by that Government so that no portion of the earnings inures any benefit to any private person
  - The asset of the said fund vests in the Government of such foreign country upon dissolution
  - It does not participate in the day to day operations of investee but the monitoring mechanism to protect the investment with the investee including the right to appoint directors or executive director shall not be considered as participation in the day to day operations of the investee
  - It is specified by the Central Government, by notification, for this purpose and fulfils conditions specified in such notification
- **A pension fund**
  - It should be created or established under the law of a foreign country including the laws made by any of its political constituents being a province, State or local body, by whatever name called
  - It should not be liable to tax in such foreign country or if liable to tax, exemption from taxation for all its income has been provided by such foreign country
  - It satisfies other prescribed conditions
  - It does not participate in the day to day operations of investee but the monitoring mechanism to protect the investment with the investee including the right to appoint directors or executive director shall not be considered as participation in day to day operations of the investee
  - It is specified by the Central Government, by notification, for this purpose and fulfills conditions specified in such notification

*** These two conditions would not apply to any payment made to creditors or depositors for loan taken or borrowing for the purpose other than for making investment in India**

Exempted Income of Non-Residents

Section	Income	Available to
10(4)(ii)	Interest on money standing to the credit in a Non-resident (External) account of an Individual in any bank in India as per the FEMA Act, 1999.	Individual resident outside India (under FEMA Act) or an individual who has been permitted to maintain said account by RBI
10(4C)	Interest payable by an Indian company or business trust in respect of moneys borrowed from a source outside India by way of issue of rupee denominated bond during the period from 17.9.2018 to 31.3.2019	A non-corporate non-resident or foreign company
10(4D)	Income accrued or arising to or received by specified fund - (i) on transfer of a capital asset, being a bond of an Indian Company or a public sector company (sold by the Government and purchased by the specified fund in foreign currency), GDR or rupee denominated bond of an Indian company or derivative or any other notified security, on a recognized stock exchange located in any IFSC and where the consideration for such transfer is paid or payable in convertible foreign exchange; or (ii) on transfer of securities (other than shares in a company resident in India); or (iii) from securities issued by a non-resident (not being a permanent establishment of a non-resident in India) and where such income otherwise does not accrue or arise in India; or (iv) from a securitisation trust which is chargeable under the head "Profits and gains of business or profession", to the extent such income accrued or arisen to, or is received, is attributable to units held by non-resident (not being the permanent establishment of a non-resident in India) or is attributable to the investment division of	A specified fund

	offshore banking unit, as the case may be, computed in the prescribed manner.	
10(4E)	***Any income accrued or arisen to, or received by a non-resident as a result of*** ***- transfer of non-deliverable forward contracts or offshore derivative instruments or over-the-counter derivatives, or*** ***- distribution of income on offshore derivative instruments,*** ***entered into with an offshore banking unit of an IFSC as referred to in section 80LA(1A), which fulfils prescribed conditions.***	***Non-resident***
10(4F)	Any income of a non-resident by way of royalty or interest, on account of lease of an aircraft or a ship in a previous year, paid by a unit of an IFSC referred to in section 80LA(1A), if the unit has commenced its operation on or before 31.3.2024. "Aircraft", here, means an aircraft or a helicopter, or an engine of an aircraft or a helicopter, or any part thereof. "Ship" means a ship or an ocean vessel, engine of a ship or ocean vessel, or any part thereof.	Non-resident
10(4G)	***Any income received by a non-resident from*** ***- portfolio of securities or financial products or funds, managed or administered by any portfolio manager on behalf of such non-resident, or*** ***- such activity carried out by such person as may be notified by the Central Government,*** ***in an account maintained with an Offshore Banking Unit in any IFSC, as referred to in section 80LA(1A), to the extent such income accrues or arises outside India and is not deemed to accrue or arise in India.***	***Non-resident***

10(4H)	***Any income by way of capital gains on transfer of equity shares of domestic company, being a Unit of an IFSC, as referred to in section 80LA(1A), engaged primarily in the business of lease of an aircraft which has commenced operations on or before 31.3.2026.*** ***The exemption from capital gains on transfer of equity shares of such domestic company is available for a period of ten assessment years -*** ***(i) from A.Y. relevant to the P.Y. in which the domestic company has commenced its operations or*** ***(ii) from A.Y. 2024-25, where the period of 10 A.Ys. under (i) above ends before 1.4.2034.***	***- Non-resident or*** ***- a Unit of IFSC, as referred to in section 80LA(1A) engaged primarily in the business of leasing of an aircraft***
10(6)(ii)	Remuneration received by Foreign Diplomats/Consulate and their staff (Subject to conditions)	Individual (not being a citizen of India)
10(6)(vi)	Remuneration received as an employee of a foreign enterprise for services rendered by him during his stay in India, if: a) Foreign enterprise is not engaged in any trade or business in India; b) His stay in India does not exceed in the aggregate a period of 90 days in such previous year; and c) Such remuneration is not liable to deducted from the income of employer chargeable under this Act	Individual Salaried Employee (not being a citizen of India) of a foreign enterprise
10(6)(viii)	Salary received by or due for services rendered in connection with his employment on a foreign ship if his total stay in India does not exceed 90 days in the previous year.	Individual Salaried Employee (Non-resident who is not a citizen of India) of a foreign ship
10(6)(xi)	Remuneration received as an employee of the Government of a foreign state during his stay in India in connection with his training in any Government Office/ Statutory Undertaking/ corporation/ registered society etc.	Individual Salaried Employee (not being a citizen of India) of Government of foreign state

10(6BB)	Tax paid by Indian company, engaged in the business of operation of aircraft, which has acquired an aircraft or an aircraft engine on lease, under an approved (by Central Government) agreement entered into between 1-4-1997 and 31-3-1999, or after 31-3-2007, on lease rental/income derived (other than payment for providing spares or services in connection with the operation of leased aircraft) by the Government of a Foreign State or foreign enterprise.	Government of foreign State or foreign enterprise (i.e., a person who is a non-resident)
10(6C)	Royalty income or fees for technical services under an agreement with the Central Government for providing services in or outside India in projects connected with security of India	Foreign company (notified by the Central Government)
10(6D)	Royalty income from or fees from technical services rendered in or outside India to, the National Technical Research Organisation (NTRO)	Non-corporate non-resident or foreign company
10(15)(iiia)	Interest on deposits made by a foreign bank with a scheduled bank with approval of RBI.	Bank incorporated outside India and authorised to perform Central Banking functions in that country.
10(15)(iv)(fa)	Interest payable by scheduled bank on deposits in foreign currency where acceptance of such deposits is duly approved by RBI. [Scheduled bank does not include co-operative bank]	a) Non-resident b) Individual or HUF being a resident but not ordinary resident
10(15)(viii)	Interest on deposit on or after 01.04.2005 in an Offshore Banking Unit	
10(15)(ix)	Interest payable by a unit located in an IFSC in respect of monies borrowed by it on or after 1.9.2019	Non-resident
10(15A)	Lease rental paid by Indian company, engaged in the business of operation of aircraft, to acquire an aircraft or an aircraft engine on lease (other than payment for providing spares or services in connection with the operation of leased aircraft) under an approved (by Central	Government of foreign State or foreign enterprise (i.e., a person who is a non-resident)

	Government) agreement not entered into between 1-4-1997 and 31-3-1999, or after 31-3-2007.	
10(23BBB)	Income of European Economic Community derived in India from interest, dividends or capital gains from investment out of its funds under notified scheme of Central Government.	European Economic Community
10(23BBC)	Income of SAARC Fund for Regional Projects set up by Colombo Declaration.	SAARC Fund for Regional Projects.
10(23FBC)	Any income accruing or arising to or received by a unit holder from a specified fund or on transfer of units in a specified fund	Unit holder of specified fund
10(23FE)	Dividend, interest, ***any sum referred to in section 56(2)(xii)*** or long-term capital gains arising to specified person from an investment made by it in India, whether in the form of debt or share capital or unit, if such investment (i) is made between 1.4.2020 and 31.3.2024; (ii) is held for at least 3 years (iii) is in a business trust, a company/ enterprise/entity in developing/ operating/maintaining an infrastructure facility or (iv) a SEBI Category I or II AIF having not less than 50% investment in one or more of the company or enterprise or entity referred to in (iii) or in (v) or in (vi) or in an Infrastructure Investment Trust or (v) a domestic company, set up and registered on or after 1.4.2021, having minimum 75% investments in one or more of the companies or enterprises or entities referred to in (iii) or (vi) a NBFC registered as an Infrastructure Finance Company or in	Specified person, being (i) a wholly owned subsidiary of the Abu Dhabi Investment Authority (ii) a sovereign wealth fund (iii) Pension fund satisfying the prescribed conditions.

	an Infrastructure Debt Fund, having minimum 90% lending to one or more of the companies or enterprises or entities referred to in (iii). Refer detailed discussion in pages 21.69 to 21.72	
10(23FF)	Income of the nature of capital gains on account of transfer of share of a company resident in India, by the resultant fund or a specified fund to the extent attributable to units held by non-resident (not being a PE of a non-resident in India) in such manner as may be prescribed, and such shares were transferred from the original fund, or from its wholly owned special purpose vehicle, to the resultant fund in relocation, and where capital gains on such shares were not chargeable to tax if that relocation had not taken place. Income would be exempt only when the specified fund furnishes an annual statement of exempt income in the prescribed form electronically under digital signature on or before the due date specified u/s 139(1). Where such form is not filed by the specified fund, the exempt income would be NIL. Further, such annual statement in prescribed form has to be certified by an accountant before the specified date [one month prior to the due date u/s 139(1)] and such accountant has to furnish by that date, the certificate in the prescribed form electronically under digital signature.	Non-resident or specified fund
10(34B)	***Any income by way of dividends from a company being a unit of any IFSC primarily engaged in the business of leasing of an aircraft.***	***Unit of any IFSC engaged in the business of leasing of an aircraft***
10(48)	Income received in India in Indian currency on account of sale of Crude oil or any other goods or rendering of services, as may be notified by the Central Government in this	Foreign company on account of sale of crude oil, any other goods or rendering of services. It should not be engaged in any other

	behalf, to any person in India. Foreign company and agreement should be notified by the Central Government in national interest.	activity in India.
10(48A)	Income accruing or arsing on account of storage of crude oil in a facility in India and sale of crude oil therefrom to any person resident in India. Foreign company and agreement should be notified by the Central Government in national interest.	Foreign company on account of storage of crude oil in a facility in India and sale of crude oil therefrom.
10(48B)	Income from sale of leftover stock of crude oil from facility in India after the expiry of agreement or arrangement referred to in section 10(48A) or on termination of the said agreement or arrangement, in accordance with the terms mentioned therein, as the case may be, subject to such conditions, as may be notified by the Central Government.	Foreign company from sale of leftover stock of crude oil from the facility in India.

21.4 PRESUMPTIVE TAXATION FOR NON RESIDENTS

Section 28 details the income chargeable to tax under the head "Profits and Gains of Business or Profession". Certain provisions have been incorporated in the Income-tax Act, 1961, whereby the "Profits and gains of business or profession" of certain non-resident assessee is computed on the basis of certain percentage of the amount accrued or arisen and received in India.

(1) Special provision for computing the profits and gains of shipping business in the case of non-residents [Section 44B]

Section 44B is a non-obstante clause. Accordingly, sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of ships.

Profits and gains of a non-resident engaged in the business of operation of ships would be@7.5% of the aggregate of the following amounts

Amounts paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods shipped at any port in India

+

Amounts received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock mail or goods shipped at any port outside India

The amounts referred above would include demurrage charges or handling charges or any other amount of similar nature.

The amounts paid or payable or the amounts received or deemed to be received will also include the amount paid or payable or received or deemed to be received by way of demurrage charges or handling charges or any other amount of similar nature [*CIT v. Japan Lines Ltd. 260 ITR 656(Mad)*]. Thus 7.5% of the gross amounts mentioned above would be liable to tax and no deduction would be allowed for any expenditure, (i.e. the provisions of section 28 to 43A are not to be taken into account) however carried forward losses would be allowed to be set off from such income.

Analysis of section 44B and section 172:

Section 44B	Section 172
Presumptive tax provisions for non-residents engaged in shipping business. It does not, however, contain any procedure for assessment and collection of tax.	Complete code for taxation of occasional shipping business of non-residents, including assessment and collection of tax.
Manner of computation of presumptive Income:	
Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the - - amount paid or payable (whether in or outside India) to the non-resident or to any other person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any Indian port and	Where a ship carries passengers, livestock, mail, or goods shipped at a port in India, a sum equal to **7.5%** of - the amount paid or payable on account of such carriage to the owner or the charterer or to any person on his behalf, whether that amount is paid or payable in or out of India, **shall be deemed to be income**

- the amount received or deemed to be received in India on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India. **shall be deemed to be the profits and gains of such business** chargeable to tax under the head "Profits and gains of business or profession".	**accruing in India** to the owner or charterer on account of such carriage.

Other provisions of section 172

(i) **Furnish a return of the amount paid to the owner:** Section 172(3) imposes an obligation on the master of the ship to prepare and furnish to the Assessing Officer a return of the full amount paid or payable to the owner or charterer or any person on this behalf, on account of the carriage of all passengers, livestock, mail or goods shipped at any port in India since the last arrival of the ship thereat. Such return is, ordinarily, to be furnished by the master of the ship before the departure, from that port in India, of the ship.

A return may, however, be filed by the person authorized by the master of the ship within 30 days of the departure of the ship from the port, if:

(a) the Assessing Officer is satisfied that it is not possible for the master of the ship to furnish the return required by section 172(3) before the departure of the ship from the port; and

(b) the master of the ship has made satisfactory arrangement for the filing of the return and payment of tax by any other person on this behalf.

(ii) **Assessment [Section 172(4)]:** This section provides for a summary procedure of assessment. On receipt of the return filed by the master of the ship or by any person on this behalf, the Assessing Officer has to determine the tax payable on the taxable income. By virtue of the provisions of section 172(2), the taxable income is a sum equal to 7.5% of the amount paid or payable on account of carriage of passengers etc. to the owner or charterer or to any person on his behalf, whether that amount is paid or payable in or out of India. The tax payable on such taxable income is to be calculated at the **rate or rates in force applicable to the total income of a foreign company**. The master of the ship is liable for payment of such tax.

(iii) **Time limit for passing the assessment order [Section 172(4A)/(5)]:** It is incumbent on the Assessing Officer to pass the order of assessment within 9 months from the end of the financial year in which the return of income under section 172(3) is filed.

For the purpose of determining the tax payable, Assessing Officer is empowered to call for such accounts and documents as he may require.

(iv) **Grant of port of clearance to the ship [Section 172(6)]:** A port clearance shall not be granted to the ship until the Collector of customs or other authorized officer, is satisfied that the tax assessable under section 172 has been duly paid or that satisfactory arrangements have been made for the payment thereof.

(v) **Option to pay tax as per normal provisions of the Income-tax Act, 1961 on the income chargeable to tax under section 172 [Section 172(7)]:** The owner or charterer has the option to claim before the expiry of the assessment year relevant to the previous year in which the date of departure of the ship from the Indian port falls, that an assessment in respect of his total income for the previous year and the tax payable on the basis thereof be determined in accordance with the other provisions of this Act. In such a case, any payment made under section 172 is to be treated as a payment in advance of the tax leviable for that assessment year and the difference between the sum so paid and the amount of tax found payable by him on such assessment is to be paid by him or refunded to him, as the case may be.

The sum chargeable to tax under this section shall include amounts payable by way of **demurrage charge or handling charge** or any other amount of similar nature [Section 172(8)].

Section 172 *vis-à-vis* section 44B

In case the assessee is covered under section 172, 7.5% of the amount paid or payable on account of the carriage of the passengers, livestock, mail or goods to the owner or the chartered or to any person on his behalf is deemed as his income and tax is levied on such income at a rate applicable to a foreign company i.e., 40% *plus* surcharge, if any, and *plus* health and education cess @4%.

Under the provisions of section 172(7), the non-resident owner or charterer is allowed an option to be assessed on his total income of the previous year in accordance with other provisions of the Act i.e., as per section 44B.

When such option is exercised, a regular assessment is made. In such a case, the tax already paid under the provisions of section 172(4) by the non-resident owner or charterer would be treated as tax paid in advance for that assessment year before determining the amount of tax finally due**.** The difference between the sum so paid and the amount of tax payable by him on such assessment shall be paid by the assessee or refunded to him (See Note below).

In that case, the non-resident assessee is liable to pay interest under sections 234B and 234C and also entitled to receive interest under section 244A of the Income-tax Act, 1961 as the case may be. **[Circular No. 9/2001, dated 9-7-2001]**

Note *–Refund may arise in case of non-corporate non-residents, since they are liable to pay tax at a rate lower than the rate of 40% (plus surcharge, if any, and cess@4%) applicable to a foreign company.*

The Supreme Court, in *A.S. Glittre v CIT (1997) 225 ITR 739 (SC)*, held that the assessment made under section 172(4) shall be an 'adhoc' assessment and it will be superseded if a regular assessment is opted as per the provisions of the Act.

ILLUSTRATION 7

Sea Port Shipping Line, a non-resident foreign company, is engaged in the business of carriage of goods shipped at Mumbai port. During the previous year ended on 31.3.2024, it had collected freight of ₹ 100 lakhs, demurrages of ₹ 20 lakhs and handling charges of ₹ 10 lakhs. The expenses of operating its fleet during the year for the Indian Ports were ₹ 110 lakhs. Compute its income applying the presumptive provisions under section 44B.

SOLUTION

Section 44B provides that in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the following amounts would be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(i) The amount paid or payable, whether within India or outside, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India; and

(ii) The amount received or deemed to be received in India by the assessee himself or by any other person on behalf of or on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The above amounts will include demurrage charges and handling charges.

These provisions for computation of income from the shipping business in case of non-residents would apply notwithstanding anything to the contrary contained in the provisions of sections 28 to 43A of the Income-tax Act, 1961.

Therefore, in this case, M/s. Sea Port Shipping Line is required to pay tax in India on the basis of presumptive scheme as per the provisions of section 44B. The assessee shall not be entitled to set off any of the expenses incurred for earning of such income. Therefore, the Shipping Line is required to pay tax on deemed profit of ₹ 9.75 lacs (7.50% on the total receipts of ₹ 130 lacs). The tax payable would be reduced by the amount of tax paid under section 172(4).

(2) Special provision for computing profits and gains in connection with the business of exploration etc. of mineral oils [Section 44BB]

Section 44BB is a non-obstante clause. Accordingly, sections 28 to 41 and section 43 and 43A are not applicable in the case of a non-resident engaged in the business of providing services of facilities in connection with, or supplying plant and machinery on hire used, or to be used in the prospecting for, or extraction or production of, mineral oils.

(i) **Eligible assessee:** Section 44BB provides for determination of income of taxpayer being a non-resident engaged in the business of providing services and facilities in connection with, or supplying plant and machinery on hire used or to be used in the prospecting for, or extraction or production of mineral oils.

(ii) **Presumptive rate:** In such case, the profits and gains shall be deemed to be equal to **10%** of the following amounts:

- paid or payable to the taxpayer or to any person on his behalf whether in or out of India, on account of the provision of such services or facilities or supply of plant & machinery for the aforesaid purposes in India; and
- received or deemed to be received in India by or on behalf of the assesse on account of such service or facilities or supply of plant and machinery used or to be used in prospecting for, or extraction or production of mineral oils outside India.

(iii) **Non-applicability of presumptive taxation under section 44BB:** The provisions of section 44BB shall not apply to any income to which the provisions of section 42 or section 44DA, 115A or 293A apply for the purpose of computing profit or gains or any other income referred to in these sections.

Section	Provision
42	Special provision for deductions in the case of business for prospecting, etc., for mineral oil
44DA	Special provisions for computing income by way of royalties, etc., in case of non-residents.
115A	Tax on royalty and fees for technical services in the case of foreign companies

293A	Power to make exemption, etc., in relation to participation in the business of prospecting for, extraction, etc., of mineral oils.

(iv) **Option to claim lower profits:** An assessee may claim lower income than the presumptive rate of 10%, if he keeps and maintains books of account under section 44AA(2) and get them audited and furnish a report of such audit under section 44AB. The assessment in all such cases shall be done by the Assessing Officer under section 143(3).

(v) ***No set-off of unabsorbed depreciation and brought forward loss:*** *Where an assessee declares profits and gains of business @10% for any previous year in accordance with the presumptive provisions under this section, no set off of unabsorbed depreciation and brought forward loss would be allowed to the assessee for such previous year.*

(vi) **Meaning of certain terms:** For the purposes of this section,-

(a) "Plant" includes ships, aircraft, vehicles, drilling units, scientific apparatus and equipment, used for the purposes of the said business;

(b) "Mineral oil" includes petroleum and natural gas.

Note - *If the income of a non-resident is in the nature of fees for technical services, it shall be taxable under the provisions of either section 44DA or section 115A irrespective of the business to which it relates. Section 44BB would apply only in a case where consideration is for services and other facilities relating to exploration activity which are not in the nature of technical services..*

(3) Special provision for computing profits and gains of the business of operation of aircraft in the case of non-residents [Section 44BBA]

Section 44BBA is a non-obstante clause. Accordingly, sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of aircraft.

(i) **Eligible assessee:** Section 44BBA provides presumptive rate in case of a non-resident engaged in the business of operation of aircraft.

(ii) **Presumptive rate:** Income from such business is calculated at a flat rate of **5%** of the following:

(a) amount paid or payable, in or out of India, to the tax payer or to any person on his behalf on account or carriage of passenger, livestock, mail or goods from any place in India and

(b) amount received or deemed to be received in India by or on behalf of the taxpayer on account of carriage of passenger, livestock, mail or goods from any place outside India.

ILLUSTRATION 8

Mr. Q, a non-resident, operates an aircraft between Singapore and Chennai. He received the following amounts while carrying on the business of operation of aircrafts for the year ended 31.3.2024:

(i) ₹ 2 crores in India on account of carriage of passengers from Chennai.

(ii) ₹ 1 crore in India on account of carriage of goods from Chennai.

(iii) ₹ 3 crores in India on account of carriage of passengers from Singapore.

(iv) ₹ 1 crore in Singapore on account of carriage of passengers from Chennai.

The total expenditure incurred by Mr. Q for the purposes of the business during the year ending 31.3.2024 was ₹ 6.75 crores.

Compute the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the assessment year 2024-25.

What would be your answer in case the business was carried on by a foreign company, Q Airlines (P) Ltd?

SOLUTION

Section 44BBA says for computing profits and gains of the business of operation of aircraft in the case of non-residents a sum equal to 5% of the aggregate of the following amounts -

(a) paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

Keeping in view the provisions of section 44BBA, the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" is worked out hereunder -

Particulars	₹
Amount received in India on account of carriage of passengers from Chennai	2,00,00,000

Amount received in India on account of carriage of goods from Chennai	1,00,00,000
Amount received in India on account of carriage of passengers from Singapore	3,00,00,000
Amount received in Singapore on account of carriage of passengers from Chennai	1,00,00,000
	7,00,00,000

Income from business under section 44BBA at 5% of ₹ 7,00,00,000 is ₹ 35,00,000, which is the income of Mr. Q chargeable to tax in India under the head "Profits and gains of business or profession" for the A.Y. 2024-25.

In case the assessee is a foreign company, say, Q Airlines (P) Ltd, the answer would be the same since section 44BBA does not distinguish corporate and non-corporate taxpayers who operate aircraft provided their residential status is that of non-resident.

(4) Special provision for computing profits and gains of foreign companies engaged in the business of civil construction etc. in certain turnkey power projects [Section 44BBB]

(i) Eligible assessee: A foreign company engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof in connection with a turnkey power project approved by the Central Government in this behalf.

(ii) Presumptive rate: A sum equal to 10% of the amount paid or payable (whether in or out of India) to the said assessee or to any person on his behalf on account of such civil construction, erection, testing or commissioning shall be deemed to be the profits and gains of such business chargeable to tax under the head 'profits and gains of business or profession'.

(iii) Option to claim lower profits: An assessee may claim lower income than the presumptive rate of 10%, if he keeps and maintains books of account under section 44AA(2) and get them audited and furnish a report of such audit under section 44AB. The assessment in all such cases shall be done by the Assessing Officer under section 143(3).

(iv) No set-off of unabsorbed depreciation and brought forward loss: *Where an assessee declares profits and gains of business @10% for any previous year in accordance with the presumptive provisions under this section, no set off of unabsorbed depreciation and brought forward loss would be allowed to the assessee for such previous year.*

SUMMARY OF PRESUMPTIVE PROVISIONS APPLICABLE TO NON RESIDENTS

Particulars	44B	44BBA	44BB	44BBB
Nature of business	Shipping business	Operation of aircraft	Business of providing services or facilities in connection with, or supplying P & M on hire used, or to be used, in the prospecting for, or extraction or production of, mineral oils	Business of civil construction or the business of erection of P&M or testing or commissioning thereof, in connection with turnkey power projects approved by the Central Government.
Eligible assessee	Non-resident	Non-resident	Non-resident	Only Foreign Co.
Presumptive income	7.5% of specified sum	5% of specified sum	10% of specified sum	10% of specified sum
Specified sum	(i) Amount paid or payable on account of carriage of passengers, livestock, mail or goods shipped at/ from any port/place in India; and (ii) Amount received or deemed to be received in India on account of the carriage of passengers, livestock mail or goods shipped at/ from any port/place outside India		(i) Amount paid or payable on account of the provision of such services or facilities for the aforesaid purposes in India; and (ii) Amount received or deemed to be received in India on account of the provisions of services or facilities for the aforesaid purpose outside India.	Amount paid or payable on a/c of such civil construction, erection, testing or commissioning
Option to declare lower profits	Not available		Lower profits may be claimed u/s 44BB and u/s 44BBB provided the assessee maintains books of account u/s 44AA and gets them audited u/s 44AB. No set off of unabsorbed depreciation and brought forward loss would be allowed to the assessee in the previous year in which he/it declares profits and gains @10% in accordance with the presumptive provisions of section 44BB/ 44BBB.	

(5) Deduction in respect of head office expenses in case of non-residents [Section 44C]

In case of a non-resident, head office expenditure is allowed in accordance with the provisions of section 44C. This section is a non-obstante provision and anything contrary contained in sections 28 to 43A is not applicable.

Deduction in respect of head office expenditure is restricted to the least of the following:

(a) an amount equal to 5% of **"adjusted total income"** or in the case of loss, 5% of the **"average adjusted total income"**; or

(b) the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India.

Meaning of certain terms:

Term	Meaning
Adjusted total income	Total income computed in accordance with the provisions of the Act without giving effect to the following :- ▪ Allowance under this section ▪ Unabsorbed depreciation allowance under section 32(2). ▪ Expenditure incurred by a company for the purpose of promoting family planning amongst its employees under first proviso to section 36(1)(ix). ▪ Business loss brought forward under section 72(1). ▪ Speculation loss brought forward under section 73(2). ▪ Loss under the head Capital Gain under section 74(1). ▪ Loss from certain specified source brought forward under Section 74A(3). ▪ Deduction under Chapter VI-A.
Average adjusted total income	(a) The total income of the assessee, assessable for each of the **three assessment years** immediately preceding the relevant assessment year, one third of the aggregate amount of the adjusted total income in respect of previous years relevant to the aforesaid three assessment years is average adjusted total income. (b) When the total income of the assessee is assessable only for **two of the aforesaid three assessment years**, one half of the aggregate amount of the adjusted total income in respect of the previous year's relevant to the aforesaid two assessment years is taken on average adjusted total income. (c) Where the total income of the assessee is assessable only for **one of the aforesaid three assessment years,** the amount of the adjusted total income in respect of the previous year relevant to that assessment year is average adjusted total income.
Head office expenditure	Executive and general administration expenditure incurred by the assessee outside India, including expenditure incurred in respect of: a. rent, rates, taxes, repairs or insurance of any premises outside India used

	for the purpose of the business or profession. b. salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profit in lieu of or in addition to salary, whether paid or allowed to any employee or other person employed in, or managing the affairs of, any office outside India; c. traveling by any employee or other person employed in, or managing the affairs, of any office outside India; and d. such other matters connected with executive and general administrative as may be prescribed.

Deduction of Head Office expenditure in case of Non-residents while computing Profit and gains from business or profession

Lower of

5% of adjusted Total Income	Amount of Head Office expenditure incurred by the Non-resident attributable to the business or profession in India
Meaning of Adjusted Total Income	**Meaning of Head Office expenditure**
Total Income, without giving effect to: (i) Head Office expenditure (ii) Unabsorbed depreciation (iii) Capital expenditure on family planning (iv) Losses carry forward: - Business loss u/s 72(1) - Speculative business Loss u/s 73(2) - LTCL/STCL u/s 74(1) - Loss from owning and maintaining race horses u/s 74A(3) (v) Deductions under Chapter VI-A from GTI	Executive and general administration expenditure incurred by the NR outside India, including: (a) Rent, rates, taxes, repairs or insurance of any premises outside India used for business or profession (b) Salary, wages, perquisites etc. to any employee or other person managing the affairs of any office outside India (c) Travelling expenditure by any employee or other person managing the affairs of any office outside India (d) Such other executive and general administration expenditure prescribed

ILLUSTRATION 9

The net result of the business carried on by a branch of foreign company in India for the year ended 31.03.2024 was a loss of ₹ 100 lakhs after charge of head office expenses of ₹ 200 lakhs allocated to the branch. Explain with reasons the income to be declared by the branch in its return for the assessment year 2024-25.

SOLUTION

Section 44C restricts the allowability of the head office expenses to the extent of lower of an amount equal to 5% of the adjusted total income or the amount actually incurred as is attributable to the business of the assessee in India.

For the purpose of computing the adjusted total income, the head office expenses of ₹ 200 Lakhs charged to the profit and loss account have to be added back.

The amount of income to be declared by the assessee for A.Y. 2024-25 will be as under:

Particulars	₹
Net loss for the year ended on 31.03.2024	(100 lakhs)
Add: Amount of head office expenses to be considered separately as per section 44C	200 lakhs
Adjusted total income	100 lakhs
Less: Head Office expenses allowable under section 44C is the lower of -	
(i) ₹ 5 lakhs, being 5% of ₹ 100 lakhs, or	
(ii) ₹ 200 lakhs.	5 lakhs
Income to be declared in return	**95 lakhs**

(6) Special provision for computing income by way of royalties etc. in case of non-residents [Section 44DA]

(i) Eligible assessee: Section 44DA provides the method of computation of income by way of royalty or fees for technical services arising from the agreement made by the non-resident with the Indian company or Government of India after 31.03.2003 where:

(a) such non-resident carries business/profession in India through permanent establishment or fixed place of profession; and

(b) the right, property, or contract in respect of which the royalty or fees for technical services are paid is effectively connected with such permanent establishment or fixed place of service.

(ii) **Expenses not allowed as deduction**: While computing the income chargeable to tax under this section, the following expenses are not allowed as deduction:

- expenditure or allowance incurred which is not wholly and exclusively for such permanent establishment or fixed place of service in India
- amount paid (otherwise than reimbursement of actual expenses) by the permanent establishment to head office or to any of its other offices.

(iii) **Non-applicability of section 44BB:** The provisions of section 44BB do not apply in respect of income covered by this section.

(iv) **Mandatory requirement to maintain books of account and get them audited:** Under this section, the non-resident is mandatorily required to keep and maintain the books of account under section 44AA and get them audited before the date one month prior to the due date for furnishing the return of income under section 139(1) and furnish by that date a report of such audit.

	Assessee	Due date of filing return of income u/s 139(1)	Specified date of tax audit u/s 44AB
(i)	In case of an assessee who is required to furnish report referred to in section 92E	30th November of the A.Y.	31st October of the A.Y.
(ii)	In case of other assessees computing income u/s 44DA	31st October of the A.Y.	30th September of the A.Y.

21.5 CAPITAL GAINS TAXATION FOR NON RESIDENTS

Any person including a foreign company or non-corporate non-resident is liable to capital gains tax in India, if there is a transfer of a property (capital asset) in India which results in profit or gain. The provisions relating non-residents in respect of capital gains taxation are discussed in detail in Chapter 4: Capital Gains in Module 1.

First Proviso to Section 48 read with Rule 115A:-

In case of non-residents who invest foreign exchange to acquire capital assets, exchange rate fluctuation benefit is allowed while computing the capital gains arising from the transfer of shares or debentures of an Indian company as per first proviso to section 48.

The same is to be computed in the following manner:

- The cost of acquisition, the expenditure incurred wholly and exclusively in connection with the transfer and the full value of the consideration are to be converted into the same foreign currency with which such shares or debentures were acquired.
- The resulting capital gains shall be reconverted into Indian currency.

The aforesaid manner of computation of capital gains shall be applied for every purchase and sale of shares or debentures in an Indian company.

Benefit of indexation will not be applied in this case.

Rule 115A of the Income-tax Rules, 1962 provides that the average of the telegraphic transfer buying rate and telegraphic transfer selling rate of the foreign currency initially utilized in purchase of the capital asset as on the date specified in column (3) in the table below, shall be considered to convert rupees into foreign currency for the purpose of computation of capital gains.

(1) S. No.	(2) Item	(3) Date
(a)	Cost of acquisition of capital asset	Date of acquisition of capital asset
(b)	Expenditure incurred wholly and exclusively in connection with transfer of capital asset	Date of transfer of capital asset
(c)	Full value of consideration received or accruing as a result of transfer of a capital asset	Date of transfer of capital asset

For reconverting capital gains computed in the foreign currency initially utilized in the purchase of the capital asset into rupees, the telegraphic transfer buying rate of such currency, as on the date of transfer of the capital asset, is to be considered.

Meaning of certain terms

Term	Meaning
Telegraphic transfer buying rate	The rate or rates of exchange adopted by the State Bank of India for buying foreign currency having regard to the guidelines specified from time to time by the RBI for buying foreign currency where such currency, made available to that bank through a telegraphic transfer.
Telegraphic transfer selling rate	The rate of exchange adopted by the State Bank of India for selling foreign currency where such currency is made available by that bank through telegraphic transfer.

However, the benefit of indexation and currency fluctuation would not be available in respect of capital gains arising from the transfer of the following long term capital assets referred to in section 112A –

(i) equity share in a company on which STT is paid both at the time of acquisition and transfer

(ii) unit of equity oriented fund or unit of business trust on which STT is paid at the time of transfer.

Other Important Points:

a. It is also provided that the aforesaid manner of computation of capital gains shall be applicable in respect of capital gains accruing or arising from every re-investment thereafter in and sale of shares in or debentures of an Indian company.

b. If the total income of an assessee includes any income chargeable under the head 'Capital Gains' arising from transfer of a capital asset being an equity share in a company or unit of an equity oriented fund or unit of a business trust, then, tax on short term capital gains shall be payable at the rates specified in section 111A if transaction of sale of such security has been entered on or after October 1, 2004 on which STT is chargeable; and tax on long-term capital gains shall be payable on such securities as per section 112A, if STT has been paid both at the time of acquisition and transfer of equity share or at the time of transfer of unit of equity oriented fund or unit of business trust.

c. Non-corporate non-residents and foreign companies to be subject to tax at a concessional rate of 10% (without indexation benefit or currency fluctuation) on long-term capital gains arising from transfer of unlisted securities or shares of a company in which public are not substantially interested [Section 112].

d. Section 50CA provides that where the consideration received or accruing as a result of transfer of a capital asset, being share of a company other than a quoted share, is less than the fair market value of such share determined in such manner as may be prescribed, such fair market value shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

   This provision would, however, not be applicable to any consideration received or accruing as a result of transfer by such class of persons and subject to such conditions as may be prescribed.

e. Section 50D provides that, in case where the consideration received or accruing as a result of the transfer of a capital asset by an assessee is not ascertainable or cannot be determined, then, for the purpose of computing income chargeable to tax as capital gains, the fair market value of the said asset on the date of transfer shall be deemed to be the full value of consideration received or accruing as a result of such transfer.

f. The shares and debentures (whether listed or non-listed) of Indian companies only are covered under this proviso. Indian company shall include Government company. However, bonds of Central Government/State Government and RBI are not covered for this purpose.

ILLUSTRATION 10

Mr. A, a non-resident Indian, remits US $ 40,000 to India on 16.09.2006. The amount is partly utilised on 3.10.2006 for purchasing 10,000 equity shares in A Ltd, an Indian Company, at the rate of ₹ 12 per share. These shares are sold for ₹ 48 per share on 30.03.2024. Fair market value of these shares on 31.01.2018 was ₹ 35 per share.

The telegraphic transfer buying and selling rate of US dollars adopted by the State Bank of India is as follows:-

Date	*Buying Rate (1 US$)*	*Selling Rate (1 US $)*
16.09.2006	*18*	*20*
3.10.2006	*19*	*21*
30.3.2024	*59*	*61*

Compute the capital gain chargeable to tax for the A.Y. 2024-25 on the assumption that –

(a) These shares have not been sold through a recognised stock exchange

(b) These shares have been purchased and sold through a recognised stock exchange.

SOLUTION

(a) Where the shares are not sold through recognised stock exchange

Particulars	US $
Sale consideration (₹ 4,80,000/60)	8000
Less: Cost of Acquisition (1,20,000/20)	6000
Long term capital gain	**2000**

Long-term capital gain converted into $ 2000 x ₹ 59 = ₹ 1,18,000

(b) Where the shares are purchased and sold through a recognised stock exchange

Particulars	₹
Sale consideration	4,80,000
Less: Cost of Acquisition	

Higher of the following		
Cost of acquisition	1,20,000	
Lower of Fair market value as on 31.1.2018 and Full value of consideration (i.e., lower of ₹ 3,50,000 and ₹ 4,80,000)	3,50,000	3,50,000
Long term capital gain		**1,30,000**

Long term capital gains upto ₹ 1,00,000 would be exempt. Long term capital gains exceeding ₹ 1,00,000, i.e., ₹ 30,000 is taxable @10% under section 112A.

Rupee Denominated Bonds of an Indian company

As a measure to enable Indian companies to raise funds from outside India, the RBI has permitted them to issue rupee denominated bonds outside India. Accordingly, in case of non-resident assesses, any gains arising on account of appreciation of rupee between the date of purchase and the date of redemption of rupee denominated bond of an Indian company held by him against foreign currency in which investment is made shall not be included in computation of full value of consideration. This would provide relief to the non-resident investor who bears the risk of currency fluctuation **[Fifth Proviso to Section 48].**

21.6 SPECIAL PROVISIONS PRESCRIBED UNDER CHAPTER XII-A

Chapter XII-A, introduced in the Income-tax Act 1961 with effect from June 01, 1983, contains seven sections viz. 115C, 115D, 115E ,115F,115G,115H and115-I. The provisions of this Chapter are applicable to a non-resident Indian who derives investment income from a foreign exchange asset and/ or long term capital gains in respect thereof.

(1) Definitions [Section 115C]

	Terms	Meaning
(a)	Convertible foreign exchange	Foreign exchange which is for the time being treated by the Reserve Bank of India as convertible foreign exchange for the purposes of the Foreign Exchange Management Act, 1999, and any rules made thereunder.
(b)	Foreign exchange asset	Any specified asset which the assessee has acquired or purchased with, or subscribed to in, convertible foreign exchange.
(c)	Investment income	Any income derived from a foreign exchange asset.
(d)	Long-term capital gains	Income chargeable under the head "Capital gains" relating to a capital asset, being a foreign exchange asset which is not a short-term capital asset.

(e)	Non-resident Indian	An individual, being a citizen of India or a person of Indian origin who is not a "resident. A person shall be deemed to be of Indian origin if he, or either of his parents or any of his grandparents, was born in undivided India
(f)	Specified asset	Any of the following assets, namely: (i) Shares in an Indian company; (ii) Debentures issued by an Indian company which is not a private company (iii) Deposits in an Indian Company which is not a private company (iv) Any security of the Central Government (v) Any other asset which the Central Government may notify

(2) Special provisions relating to taxation of investment income and long term capital gains of a non-resident [Sections 115D to 115F]

(i) **Taxation on gross basis [Section 115D(1)]:** Section 115D deals with the computation of total income of non-residents. In computing the investment income of non-resident Indian, no deduction is to be allowed under any provision of the Act in respect of any expenditure or allowance thereabout.

(ii) **No deduction allowed [Section 115D(2)]:** No deduction under Chapter VI-A shall be allowed and indexation benefit will **not** be available, where the gross total income of a non-resident Indian consists only of investment income or/and long term capital gain.

However, where the gross total income includes investment incomes or/and long term capital gain, the deduction under Chapter VI-A shall be allowed only on that portion of gross total income which does not include the investment income and long term capital gain.

(iii) **Tax rate on investment income and long term capital gains [Section 115E]:** Under section 115E, tax payable by shall be aggregate of –

(a) income-tax on Investment income at 20%;

(b) income-tax on long term capital gains from transfer of specified assets (i.e., purchased in foreign currency) at 10%; and

(c) income-tax on his other total income

Investment Income ↓ 20% + Surcharge (if applicable) + Health and Education Cess@4%
Long-term Capital Gain on Foreign Exchange Assets ↓ 10% + Surcharge (if applicable) + Health and Education Cess@4%

(iv) **Exemption for long-term capital gains [Section 115F]**

Where a non-resident Indian has transferred a long-term foreign exchange asset and has within a period of six months after the date of such transfer, invested the whole or part of the net consideration in any specified asset then

(a) If the cost of the new asset is not less than the net consideration in respect of the original asset, the whole of the capital gains shall not be charged to tax under section 45

(b) If the cost of the new asset is less than the net consideration in respect of the original asset, the amount as calculated below shall not be charged to tax under section 45

$$\text{Capital Gains x} \frac{\text{Cost of acquisition of new asset}}{\text{Net Consideration}}$$

Important points:

1. Net consideration means the full value of consideration from transfer less expenditure incurred wholly and exclusively in connection with transfer.

2. Where the new asset is transferred or converted into money within a period of 3 years from the date of its acquisition, the amount of capital gains arising from the transfer of original asset not charged to tax earlier shall be deemed to be the income under the head "Capital Gains '' relating to long term capital assets. The same shall be charged to tax in the previous year in which new asset is transferred or converted into money.

ILLUSTRATION 11

A non-resident Indian acquired shares in an Indian company, A Ltd., on 1.1.2009 for ₹ 1,00,000 in foreign currency. These shares are sold by him on 1.1.2024 for ₹ 3,00,000. He invests ₹ 3,00,000 in shares on 31.03.2024 and these shares are sold by him on 30.06.2024 for ₹ 3,50,000. Discuss the tax implications. Ignore the effect of first proviso to section 48.

SOLUTION

Computation of Long term Capital Gain for Assessment Year 2024-25

Particulars	Amount (₹)
Sale consideration	3,00,000
Less: Cost of Acquisition	1,00,000
Long term capital gain	2,00,000
Less: Exemption under section 115F	2,00,000
Exempt long-term capital gain	**NIL**

Capital Gain for Assessment year 2025-26:

1. LTCG of ₹ 2,00,000 which was exempt in A.Y.2024-25 becomes taxable this year.
2. STCG of ₹ 50,000 is also taxable this year.

ILLUSTRATION 12

Mr. John, a non-resident Indian, purchased unlisted shares of an Indian Company at a cost of ₹ 70,000 on 01.07.2010 in foreign currency. Mr. John sold the said shares for a consideration of ₹ 2,50,000 on 01.08.2023 and the expenditure incurred wholly or exclusively in connection with the transfer is ₹ 10,000. Compute the taxable capital gain if he deposited in specified assets ₹ 1,50,000 out of sale consideration. Ignore the effect of first proviso to section 48.

SOLUTION

Particulars	Amount (₹)
Sale Consideration	2,50,000
Less: Transfer Expenses	10,000
Net Consideration	2,40,000
Less: Cost of Acquisition	70,000
Long-term capital gain	1,70,000
Less: Exemption u/s 115F	1,06,250*
Taxable long-term capital gain	**63,750**

$$\frac{^{*}\,1{,}70{,}000 \times 1{,}50{,}000}{2{,}40{,}000} = ₹\ 1{,}06{,}250$$

(v) Option not to file income-tax return [Section 115G]

A non-resident Indian need not furnish a return of income under section 139(1) if he satisfies the following two conditions:-

(a) His total income consists only of investment income or income by way of long-term capital gains or both; and

(b) Tax deductible at source has been deducted from such income.

(vi) **Continuance of benefits after the non-resident becomes a resident [Section 115H]**

(a) Where a person who is NRI in any previous year becomes assessable as a resident in any subsequent year, then he may furnish a declaration in writing along with the return of income under section 139 for the year in which he is so assessable.

(b) The declaration shall be to the effect that the provisions of this chapter shall continue to apply to him in respect of the investment income derived from foreign exchange assets being debentures, deposits, securities of Central Government and such other notified assets as specified under section 115C.

(c) If he does so, the provisions of this chapter shall continue to apply to him in relation to such income for that assessment year and every subsequent year until the transfer or conversion into money of such assets.

(vii) **Option to opt out of Chapter XII-A [Section 115-I]**

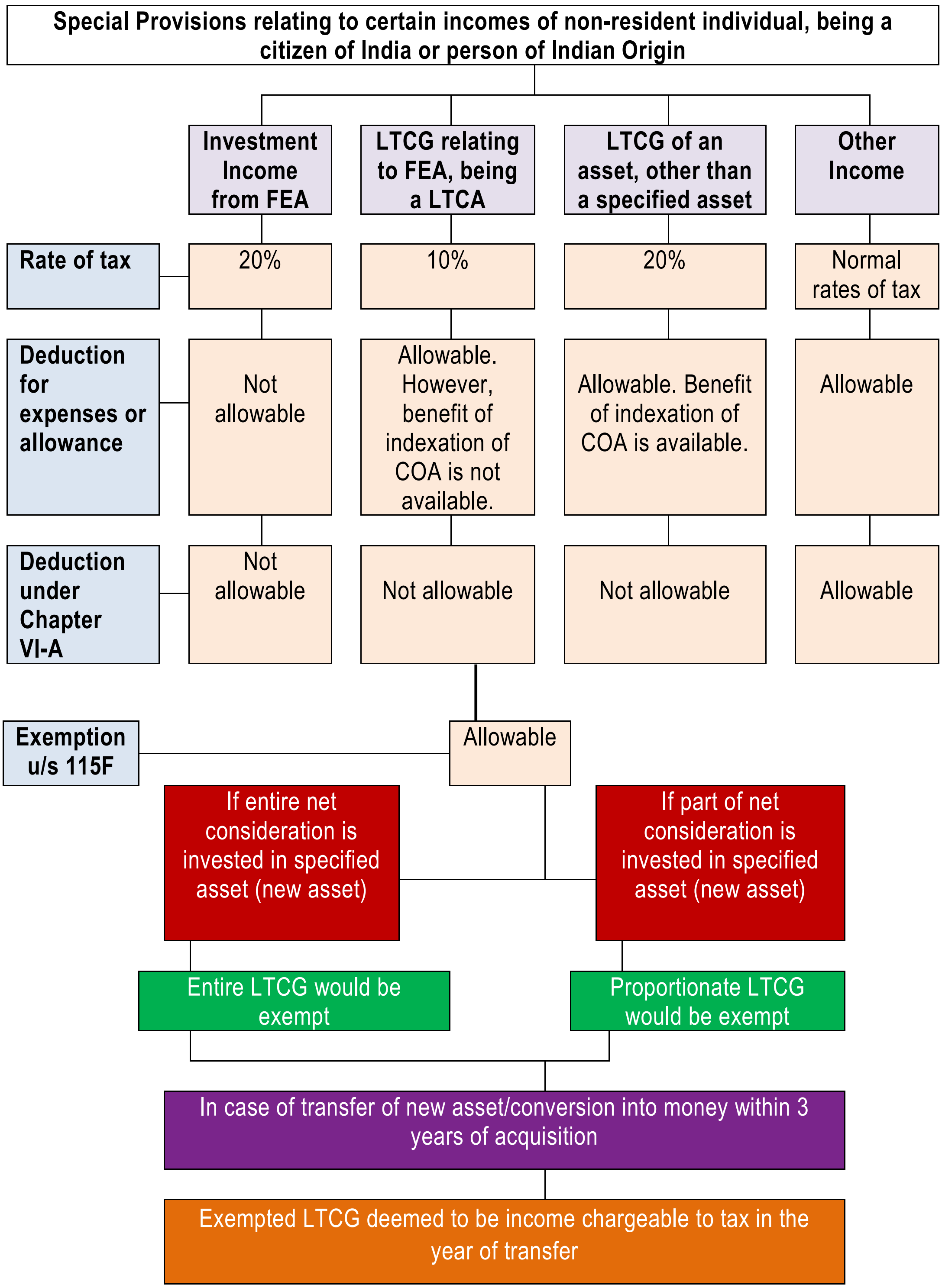
This section gives an option to a non-resident Indian to elect that he should not be governed by the special provisions of Chapter XII-A for any particular assessment year by furnishing his return of income for that assessment year under section 139 declaring therein that the provisions of Chapter XII-A shall not apply to him for that assessment year. In case where such an option is exercised by a non-resident Indian, his total income for that assessment year would be charged to tax under the general provisions of the Act.

A Quick Recap

Meaning of Foreign Exchange Asset (FEA)

- Specified asset
- Acquired/purchased/ subscribed to in convertible foreign exchange

- Shares in an Indian Company
- Debentures issued by an Indian Co. (other than a Pvt. Co.)
- Deposits with an Indian Co. (other than a Pvt. Co.)
- Any security of the CG
- Other assets notified by the CG


Special Provisions relating to certain incomes of non-resident individual, being a citizen of India or person of Indian Origin
Investment Income from FEA
LTCG relating to FEA, being a LTCA
LTCG of an asset, other than a specified asset
Other Income
Rate of tax
20%
10%
20%
Normal rates of tax
Deduction for expenses or allowance
Not allowable
Allowable. However, benefit of indexation of COA is not available.
Allowable. Benefit of indexation of COA is available.
Allowable
Deduction under Chapter VI-A
Not allowable
Not allowable
Not allowable
Allowable
Exemption u/s 115F
Allowable
If entire net consideration is invested in specified asset (new asset)
If part of net consideration is invested in specified asset (new asset)
Entire LTCG would be exempt
Proportionate LTCG would be exempt
In case of transfer of new asset/conversion into money within 3 years of acquisition
Exempted LTCG deemed to be income chargeable to tax in the year of transfer

21.7 DETERMINATION OF TAX IN CERTAIN SPECIAL CASES [CHAPTER XII]

Sections 111A, 112 and 112A have already been discussed in detail in Chapter 4: Capital Gains in Module 1. The special provisions contained in other sections under Chapter XII are discussed hereunder -

(1) Special provisions for computing tax on income by way of royalty, fees for technical service, interest etc. [Section 115A]

(i) **Tax on dividend and interest in case of non-corporate non-residents and foreign companies:**

Where the total income of a foreign company or a non-corporate non- resident includes any income by way of	Rate of Tax
(1) - ***Dividends received from a unit in an IFSC, referred to in section 80LA(1A)*** - Dividend other than mentioned above	***10%*** 20%
(2) Interest received from the Government or an Indian concern on monies borrowed or debt incurred by the Government /Indian concern in foreign currency, other than 3 and 4 mentioned below	20%
(3) Interest received from an infrastructure debt fund referred to in section 10(47)	5%
(4) Interest referred to in section 194LC received from an Indian company or business trust –	
- in respect of monies borrowed by an Indian company or business trust in foreign currency from sources outside India • Under a loan agreement between 1.7.2012 and 30.6.2023 or • by way of issue of long-term infrastructure bonds between 1.7.2012 and 30.9.2014 or • by way of issue of long-term bonds including long term infrastructure bond between 1.10.2014 and 30.6.2023 as approved by the Central Government - in respect of monies borrowed from sources outside India by way of rupee denominated bond on or before 30.6.2023	5%
- in respect of monies borrowed by it from a source outside India by way of issue of any long-term bond or rupee denominated bond between 1.4.2020 and 30.6.2023, which is listed only on a recognised stock exchange located in any IFSC	4%
- ***in respect of monies borrowed by it from a source outside India by way of issue of any long-term bond or rupee denominated bond on or after 1.7.2023, which is listed only on a recognised stock exchange located in any IFSC***	***9%***

(5)	Interest to a Foreign Institutional Investor or Qualified Foreign Investor - payable between 1.6.2013 and 30.6.2023 on investment made in • Rupee denominated bond of an Indian company • Government security - payable between 1.4.2020 and 30.6.2023 on investment made in municipal debt security	5%
(6)	Distributed income referred to in section 194LBA(2), - interest income of a business trust from a SPV, distributed by business trust to its non-resident unit holders - dividend income of a business trust received or receivable from a SPV exercising the option to pay tax at concessional rate under section 115BAA, distributed by business trust to its non-resident unit holders However, if the SPV has not exercised the option to pay tax at concessional rate under section 115BAA, dividend income would be exempt in the hands of unitholders.	5% 10%
(7)	Income received in respect of units purchased in foreign currency of a mutual fund specified under section 10(23D) or of the Unit Trust of India	20%

(ii) **Tax on royalty or fees for technical services in case of non-residents**

	Where the total income of a foreign company or a non-corporate non-resident includes any income by way of royalty or fees for technical services (FTS) other than the income referred to in section 44DA	Applicable Rate of Tax
(1)	Received from the Government in pursuance of an agreement made by the non-resident/foreign company with the Government	***20% of such royalty or FTS.*** However, if DTAA provides for a rate lower than ***20%***, then, the provisions of DTAA would apply.
(2)	Received from the Indian concern in pursuance of an agreement made by the non-resident/foreign company with the Indian concern and the agreement is approved by the Central Government or where it relates to industrial policy of Government of India, the agreement in accordance with that policy.	

Important Points:

1. Special rate of tax is applicable on the above mentioned incomes. The remaining income of the assessee will be chargeable to tax at normal rates applicable to assessee.

2. No deduction in respect of any expenditure or allowance shall be allowed to the assessee under sections 28 to 44C and section 57 in computing the above income.

3. Deduction under Chapter VI-A is not available in respect of dividend and interest referred to in (i) above. However, this condition would not be applicable to deduction allowed to a unit of an International Financial Services Centre (IFSC) under section 80LA i.e. a unit of an IFSC can claim deduction under section 80LA against dividend and interest referred to in (i) above.

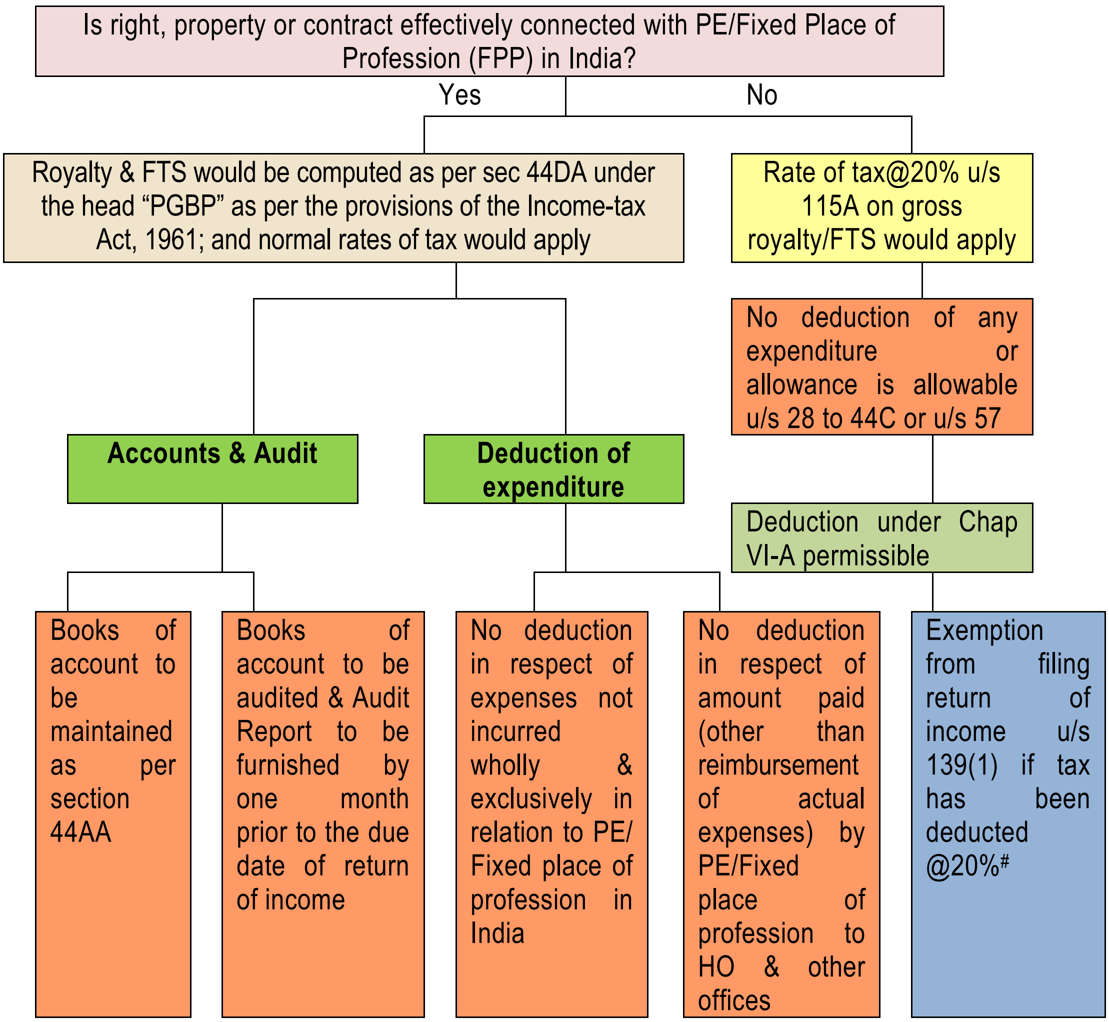
4. It shall not be necessary for the assessee to furnish a return of income if the following conditions are satisfied:

   (a) The total income consists of only the interest or dividend income referred to in (i) above or royalty or fees for technical services referred to in (ii) above; and

   (b) Tax deductible at source has been deducted from such income and the rate of such deduction is not less than the rate specified in (i) or the rate of ***20%*** specified in (ii).

A Quick Recap

Tax treatment of Royalty & Fees for technical service received from Government/Indian concern in pursuance of approved agreement



If tax has been deducted at a rate lower than 20% by availing the beneficial provisions of DTAA, then, no exemption would be available from filing return of income.

(2) Special provision for computing tax on income from units purchased in foreign currency or capital gains arising from their transfer in case of offshore fund [Section 115AB]

Where the total income of an overseas financial organisation (Offshore Fund) includes the following incomes namely-

(i) Income received in respect of units purchased in foreign currency or

(ii) by way of long-term capital gains arising from the **transfer of units** of a mutual fund specified under section 10(23D) or units of UTI purchased in **foreign currency**,

Then, the income tax payable shall be the aggregate of the following:

(a) **10%** on income referred to above

(b) the amount of income-tax with which the Offshore Fund would have been chargeable had its total income been reduced by the amount of long term capital gains and income received referred to above.

Important Points:

(i) The benefit of indexation shall **not** be available in the computation of long- term capital gains.

(ii) No deduction shall be allowed to the assessee under sections 28 to 44C or section 57(i)/(iii) or under Chapter VI-A in computing the above income.

(iii) Where the gross total income of the Overseas Financial Organisation consists of other incomes, then, the deduction under Chapter VI- A will be available in respect of other incomes. The normal provisions of the Income-tax Act, 1961 will apply for computation of other income.

(iv) **"Overseas Financial Organisation"** means any fund, institution, association or body, whether incorporated or not, established under the laws of a country outside India, which has entered into an arrangement for investment in India with any public sector bank or public financial institution or a mutual fund specified under section 10(23D). Such arrangement should be approved by the Securities and Exchange Board of India.

(v) It may be noted that long term capital gains upto ₹ 1,00,000 on units of equity oriented fund would be exempt and long term capital gains exceeding ₹ 1,00,000 shall be taxable @10% under section 112A provided securities transaction tax has been paid on the sale of such units.

(vi) It may be noted that short term capital gains on units of equity oriented fund are taxable @15% under section 111A provided securities transaction tax has been paid on the sale of such units.

(vii) It may be noted that capital gain on transfer of unit of specified mutual fund (mutual fund where not more than 35% of its total proceeds is invested in the equity shares of domestic companies) is a short term capital gain [Section 50AA].

(3) Special provision for computing tax on income from bonds or Global Depository Receipts purchased in foreign currency or capital gains arising from their transfer [Section 115AC]

(i) **Eligible assessee and special rate of tax:** According to section 115AC(1), where the total income of an assessee, being a non-resident includes:

(a) income by way of interest on bonds of an Indian company issued in accordance with such scheme as the Central Government may notify or on bonds of a public sector company sold by the Government, and purchased by him in foreign currency; or

(b) income by way of dividends on Global Depository Receipts –

(1) issued in accordance with such scheme as the Central Government may specify against the initial issue of shares of an Indian company and purchased by him in foreign currency through an approved intermediary; or

(2) issued against the shares of a public sector company sold by the Government and purchased by him in foreign currency through an approved intermediary; or

(3) issue or re-issued in accordance with such scheme as the Central Government may specify against the existing shares of an Indian company purchased by him in foreign currency through an approved intermediary; or

(c) income by way of long-term capital gains arising from the transfer of above bonds or GDRs,

then, income-tax will be charged at the rate of 10% on the above income.

(ii) **Deductions not allowable [Section 115AC(2)]:** Where the gross total income of the non-resident consists only the aforesaid interest or dividend income referred to in (a) and

(b) of (i) above, no deduction shall be allowed to him under section 28 to 44C or section 57(i) or 57(iii) or under Chapter VIA.

Deduction under Chapter VI-A is also **not** allowable against long term capital gains arising from transfer of bonds or GDRs.

Where the gross total income of the non-resident consists of incomes other than interest, dividend and long term capital gains referred to in (a), (b) and (c) of (i) above, then, the deduction under Chapter VI-A will be available in respect of other incomes.

(iii) **Non-availability of indexation benefit and computation of capital gains in foreign currency [Section 115AC(3)]:** The indexation benefit and benefit of computation of capital gains in foreign currency, shall not be available for the computation of long-term capital gains arising out of the transfer of long term asset, being bonds or GDRs.

(iv) **Filing of Return of Income not required [Section 115AC(4)]:** It shall not be necessary for a non-resident to furnish under section 139(1), a return of income if his total income in respect of which he is assessable under the Act during the previous year consisted only of aforesaid interest or dividend income, and the tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income.

(v) **Concessional tax treatment for GDR/Bonds acquired in course of Amalgamation [Section 115AC(5)]:** Where the assessee acquired GDR or bonds in an amalgamated or resulting company by virtue of his holding GDR or bonds in the amalgamating or demerged company, in accordance with the provisions of 115AC(1), the concessional tax treatment would apply to such GDR or bonds.

(vi) **Meaning of Global Depository Receipts:** "Global Depository Receipts" means any instrument in the form of a depository receipt or certificate (by whatever name called) created by the Overseas Depository Bank outside India or in an IFSC and issued to investors against the issue of —

(a) ordinary shares of issuing company, being a company listed on a recognized stock exchange in India;

(b) foreign currency convertible bonds of issuing company; or

(c) ordinary shares of issuing company, being a company incorporated outside India, if such depository receipt or certificate is listed and traded on any IFSC.

(4) Special provisions for computing tax on income of Specified Fund or Foreign Institutional Investors from securities or capital gains arising from their transfer [Section 115AD]

(i) **Special rate of tax:** Where the total income of a Specified Fund or Foreign Institutional Investor includes the income referred to in column (2), the same would be subject to tax at the rate mentioned in column (3):

(1)	(2)	(3)
S. No.	**Income**	**Rate of Tax**
(a)	Income received in respect of securities **other than** • income on units referred to in section 115AB i.e., units of Mutual Fund specified u/s 10(23D) or UTI • Interest referred u/s 194LD	20% in case of FII, 10% in case of specified fund
(b)	Interest referred u/s 194LD	5%
(c)	Income by way of Short term capital gains arising from the transfer of securities (other than Short term capital gains u/s 111A)	30%
(d)	Income by way of Short term capital gains u/s 111A	15%
(e)	Income by way of Long term capital gains arising from the transfer of securities (other than Long term capital gains u/s 112A)	10%
(f)	Income by way of long term capital gains u/s 112A exceeding ₹ 1 lakh	10%
(g)	Other income of Specified Fund or FII	At normal rates of tax

In case of specified fund, the provision of this section would apply only to the extent of income that is attributable to units held by non-resident (not being a permanent establishment of a non-resident in India) calculated in the prescribed manner.

The specified fund has to furnish an annual statement of income eligible for concessional taxation electronically under digital signature on or before the due date u/s 139(1), which is duly verified in the manner indicated therein.

The income of a specified fund attributable to the units held by a non-resident (not being the permanent establishment of a non-resident in India), would not be eligible for tax rates specified under section 115AD unless it furnishes the annual statement of income eligible for concessional taxation on or before the said due date. [Notification no. 64/2022 dated 16.6.2022]

Where the specified fund is investment division of an offshore banking unit, the provisions of this section would apply to the extent of income that is attributable to the investment division of offshore banking units [granted certificate of registration as a Category-I foreign portfolio investor under the SEBI (Foreign Portfolio Investors) Regulations, 2019 made under the SEBI Act, 1992, and fulfills the prescribed conditions, including maintenance of separate accounts for its investment division] calculated in the prescribed manner.

The eligible investment division has to furnish an annual statement of income, eligible for taxation under section 115AD(1B) in the prescribed form electronically under digital signature on or before the due date specified u/s 139(1).

The income of an eligible investment division would not be eligible for tax rates specified under section 115AD unless the eligible investment division furnishes an annual statement of income eligible for taxation under section 115AD(1B) on or before the said due date [Notification no. 64/2022 dated 16.6.2022].

(ii) Surcharge:

Under normal provisions of the Act

Surcharge applicable on tax on total income of individuals/AoPs[3]/BoIs/ Artificial Juridical Persons (having any income under section 115AD and such person has shifted out of the default tax regime and opted to pay tax under the normal provisions of the Act) for payment of advance tax for A.Y.2024-25 –

	Particulars	Rate of surcharge on income-tax	Example	
			Components of total income	Applicable rate of surcharge
(i)	Where the total income > ₹ 50 lakhs but ≤ ₹ 1 crore	10%	**Example:**	
			• Capital gains on securities referred to in section 115AD(1)(b) ₹ 60 lakhs; **and** • Other income ₹ 35 lakhs;	Surcharge would be levied@10% on income-tax computed on total income of ₹ 95 lakhs.
(ii)	Where total income > ₹ 1 crore but ≤ ₹ 2 crore	15%	**Example:**	
			• Capital gains on securities referred to in section 115AD(1)(b)	Surcharge would be levied@15% on income-tax

[3] AoPs(other than AoP consisting of only companies as its members)

			₹ 1.20 crore; **and** • Other income ₹ 60 lakhs;	computed on total income of ₹ 1.80 crore.
(iii)	Where total income [excluding dividend and STCG/LTCG on securities referred to in section 115AD(1)(b)] > ₹ 2 crore but ≤ ₹ 5 crore	25%	**Example:**	
			• Dividend ₹ 1.05 crore • Capital gains on securities referred to in section 115AD(1)(b) ₹ 1.05 crore; **and** • Other income ₹ 2.1 crores;	Surcharge would be levied: @15% on income-tax leviable on dividend of ₹ 1.05 crore and capital gains of ₹ 1.05 crore refered to in section 115AD; **and** @25% on income-tax computed on other income of ₹ 2.1 crores included in total income
	Rate of surcharge on the income-tax payable on dividend and the portion of income chargeable to tax u/s 115AD(1)(b)	Not exceeding 15%		
(iv)	Where total income [excluding dividend and STCG/ LTCG on securities referred to in section 115AD(1)(b)] > ₹ 5 crore	37%	**Example:**	
			• Dividend ₹ 1.05 crore • Capital gains on securities referred to in section 115AD(1)(b) ₹ 1.70 crore; and • Other income ₹ 6 crore	Surcharge would be levied - @15% on income-tax leviable on dividend of ₹ 1.05 crore and capital gains of ₹ 1.70 crore referred to in section 115AD; **and** @37% on income-tax computed on other income of ₹ 6 crore included in total income.
	Rate of surcharge on the income-tax payable on dividend and the portion of income chargeable to tax u/s 115AD(1)(b)	Not exceeding 15%		

<table>
<tr><td rowspan="2">(v)</td><td rowspan="2">Where total income [including dividend and STCG/ LTCG on securities referred to in 115AD(1)(b)] > ₹ 2 crore in cases not covered under (iii) and (iv) above</td><td rowspan="2">15%</td><td colspan="2">Example:</td></tr>
<tr><td>• Dividend ₹ 1.05 crore
• Capital gains on securities referred to in section 115AD(1)(b) ₹ 1.10 crore; and
• Other income ₹ 1.60 crore;</td><td>Surcharge would be levied@15% on tax on total income of ₹ 3.75 crore.</td></tr>
</table>

Surcharge and health and education cess would not be applicable to specified fund in respect of income received from securities referred to in section 115AD(1)(a).

Note – *In case of default tax regime, the maximum rate of surcharge would be 25% (instead of 37%).*

In case of an AoP consisting of only companies as its members, the rate of surcharge would be 10%, where the total income > ₹ 50 lakhs but ≤ ₹ 1 crore and 15%, where the total income > ₹ 1 crore.

(iii) **No deduction is allowed [Section 115AD(2)]:** Where the gross total income of the specified fund or Foreign Institutional Investor comprises only of the aforesaid interest or dividend income from securities, no deduction shall be allowed to it under sections 28 to 44C or section 57(i) or 57(iii) or under Chapter VI-A.

Deduction under Chapter VI-A is also not allowable in case of short term capital gain or long term capital gain arising from transfer of securities.

Where the gross total income of the specified fund or Foreign Institutional Investor consists of incomes other than income referred to in (a) to (f) of table in (i) above, then, the deduction under Chapter VI-A will be available in respect of other incomes. However, the provisions of AMT under section 115JEE would not apply to specified fund.

(iv) **First and second provisos to section 48 shall not apply [Section 115AD(3)]:**The benefit of computation of capital gains in foreign currency and the benefit of indexation would not be available for the computation of capital gains arising on transfer of securities.

(v) **Meaning of certain terms**

S. No.	Term	Meaning
1	Investment division of offshore banking unit	An investment division of a banking unit of a non-resident located in an IFSC, as referred to in section 80LA(1A) and which has commenced its operations on or before 31.3.2024

2	Specified fund	(i) A fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate, – (a) which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, made under the SEBI Act, 1992 or IFSC Authority Act, 2019; (b) which is located in any IFSC and (c) of which all the units are held by non-residents other than units held by a sponsor or manager; or However, this condition would not apply where any unit holder or holders, being non-resident during the previous year when such unit or units were issued, becomes resident under section 6(1) or (1A) in any previous year subsequent to that year, if the aggregate value and number of the units held by such resident unit holder or holders do not exceed 5% of the total units issued and fulfill such other conditions as may be prescribed. (ii) investment division of an offshore banking unit, which has been (a) granted a certificate of registration as a Category-I foreign portfolio investor under the SEBI (Foreign Portfolio Investors) Regulations, 2019 made under the SEBI Act, 1992 and which has commenced its operations on or before 31.3.2024; and (b) fulfils such conditions including maintenance of separate accounts for its investment division, as may be prescribed.

(5) Special provision for computing tax on non-resident sportsmen or sports associations [Section 115BBA]

(i) **Eligible assessee and special rate of tax:** Where the total income of an assessee, referred to in column (2) includes income referred to in column (3) of the table below, such income would be chargeable to tax@20%.

	Assessee	Income
(1)	(2)	(3)
(a)	A sportsman (including an	Any income received or receivable by way of—

	athlete), who is not a citizen of India and is a non-resident	(i) participation in India in any game (other than a game the winnings wherefrom are taxable under section 115BB, being winning from crossword puzzles, races including horse races, card games and other games of any sort of gambling or betting) or sport; or (ii) advertisement; or (iii) contribution of articles relating to any game or sport in India in newspapers, magazines or journals;
(b)	A non-resident sports association or institution	Any amount guaranteed to be paid or payable to such association or institution in relation to any game (other than a game the winnings wherefrom are taxable under section 115BB) or sport played in India
(c)	An entertainer who is not a citizen of India and is a non-resident	Any income received or receivable from his performance in India

(ii) **Deduction of expenditure not permissible:** No deduction in respect of any expenditure or allowance shall be allowed under any provision of this Act in computing the income referred to in (*a*) or (b) or (c) in the table given above.

(iii) **Filing of return of income not required:** The assessee is **not** required to furnish under section 139(1) a return of his income if—

(a) his total income in respect of which he is assessable under this Act during the previous year consisted **only** of income referred to in (a) or (b) or (c) above; and

(b) the tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income.

ILLUSTRATION 13

During the financial year 2023-24, Nadal, a tennis professional and a Spanish citizen participated in India in a Tennis Tournament and won prize money of ₹ 15 lakhs. He contributed articles on the tournament in a local newspaper for which he was paid ₹ 1 lakh. He was also paid ₹ 5 lakhs by a Soft Drink company for appearance in a T.V. advertisement. Although his expenses in India were met by the sponsors, he had to incur ₹ 3 lakhs towards his travel costs to India. He was a non-resident for tax purposes in India.

What would be his tax liability in India for A.Y. 2024-25? Is he required to file his return of income?

SOLUTION

Under section 115BBA, all the three items of receipts in India viz. prize money of ₹ 15 lakhs, amount received from newspaper of ₹ 1 lakh and amount received towards TV advertisement of ₹ 5 lakhs - are chargeable to tax. No expenditure is allowable as deduction against such receipts. The rate of tax chargeable under section 115BBA is 20%, *plus* health and education cess @4%. The total tax liability works out to ₹ 4,36,800 being 20.8% of ₹ 21 lakhs. Thus, Nadal will be liable to tax on the income earned in India

He is not required to file his return of income if -

(a) his total income during the previous year consists only of income arising under section 115BBA; **and**

(b) the tax deductible at source under the provisions of Chapter XVII-B have been deducted from such incomes.

21.8 SPECIAL PROVISIONS RELATING TO CONVERSION OF INDIAN BRANCH OF A FOREIGN BANK INTO A SUBSIDIARY COMPANY [CHAPTER XII-BB]

(1) Conversion of an Indian branch of foreign company into subsidiary Indian company [Section 115JG(1)]

(i) The provisions of this section apply to a foreign company engaged in banking business in India through its branch situated in India, which is converted into an Indian subsidiary company in accordance with the scheme framed by RBI.

(ii) If the conditions notified by the Central Government in this behalf are satisfied, then capital gains arising from such conversion would not be chargeable to tax in the assessment year relevant to the previous year in which such conversion takes place.

(iii) Also, the provisions of the Act relating to computation of income of foreign company and Indian subsidiary company would apply with such exceptions, modifications and adaptations as specified in the notification.

(iv) Further, the benefit of set-off of unabsorbed depreciation, set-off or carry forward and set-off of losses, tax credit in respect of tax paid on deemed income relating to certain companies available under the Act shall apply with such exceptions, modifications and adaptations as specified in the notification.

Accordingly, the Central Government has, vide Notification no. 85/2018, specified the conditions to be fulfilled –

(1) For Capital Gains exemption:

Where a foreign company is engaged in the business of banking through its Indian branch and converts such Indian branch into its Indian subsidiary company in accordance with the scheme framed by RBI, the capital gains arising from such conversion would not be chargeable to tax, if -

(a) the Indian branch amalgamates with the Indian subsidiary company in accordance with the scheme of amalgamation approved by the shareholders of the foreign company and the Indian subsidiary company and sanctioned by the RBI[4]

(b) all the assets and liabilities of the Indian branch immediately before conversion would become the assets and liabilities of the Indian subsidiary company;

(c) the asset and liabilities of the Indian branch are transferred to the Indian subsidiary company at values appearing in the books of account of the Indian branch immediately before its conversion.

Note - Any change in the value of assets consequent to their revaluation would not be considered while determining the value of the assets.

(d) the foreign bank or its nominee shall hold the whole of the share capital of the Indian subsidiary company during the period beginning from the date of conversion and ending on the last day of the previous year in which the conversion took place and continue to hold the shares of Indian subsidiary company carrying not less than 51% of the voting power for a period of five years immediately succeeding the said previous year;

(e) the foreign company does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the Indian subsidiary company.

(2) Application of the provisions of the Income-tax Act, 1961 with modifications/ exceptions

The provisions of the Income-tax Act, 1961 relating to unabsorbed depreciation, set off or carry forward and set off of losses, tax credit in respect of tax paid on deemed income relating to certain

[4]under paragraph 20(h) of the Framework for setting up of wholly owned subsidiaries by foreign banks in India issued by the Reserve Bank of India *vide* Press release number 2013-2014/936 dated 6th November, 2013

companies and the computation of income in case of foreign company and Indian subsidiary company shall apply with following modifications, exceptions and adaptation –

	Purpose	Modification/exception/adaptation
(a)	**Allowance of depreciation under section 32**	The aggregate deduction, in respect of depreciation on buildings, machinery, plant or furniture, being tangible assets, or know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature, being intangible assets, allowable to the Indian branch and the Indian subsidiary company shall not exceed in any previous year the deduction calculated at the prescribed rates as if the conversion had not taken place. Such deduction would be apportioned between the Indian branch and the Indian subsidiary company in the ratio of the number of days for which the assets were used by them;
(b)	**Set-off and c/f of loss and depreciation**	The accumulated loss and the unabsorbed depreciation of the Indian branch would be deemed to be the loss or allowance for depreciation of the Indian subsidiary company for the previous year in which conversion was effected; and provisions of the Income-tax Act, 1961, relating to set off and carry forward of loss and allowance for depreciation shall apply accordingly.
(c)	**Determination of actual cost u/s 43(1)**	The actual cost of the block of assets in the case of the Indian subsidiary company shall be the written down value of the block of assets as in the case of the Indian branch on the date of its conversion into the Indian subsidiary company The actual cost of any capital asset on which deduction has been allowed or is allowable under section 35AD, shall be treated as 'nil' in the case of the Indian subsidiary company if the capital asset became the property of the Indian subsidiary company as a result of conversion of the Indian branch
(d)	**Cost of acquisition of other capital assets**	Where the capital asset other than those referred to in (c) above became the property of the Indian subsidiary company as a result of conversion of the Indian branch, the cost of acquisition of the asset for the purposes of computation of capital gains shall be deemed to be the cost for which the Indian branch acquired it or, as the case may be, the cost for which previous owner has acquired it.
(e)	**Tax credit**	The tax credit of the Indian branch shall be deemed to be the tax credit of the Indian subsidiary company for the purpose of the previous year in which conversion was effected; and the provisions of section 115JAA of the Income-tax Act, 1961 shall apply accordingly.
(f)	**Amortisation of VRS Expenditure**	The provisions of 35DDA of the Act shall be, as far as may be, apply to the Indian subsidiary company, as they would have applied to the Indian branch, if the conversion had not taken place

(g)	**Deemed credit balance in provision for bad and doubtful debts**	The credit balance in the provision for bad and doubtful debts account made under section 36(1)(viia) of the Indian branch on the date of conversion shall be deemed to be the credit balance of the Indian subsidiary company and the provisions of section 36 of the Income-tax Act, 1961, shall apply accordingly
(h)	**Non-applicability of section 56(2)(x)**	The provisions of section 56(2)(x) shall not apply to the transaction of receipt of shares in the Indian subsidiary company by the foreign company or its nominee in consequence of the conversion of the Indian branch into the Indian subsidiary company.

Meaning of certain terms:

Term	Meaning
Accumulated loss	So much of the loss of the Indian branch before its conversion into Indian subsidiary company under the head "Profits and gains of business or profession" (not being a loss sustained in a speculation business) which such Indian branch would have been entitled to carry forward and set off under the provisions of section 72, if the conversion had not taken place.
Unabsorbed depreciation	So much of the allowance for depreciation of the Indian branch before its conversion into Indian subsidiary company, which remains to be allowed and which would have been allowed to the Indian branch under the provisions of the Act, if the conversion had not taken place.
Previous owner	In relation to any capital asset owned by the Indian subsidiary company means the last previous owner of the capital asset who acquired it by a mode of acquisition other than those referred in section 49(1)(i)/(ii)/(iii)/(iv) or section 115JG(1).
Tax credit	So much of the tax credit of the Indian branch before conversion into Indian subsidiary company which such Indian branch would have been entitled to carry forward and set off under the provisions of section 115JAA of the Act, if the conversion had not taken place.
Date of conversion	The date, which the Reserve Bank of India appoints for the vesting of undertaking of the Indian branch in Indian subsidiary company[5]

(2) Consequences of failure to comply with the specified conditions [Section 115JG(2)]

If the conditions specified in the scheme of RBI or notification issued by the Central Government are not complied with, then, all the provisions of the Act would apply to the foreign company and Indian subsidiary company without any benefit, exemption or relief under this section.

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[5]under paragraph 20(i) of the Framework for setting up of wholly owned subsidiaries by foreign banks in India issued by the Reserve Bank of India vide press release number 2013-2014/936 dated 6th day of November, 2013.

(3) Consequences of subsequent failure to comply with the conditions [Section 115JG(3)]

(i) If the benefit, exemption or relief has been granted to the foreign company or Indian subsidiary company in any previous year and thereafter, there is a failure to comply with any of the conditions specified in the scheme or notification, then, such benefit, exemption or relief shall be deemed to have been wrongly allowed.

(ii) In such a case, the Assessing Officer is empowered to re-compute the total income of the assessee for the said previous year and make the necessary amendment. This power is notwithstanding anything contained in the Income-tax Act, 1961.

(iii) The provisions of rectification under section 154, would, accordingly, apply and the four year period within which such rectification should be made has to be reckoned from the end of the previous year in which the failure to comply with such conditions has taken place.

(iv) Every notification under issued under this section shall be laid before each House of Parliament.

21.9 WITHHOLDING TAX PROVISIONS FOR NON-RESIDENTS

(1) Salary payable in foreign currency [Section 192]

By virtue of section 9(1)(ii), salary is deemed to accrue or arise in India, if services are rendered in India. Therefore, if a non-resident renders services in India, the salary income would be chargeable to tax in India and the person responsible for paying the salary income i.e., the employer, has to deduct withholding tax in accordance with the provisions of section 192, at the rates in force for the financial year in which the payment is made where the employee exercises option to opt out of new tax regime under section 115BAC.

(i) Tax on non-monetary perquisites paid by employer [Section 192(1A)] – In case of non-monetary perquisite, employer can opt to pay tax on whole or part of such income without making any deduction therefrom at the time tax was otherwise deductible.

Such tax will have to be calculated at the average rate applicable to aggregate salary income of the employee and payment of tax will have to be made every month along with tax deducted at source on monetary payment of salary, allowances etc [Section 192(1)].

(ii) **Meaning of Average rate of income-tax –** Average rate of income-tax means the rate arrived at by dividing the amount of income-tax calculated on the total income, by such total income.

(iii) **Deferment of TDS on perquisite of specified security or sweat equity shares provided by an eligible start-up [Section 192(1C)] -** An employer, being an eligible start up referred to in section 80-IAC, responsible for paying any income to the assessee by way of perquisite being any specified security or sweat equity shares allotted or transferred free of cost or at concessional rate to the assessee, has to deduct or pay, as the case may be, tax on the value of such perquisite provided to its employee within 14 days from the earliest of the following dates –

- after the expiry of 48 months from the end of the relevant assessment year; or
- from the date of the sale of such specified security or sweat equity share by the assessee; or
- from the date of the assessee ceasing to be the employee of the employer who allotted such shares

Such tax has to deducted or paid for the financial year in which said specified security or sweat equity share is allotted or transferred.

(iv) **Calculation of TDS where salary is payable in foreign currency [Section 192(6)]** - Section 192(6) deals with the provisions of withholding tax in case of salary payable in foreign currency. In case, where salary is payable in foreign currency, the amount of tax deducted is to be calculated after converting the salary payable into Indian currency at the telegraphic transfer buying rate as adopted by State Bank of India on the last day of the month immediately preceding the month in which the salary is due, or is paid in advance or in arrears [Rule 26 read with Rule 115].

Students may note that the Rule 26 and Rule 115 have been given as Annexure – 1 at the end of this module.

(2) Payments to non-resident sportsmen or sports association [Section 194E]

(i) **Applicability**

This section provides for deduction of tax at source in respect of any income referred to in section 115BBA payable to a non-resident sportsman (including an athlete) or an entertainer who is not a citizen of India or a non-resident sports association or institution.

(ii) Rate of TDS

Deduction of tax at source **@20%** (*plus* surcharge, if applicable, and health and education cess@4%) should be made by the person responsible for making the payment. Health and education cess @4% on TDS rate of 20% would be leviable, since payment is made to a non-resident.

(iii) Time of deduction of tax

Such tax deduction should be at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier.

(iv) Income referred to in section 115BBA

(i) income received or receivable by a non-resident sportsman (including an athlete), who is not a citizen of India, by way of-

(a) participation in any game or sport in India (However, games like crossword puzzles, horse races etc. taxable under section 115BB are not included herein); or

(b) advertisement; or

(c) contribution of articles relating to any game or sport in India in newspapers, magazines or journals.

(ii) Guarantee amount paid or payable to a non-resident sports association or institution in relation to any game or sport played in India. However, games like crossword puzzles, horse races etc. taxable under section 115BB are not included herein.

(iii) income received or receivable by a non-resident entertainer (who is not a citizen of India) from his performance in India.

Note: The issue as to whether the non-resident match referees and umpires in the games played in India fall within the meaning of "sportsmen" to attract taxability under the provisions of section 115BBA, and consequently attract the TDS provisions under section 194E in the hands of the payer was taken up by the Calcutta High Court in *Indcomv. CIT (TDS) (2011) 335 ITR 485*.

In order to attract the provisions of the section 194E, the person should be a non-resident sportsperson or non-resident sports association or institution whose income is taxable as per the provisions of section 115BBA.

Umpires and match referees can be described as professionals or technical persons who render professional or technical services, but they cannot be said to be either non-resident sportsmen (including an athlete) or non-resident sports association or institution so as to attract the provisions of section 115BBA and consequently, the provisions of tax deduction at source under section 194E are can not be attracted.

The Calcutta High Court held that although the payments made to non-resident umpires and the match referees are "income" which has accrued and arisen in India, the same are not taxable under the provisions of section 115BBA and thus, the assessee is not liable to deduct tax under section 194E.

It may be noted that since income has accrued and arisen in India to the non-resident umpires and match referees, the TDS provisions under section 195 would be attracted and tax would be deductible at the rates in force.

Board of Control for Cricket in Sri Lanka v. DIT (International Taxation) & Pilcom v. CIT (2020) 425 ITR 312 (SC)

The International Cricket Council (ICC), having its headquarters in London, is the organisation which makes and alters the rules of the game of cricket, sets the different levels and minimum standards at which the game is to be played in each country to get its recognition, the different formats of the game, e. g. test cricket, first class cricket, limited overs competition and so on. It has affiliates from similar organisations in countries, all over the world. It controls, supervises and regulates the game of cricket in every respect.

At a special meeting of the ICC held in London in the year 1993, India, Pakistan and Sri Lanka were chosen to co-host the world cup. A joint management committee of these three countries, [(Pak-Indo-Lanka) joint management committee (PILCOM)] was formed to conduct this world cup cricket tournament. Bank accounts were opened by PILCOM in London to be operated jointly by the India and Pakistan Cricket Boards. In this account were deposited moneys from sponsorships, TV rights, etc. The Board of Control for Cricket in India (BCCI) appointed its own committee, INDCOM, for discharge of its functions. INDCOM had its bank account at Calcutta. From the bank account of PILCOM at London certain amounts were transferred to the bank accounts of the host countries for the purpose of payment of fees to umpires and referees, defraying administrative expenses and payment of prize money. PILCOM paid £ 43,50,000 which included £ 19,55,000 as guarantee money to eleven cricket associations.

The payments of £ 8,85,000 representing guarantee money paid to the Boards of Australia, England, New Zealand, Sri Lanka and Kenya with whom Double Taxation Avoidance Agreements exist, and of £ 7,10,000 representing guarantee money paid to the Boards of Pakistan, West Indies, Zimbabwe and Holland were in the nature of guarantee money paid to non-resident sports associations. The payments were not made by the assessee in India but through its bank accounts at London or elsewhere. The non-resident sports associations had participated in the event, where cricket teams of these associations had played various matches in the country. Though the payments were described as guarantee money, they were intricately connected with the event where various cricket teams were scheduled to play and did participate in the event. The source of income was in the playing of the matches in India.

The mandate under section 115BBA(1)(b) is that if the total income of a non-resident sports association includes the amount guaranteed to be paid or payable to it in relation to any game or sports played in India, the amount of Income-tax calculated in terms of the section shall become payable. The expression "in relation to" emphasises the connection between the game or sport played in India on the one hand and the guarantee money paid or payable to the non-resident sports association on the other. Once the connection is established, the liability under the provision must arise. To the extent the payments represented amounts which could not be subject matter of charge under the provisions of the Act, appropriate benefit had already been extended to the assessee.

The payments made to the non-resident sports associations represented their income which accrued or arose or was deemed to have accrued or arisen in India. Consequently, the assessee was liable to deduct tax at source in terms of section 194E.

ILLUSTRATION 14

Smith, a foreign national and a cricketer came to India as a member of Australian cricket team in the year ended 31st March, 2023. He received ₹ 5 lakhs for participation in matches in India. He also received ₹ 1 lakh for an advertisement of a product on TV. He contributed articles in a newspaper for which he received ₹ 10,000. When he stayed in India, he also won a prize of ₹ 20,000 from horse racing in Mumbai. He has no other income in India during the year.

(i) Compute tax liability of Smith for Assessment Year 2024-25.

(ii) Are the income specified above subject to deduction of tax at source?

(iii) Is he liable to file his return of income for Assessment Year 2024-25?

(iv) *What would have been his tax liability, had he been a match referee instead of a cricketer and pays tax under the default tax regime under section 115BAC?*

SOLUTION

(i) Computation of tax liability of Smith for the A.Y.2024-25

Particulars	₹	₹
Income taxable under section 115BBA		
Income from participation in matches in India	5,00,000	
Advertisement of product on TV	1,00,000	
Contribution of articles in newspaper	10,000	
Income taxable under section 115BB		
Income from horse races	20,000	
Total income	**6,30,000**	
Tax@ 20% under section 115BBA on ₹ 6,10,000		1,22,000
Tax@ 30% under section 115BB on income of ₹ 20,000 from horse races		6,000
		1,28,000
Add: Health and Education cess@4%		5,120
Total tax liability of Smith for the A.Y.2024-25		**1,33,120**

(ii) Yes, the above income is subject to tax deduction at source.

Income referred to in section 115BBA (i.e., ₹ 6,10,000, in this case) is subject to tax deduction at source@ 20% under section 194E.

Income referred to in section 115BB (i.e.,₹ 20,000, in this case) is subject to tax deduction at source@30% under section 194BB.

Since Smith is a non-resident, the amount of tax to be deducted calculated at the prescribed rates mentioned above, would be increased by health and education cess@4%.

(iii) Section 115BBA provides that if the total income of the non-resident sportsman comprises of only income referred to in that section and tax deductible at source has been fully deducted, it shall not be necessary for him to file his return of income. However, in this case, Mr. Smith has income from horse races as well. Therefore, he cannot avail the benefit of exemption from filing of return of income as contained in section 115BBA. Hence, he would be liable to file his return of income for A.Y.2024-25.

(iv) The Calcutta High Court in *Indcom v. CIT (TDS)(2011) 335 ITR 485* has held that 'match referee' would not fall within the meaning of "sportsmen" to attract the provisions of section 115BBA.Therefore, although the payments made to non-resident 'match referee' are "income" which has accrued and arisen in India, the same are not taxable under the provisions of section 115BBA. They are subject to the normal rates of tax under section 115BAC.

Particulars		₹
Tax@30% under section 115BB on winnings of ₹ 20,000 from horse races		6,000
Tax on ₹ 6,10,000 at normal rate of tax		
Upto ₹ 3,00,000	Nil	
3,00,000 – 6,00,000 @5%	15,000	
6,00,000 – 6,10,000 @ 10%	1,000	16,000
		22,000
Add: Health and Education cess@4%		880
Total tax liability		**22,880**

(3) Income by way of interest from Infrastructure Debt Fund [Section 194LB]

(i) Special rate of tax on interest received by non-residents from notified infrastructure debt funds

Interest income received by a non-corporate non-resident or a foreign company from notified infrastructure debt funds set up in accordance with the prescribed guidelines would be subject to tax at a concessional rate of ***5%*** under section 115A on the gross amount of such interest income as compared to tax @20% on other interest income of non-resident. The concessional rate of tax is expected to give a fillip to infrastructure and encourage inflow of long-term foreign funds to the infrastructure sector.

(ii) Rate of TDS

Accordingly, tax would be deductible @***5%*** *plus* surcharge, if applicable, *plus* health and education cess @4% on interest paid/credited by such fund to a non-resident/foreign company.

(iii) Time of deduction

The person responsible for making the payment shall, **at the time of credit of such income to the account of the payee or at the time of payment thereof** in cash or by issue of a cheque or draft or by any other mode, **whichever is earlier**, deduct income-tax.

(4) Income by way of interest from an Indian company or business trust [Section 194LC]

(i) Concessional rate of tax on interest on foreign currency borrowings by an Indian company or business trust

Interest paid by an Indian company or business trust to a foreign company or a non-corporate non-resident would be subject to tax at a concessional rate on gross interest (as against the rate of 20% of gross interest applicable in respect of other interest received by a non-corporate non-resident or foreign company from Government or an Indian concern on money borrowed or debt incurred by it in foreign currency)

Tax is deductible at concessional rate of 5% on the following interest paid by an Indian company or business trust to a foreign company or a non-corporate non-resident -

(a) in respect of borrowing made in foreign currency from sources outside India

- under a loan agreement at any time between 1.7.2012 and 30.6.2023 or
- by way of issue of long-term infrastructure bonds during the period between 1.7.2012 and 30.9.2014 or
- by way of issue of any long-term bond, including long-term infrastructure bond during the period between 1.10.2014 and 30.6.2023

as approved by the Central Government in this behalf.

(b) in respect of monies borrowed by it from a source outside India by way of issue of rupee denominated bond on or before 30.6.2023.

Tax is deductible at concessional rate of ***4%*** in respect of monies borrowed by an Indian company or business trust from a source outside India by way of issue of any long-term bond or rupee denominated bond between 1.4.2020 and 30.6.2023, which is listed only on a recognised stock exchange located in any IFSC.

Tax is deductible at concessional rate of 9% in respect of monies borrowed by an Indian company or business trust from a source outside India by way of issuance of any long-term bond or rupee denominated bond on or after 1.7.2023, which is listed only on a recognised stock exchange located in any IFSC.

The interest to the extent the same does not exceed the interest calculated at the rate approved by the Central Government, taking into consideration the terms of the loan or the bond and its repayment, will be subject to tax at a concessional rate of **5%, 4% or 9%, as the case may be,** *plus* surcharge, wherever applicable, *plus* health and education cess @4%.

***Note** - Interest payable by an Indian company or a business trust to a non-resident, including a foreign company, in respect of rupee denominated bond issued outside India during the period from 17.9.2018 to 31.3.2019 shall be exempt from tax, and consequently, no tax shall be deducted on the payment of interest in respect of the said bond under section 194LC.*

(ii) Non-applicability of higher rate of TDS under section 206AA for non-furnishing of PAN

Section 206AA provides that any person whose receipts are subject to deduction of tax at source i.e., the deductee, shall mandatorily furnish his PAN to the deductor failing which the deductor has to deduct tax at source at higher of the following rates –

(i) the rate prescribed in the Act;

(ii) at the rate in force i.e., the rate mentioned in the Finance Act; or

(iii) at the rate of 20

Levy of higher rate of TDS under **section 206AA in the absence of PAN would not be attracted** in respect of payment of interest on long-term bonds, as referred to in section 194LC, to a non-corporate non-resident or to a foreign company and other payment subject to prescribed conditions.

For the purpose of reducing the compliance burden, Rule 37BC provides for relaxation to a non-corporate non-resident or a foreign company not having PAN in respect of payment in the nature of interest, royalty, fees for technical services, dividends and payments on transfer of any capital asset, subject to the deductee furnishing the following details and documents to the deductor, namely:-

a. name, e-mail id, contact number;

b. address in the country or specified territory outside India of which the deductee is a resident;

c. a certificate of his being resident in any country or specified territory outside India from the Government of that country or specified territory if the law of that country or specified territory provides for issuance of such certificate;

d. Tax Identification Number of the deductee in the country or specified territory of his residence and in case no such number is available, then a unique number on the basis of which the deductee is identified by the Government of that country or the specified territory of which he claims to be a resident.

(5) Interest on Government securities or rupee-denominated bonds of an Indian company payable to a Foreign Institutional Investor (FII) or a Qualified Foreign Investor (QFI) [Section 194LD]

(i) Applicability and Rate of TDS

Section 194LD provides that any income by way of interest payable during the period between 1.6.2013 and 30.6.2023 in respect of investment made by an FII or QFI in a rupee denominated bond of an Indian company or a Government security, shall be subject to tax deduction at source at a concessional rate of 5% (as against the rate of 20% of interest applicable in respect of other interest received by a QFI or FII).

The concessional rate of TDS @ 5% is also available on interest payable between 1.4.2020 and 30.6.2023, to a FII or QFI in respect of the investment made in municipal debt security.

The interest on Rupee Denominated Bond of an Indian company to the extent the same does not exceed the interest calculated at the rate notified by the Central Government in this behalf will be subject to tax deduction at a concessional rate of **5%** *plus* surcharge, wherever applicable, *plus* health and education cess @4%.

(ii) Time of deduction

Any person who is responsible for paying to a person being a FII or a QFI, any such interest shall, at the time of credit of such income to the account of the payee or at the time of payment of such income in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon @5% *plus* surcharge, wherever applicable, *plus* health and education cess @4%.

(iii) Meaning of FII and QFI

S.No.	Term	Meaning
(i)	**FII**	Foreign Institutional Investors specified by the Central Government by notification in the Official Gazette.
(ii)	**QFI**	Qualified Foreign Investor (QFI) shall mean a person resident in a country that is compliant with Financial Action Task Force (FATF) standards and that is a signatory to International Organization of Securities Commission's (IOSCO's) Multilateral Memorandum of Understanding. Such person is, however, not resident in India These Qualified Foreign Investors i.e., Foreign Investors, being non-residents, who meet certain KYC requirements under SEBI laws and are hence permitted to invest in equity and debt schemes of Mutual Funds, thereby enabling Indian Mutual Funds to have direct access to foreign investors and widen the class of foreign investors in Indian equity and debt market. **QFI does not include FII.**
(iii)	**Municipal debt securities**	It means non-convertible debt securities which create or acknowledge indebtedness, and include debenture, bonds and such other securities of an issuer.

(6) Other sums (payable to non-residents) [Section 195]

(i) Applicability

Any person responsible for paying interest (other than interest referred to in section 194LB or section 194LC or section 194LD) or any other sum chargeable to tax (other than salaries) to a non-corporate non-resident or to a foreign company is liable to deduct tax at source at the rates prescribed by the relevant Finance Act. Such persons are also required to furnish the information relating to payment of any sum in such form and manner as may be prescribed by the CBDT.

Payee to be a non-resident - In order to subject an item of income to deduction of tax under this section the payee must be a non-corporate non-resident or a foreign company.

Payer may be a resident or non-resident - Under section 195(1), the obligation to deduct tax at source from interest and other payments to a non-resident, which are chargeable to tax in India, is on "any person responsible for paying to a non-resident or to a foreign company".

The words "any person" used in section 195(1) is intended to include both residents and non-residents. Therefore, a non-resident person is also required to deduct tax at source before making payment to another non-resident, if the payment represents income of the payee non-resident, chargeable to tax in India. Therefore, if the income of the payee non-resident is chargeable to tax, then tax has to be deducted at source, whether the payment is made by a resident or a non-resident.

Explanation 2 clarifies that the obligation to comply with section 195(1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:-

(a) a residence or place of business or business connection in India; or

(b) any other presence in any manner whatsoever in India.

(ii) Time of deduction

The tax is to be deducted at source at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

Where any interest or other sum as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee.

However, in the case of interest payable by the Government or a public sector bank within the meaning of section 10(23D) or a public financial institution within the meaning of section 10(23D), deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode.

(iii) Payments subject to tax deduction

The statutory obligation imposed under this section would apply for the purpose of deduction of tax at source from any sum being income assessable to tax (other than salary income) in the hands of the non-resident non-corporate/foreign company.

Payment to a non-resident by way of royalties and payments for technical services rendered in India are common examples of sums chargeable under the said provisions of the Act to which the liability for deduction of tax at source would apply.

(iv) Certificate of non-deduction of tax at source

(a) Under section 195(3), any person entitled to receive any interest or other sum on which income-tax has to be deducted under section 195(1) may make an application in the prescribed form to the Assessing Officer for grant of certificate authorizing him to receive such interest or other sum without deduction of tax thereunder.

(b) Where any such certificate is granted, every person responsible for paying such interest or other sum to the person to whom certificate is granted make payment of such interest or other sum without deduction of tax at source under section 195(1), so long as the certificate in force.

(c) Such certificate shall remain in force till the expiry of the period specified therein. However, if it is cancelled by the Assessing Officer before the expiry of such period, the certificate shall remain in force till such cancellation.

(d) The CBDT is empowered to make rules specifying the cases in which, and the circumstances under which, an application may be made for the grant of certificate. While doing so, it should take into account the convenience of the assessees and the interests of the revenue.

(e) Such Rules would provide for the conditions subject to which such certificate may be granted and any other matter connected therewith.

(v) Person responsible for paying any sum to non-resident to furnish prescribed information

Section 195(6) provides that the person responsible for paying any sum, whether or not chargeable to tax under the provisions of the Act, to a non-corporate non-resident or to a foreign company, shall be required to furnish the information relating to payment of such sum in the prescribed form and prescribed manner.

(vi) Specified class or classes of persons, making payment to the non-resident, to mandatorily make application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax

(a) Under section 195(1), any person responsible for paying to a non-corporate non-resident or to a foreign company, any interest or any other sum chargeable under the provisions of the Act (other than salary), has to deduct tax at source at the rates in force.

(b) Under section 195(2), where the person responsible for paying any such sum chargeable to tax under the Act (other than salary) to a non-resident, considers that the whole of such sum would not be income chargeable in the hands of the recipient, he may make an application in such form and manner to the Assessing Officer, to determine in such manner, as may be prescribed, the appropriate proportion of such sum so chargeable. When the Assessing Officer so determines, the appropriate proportion, tax shall be deducted under section 195(1) only on that proportion of the sum which is so chargeable.

(c) Section 195(7) provides that, notwithstanding anything contained in sections 195(1) and 195(2), the CBDT may, by notification in the Official Gazette, specify a class of persons or cases, where the person responsible for paying to a non-corporate non-resident or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall make an application in the prescribed form and manner to the Assessing Officer, to determine in the prescribed manner, the appropriate proportion of sum chargeable to tax. Where the Assessing Officer determines the appropriate proportion of the sum chargeable, tax shall be deducted under sub-section (1) on that proportion of the sum which is so chargeable.

(d) Consequently, where the CBDT specifies a class of persons or cases, the person responsible for making payment to a non-corporate non-resident or a foreign company in such cases has to mandatorily make an application in the prescribed form and manner to the Assessing Officer, whether or not such payment is chargeable under the provisions of the Act.

Accordingly, the CBDT has inserted Rule 29BA to specify the following form and manner of making application to the Assessing Officer and manner for determining the appropriate fraction on which tax is deductible at source:

Sub-rule	Provision
(1)	**Form and manner of making application:** An application by a person for determination of appropriate proportion of sum chargeable in the case of non-resident recipient under section 195(2)/(7) has to be made in **Form 15E** electronically – (i) under digital signature; or (ii) through electronic verification code.
(2)	**Determination of appropriate proportion of sum chargeable to tax after examining the taxability of the amount as per the Act and the relevant DTAA:** The Assessing Officer has to examine whether the sum being paid or

	credited is chargeable to tax under the provisions of the Act read with the relevant DTAA, if any. If the sum is chargeable to tax, he has to determine the appropriate proportion of such sum chargeable to tax.
(3)	**Issuance of certificate determining appropriate proportion of sum chargeable to tax:** The Assessing Officer has to examine the application and on being satisfied that the whole of such sum would not be the income chargeable in case of the recipient, he may issue a certificate determining appropriate proportion of such sum chargeable under the provision of the Act, for the purposes of tax deduction under section 195(1).
(4)	**Information to be considered while examining the application:** While examining the application, the Assessing Officer has to take into consideration, following information in relation to the recipient:- (i) tax payable on estimated income of the previous year relevant to the assessment year (ii) tax payable on the assessed or returned or estimated income, as the case may be, of preceding four previous years (iii) existing liability under the Income-tax Act, 1961 (iv) advance tax payment, tax deducted at source and tax collected at source for the assessment year relevant to the previous year till the date of making application in Form 15E.
(5)	**Validity of the certificate:** The certificate would be valid only for the payment to non-resident named therein and for such period of the previous year as may be specified in the certificate, unless it is cancelled by the Assessing Officer at any time before the expiry of the specified period.
(6)	**Application for fresh certificate:** An application for a fresh certificate may be made, if the assessee so desires, - - after the expiry of the period of validity of the earlier certificate or - within three months before the expiry thereof.
(7)	**Procedures, formats and standards to be laid down for ensuring secure capture and transmission of data and uploading of documents:** The PDGIT (Systems) or the DGIT (Systems), as the case may be, has to lay down procedures, formats and standards for ensuring secure capture and transmission of data and uploading of documents. They would also be responsible for evolving and implementing appropriate security, archival and retrieval policies in relation to the furnishing of Form No 15E and issuance of Certificate.

(vii) Refund for denying liability to deduct tax under section 195 [Section 239A]:

(a) Application for refund of tax - This section provides that where under an agreement or other arrangement, in writing, the tax deductible on any income, other than interest, under section 195 is to be borne by the person by whom the income is payable, and such person having paid such tax to the credit of the Central Government, claims that no tax was required to be deducted on such income, he may file an application before the Assessing Officer for refund of such tax in prescribed form and manner.

(b) Time limit for filing application - Such application may be filed within 30 days from the date of payment of such tax.

(c) Passing of order by Assessing Officer - The Assessing Officer has to, by an order in writing, allow or reject the application. However, no application would be rejected unless an opportunity of being heard has been given to the applicant. The Assessing Officer, may, before passing an order make such inquiry as he considers necessary.

(d) Time limit for passing order - The order has to be passed within 6 months from the end of the month in which application for refund is received.

(viii) Procedure for refund of TDS under section 195 to the person deducting tax in cases where tax is deducted at a higher rate prescribed in the DTAA

(I) The CBDT has, through *Circular No.7/2011 dated 27.9.2011*, modified Circular No.07/2007, dated 23.10.2007 which laid down the procedure for refund of tax deducted at source under section 195 of the Income-tax Act, 1961 to the person deducting tax at source from the payment to a non-resident. The said Circular allowed refund to the person making payment under section 195 in the circumstances indicated below where, after the deposit into Government account of the tax deducted at source under section 195,

(a) the contract is cancelled, and no remittance is made to the non-resident;

(b) the remittance is duly made to the non-resident, but the contract is cancelled. In such cases, the remitted amount has been returned to the person responsible for deducting tax at source;

(c) the contract is cancelled after partial execution and no remittance is made to the non-resident for the non-executed part;

(d) the contract is cancelled after partial execution and remittance related to non-executed part is made to the non-resident. In such cases, the remitted amount has been returned to the person responsible for deducting the tax at source or no remittance is made but tax was deducted and deposited when the amount was credited to the account of the non-resident;

(e) there occurs exemption of the remitted amount from tax either by amendment in law or by notification under the provisions of Income-tax Act, 1961;

(f) an order is passed under section 154 or 248 or 264 of the Income-tax Act, 1961 reducing the tax deduction liability of a deductor under section 195;

(g) there occurs deduction of tax twice from the same income by mistake;

(h) there occurs payment of tax on account of grossing up which was not required under the provisions of the Income-tax Act, 1961;

(i) there occurs payment of tax at a higher rate under the domestic law while a lower rate is prescribed in the relevant double taxation avoidance treaty entered into by India.

In the cases mentioned above, income does not either accrue to the non-resident or it accrues but the excess amount in respect of which refund is claimed, is borne by the deductor. The amount deducted as tax under section 195 and paid to the credit of the Government therefore belongs to the deductor.

In the type of cases referred to in (a), the non-resident not having received any payment would not apply for a refund. For cases covered in (b) to (i), no claim may be made by the non-resident where he has no further dealings with the resident deductor of tax or the tax is to be borne by the resident deductor. The resident deductor was therefore put to genuine hardship as he would not be able to recover the amount deducted and deposited as tax.

In the type of cases referred to above, where no income has accrued to the non-resident due to cancellation of contract or where income has accrued but no tax is due on that income or tax is due at a lesser rate, the amount deposited to the credit of Government to that extent under section 195, cannot be said to be "tax".

Therefore, the CBDT decided that this amount can be refunded to the person who deducted it from the payment to the non-resident, under section 195.

Refund to the person making payment under section 195 is being allowed as income does not accrue to the non-resident or if the income is accruing no tax is due or tax is due at a lesser rate. The amount paid into the Government account in such cases to that extent, is no longer "tax".

If a resident deductor is entitled for the refund of tax deposited under section 195, then, it has to be refunded with interest under section 244A from the date of payment of such tax [Circular No. 11/2016 dated 26.4.2016].

In case of refund being made to the person who made the payment under section 195, the Assessing Officer may, after giving intimation to the deductor, adjust it against any existing tax liability of the deductor under the Income-tax Act, 1961, or any other direct tax law. The balance amount, if any, should be refunded to the person who made such payment under section 195.

A refund in terms of this circular should be granted only after obtaining an undertaking that no certificate under section 203 of the Income-tax Act has been issued to the non-resident. In cases where such a certificate has been issued, the person making the refund claim under this circular should either obtain it or should indemnify the Income-tax Department from any possible loss on account of any separate claim of refund for the same amount by the non-resident. A refund in terms of this circular should be granted only if the deductee has not filed return of income and the time for filing of return of income has expired.

The refund as per this circular is, *inter alia*, permitted in respect of transactions with non-residents, which have either not materialized or have been cancelled subsequently. It, therefore, needs to be ensured by the Assessing Officer that they disallow corresponding transaction amount, if claimed, as an expense in the case of the person, being the deductor making refund claim. Besides, in all cases, the Assessing Officer should also ensure that in the case of a deductor making the claim of refund, the corresponding disallowance of expense amount representing TDS refunded is made.

(II) The said Circular, however, did not cover a situation where tax is deducted at a rate prescribed in the relevant DTAA which is higher than the rate prescribed in the Income-tax Act, 1961. Since the law requires deduction of tax at a rate prescribed in the relevant DTAA or under the Income-tax Act, 1961, whichever is lower, there is a possibility that in such cases excess tax is deducted relying on the provisions of relevant DTAA.

(III) Accordingly, in order to remove the genuine hardship faced by the resident deductor, the CBDT has modified *Circular No. 07/2007, dated 23-10-2007* to the effect that the beneficial provisions under the said Circular allowing refund of tax deducted at source under section 195 to the person deducting tax at source shall also apply to those cases where deduction of tax at a higher rate under the relevant DTAA has been made while a lower rate is prescribed under the domestic law.

(7) Income from units of mutual fund or specified company [Section 196A]

(i) **Applicability and rate of TDS:** The person responsible for paying to non-corporate non-resident or a foreign company any income in respect of units of a mutual fund specified under section 10(23D) or from the specified company referred to in section 10(35) shall deduct tax **@20%** plus surcharge, wherever applicable, plus health and education cess@4%.

However, where an agreement referred to in section 90(1) or section 90A(1) applies to the payee and if the payee has furnished a tax residency certificate referred to in section 90(4) or section 90A(4), as the case may be, then, tax thereon shall be deducted @20% or at the rate or rates of income-tax provided in such agreement for such income, whichever is lower.

(ii) **Time of deduction:** Tax shall be deducted at the time of credit of such income to the account of the payee or at the time of payment thereof by any mode, whichever is earlier.

Where any such income is credited to any account, whether called "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section will apply accordingly.

(iii) **Meaning of non-resident:** An individual, being a citizen of India or a person of Indian origin who is not a "resident. A person would be deemed to be of Indian origin if he, or either of his parents or any of his grandparents, was born in undivided India.

(8) Income from units [Section 196B]

The person responsible for making the following payment to an Offshore Fund shall deduct tax **@10%** plus surcharge, wherever applicable, *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof by any mode, whichever is earlier.

- income in respect of units referred to in section 115AB or
- income by way of long-term capital gains arising from the transfer of such units.

(9) Income from foreign currency bonds or shares of Indian company [Section 196C]

The person responsible for making the following payments to a non-resident has to deduct tax **@10%** plus surcharge, wherever applicable, *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof by any mode, whichever is earlier.

- income by way of interest or dividend in respect of bonds or Global Depository Receipts referred to in section 115AC or
- income by way of long-term capital gains arising from the transfer of such bonds or Global Depository Receipts.

(10) Income of foreign institutional investors and specified funds from securities [Section 196D]

(i) Applicability and rate of TDS: The person responsible for making the payment in respect of securities referred to in section 115AD(1)(a)

- to a Foreign Institutional Investor has to deduct tax **@20%** or
- to a specified fund referred to in section 10(4D) has to be deduct tax **@10%**

plus surcharge, wherever applicable**,** *plus* health and education cess@4% at the time of credit of such income to the account of the payee or at the time of payment thereof by any mode, whichever is earlier.

However, where an agreement referred to in section 90(1) or section 90A(1) applies to the Foreign Institutional Investor and if the FII has furnished a tax residency certificate referred to in section 90(4) or section 90A(4), as the case may be, then, tax thereon shall be deducted @20% or at the rate or rates of income-tax provided in such agreement for such income, whichever is lower.

Note – The enhanced rate of surcharge@25% and 37% of tax payable are **not** applicable in case of tax deductible u/s 196D on dividend income.

Surcharge and health and education cess would not be applicable to specified fund in respect of income received from securities referred to in section 115AD(1)(a)

(ii) Non-applicability of TDS: No deduction shall be made in respect of

- income by way of interest referred to in section 194LD to specified fund or FII;
- income exempt under section 10(4D) in the hands of specified fund; or
- income, by way of capital gains arising from the transfer of securities referred to in section 115AD, payable to a Foreign Institutional Investor.

The summary of withholding tax provisions relating to non-residents is given below. These provisions are discussed in detail in the following chapters mentioned in Column (4):

Section	Nature of payment	Rate of TDS	Chapter
(1)	(2)	(3)	(4)
192	Salary	Concessional rate u/s 115BAC/ normal slab rates if the individual has exercised the option to shift out of the default tax regime	13: Deduction, Collection and Recovery of Tax (Module 3)
192A	Premature withdrawal from EPF, aggregating to ₹ 50,000 or more	10%	
194B	Income by way of winnings from lotteries, crossword puzzles, card games and other games of any sort ***or from gambling or betting of any form or nature whatsoever***, ***where amt or aggregate of amts paid to a person*** > ₹ 10,000 in a F.Y.	30%	
194BA	***Income by way of winnings from any online game***	***30%***	
194BB	Income by way of winnings from horse races, ***where amt or aggregate of amts paid to a person*** > ₹ 10,000 in a F.Y.	30%	
194E	Income referred to under section 115BBA payable to non-resident sportsmen/sports association or an entertainer	20%	
194G	Commission etc. on the sale of lottery tickets, where amount payable to a person > ₹ 15,000	5%	

194LB	Interest payable by infrastructure debt fund to a non-corporate non-resident or foreign company	5%	
194LBA(2)	Distribution of any interest income, received or receivable by a business trust from a SPV, to its unit holders.	5%	10: Assessment of Trusts, Political Parties and other Special Entities (Module 2)
	Distribution of any dividend income, received or receivable by business trust from a SPV exercising option to pay tax at concessional rate under section 115BAA, to its unit holders However, if the SPV is not exercising the option to pay tax at concessional rate under section 115BAA, dividend income would be exempt in the hands of unit holders and tax would not be deductible at source.	10%	
194LBA(3)	Distribution of any income received from renting or leasing or letting out any real estate asset directly owned by the business trust, to its unit holders.	At the rates in force	
194LBB	Investment fund paying income to a unit holder [other than income which is exempt under section 10(23FBB)].		
194LBC(2)	Income in respect of investment made in a securitisation trust (specified in *Explanation* to section 115TCA)		
194LC	Interest payable by an Indian Company or a business trust to a non-corporate non-resident or foreign company - in respect of money borrowed in foreign currency from a source outside India • under a loan agreement between 1.7.2012 and 30.6.2023 or • by way of issue of long-term infrastructure bonds during the period between 1.7.2012 and 30.9.2014 • by way of issue of long term bonds (including long term infrastructure bond) between 1.10.2014 and 30.6.2023 as approved by Central Government or - in respect of money borrowed from source	5%	21: Non Resident Taxation (Module 4)

	outside India by way of rupee denominated bond on or before 30.6.2023		
	Interest payable by an Indian company or a business trust to a non-corporate non-resident or foreign company, in respect of monies borrowed by it from a source outside India by way of issue of any long-term bond or rupee denominated bond between 1.4.2020 and 30.6.2023, which is listed only on a recognised stock exchange located in any International Financial Services Centre	4%	
	Interest payable by an Indian company or a business trust to a non-corporate non-resident or foreign company, in respect of monies borrowed by it from a source outside India by way of issue of any long-term bond or rupee denominated bond on or after 1.7.2023, which is listed only on a recognised stock exchange located in any International Financial Services Centre	***9%***	
	Interest payable by an Indian company or a business trust to a non-resident, including a foreign company, in respect of rupee denominated bond issued outside India during the period from 17.9.2018 to 31.3.2019	Nil (Since such interest is exempt u/s 10(4C), no tax is deductible u/s 194LC)	
194LD	On interest payable - between 1.6.2013 and 30.6.2023 on • rupee denominated bond of an Indian Company or • Government securities or - between 1.4.2020 and 30.6.2023 on municipal debt securities to a Foreign Institutional Investor or a Qualified Foreign Investor	5%	
194N	On withdrawal of cash in excess of ₹ 1 crore ***Where the recipient is a co-operative society, the higher threshold limit of ₹ 3 crores is applicable for withdrawals***	2% on amount exceeding ₹ 1 crore	
	In case the recipient has not filed ROI for all the 3 immediately preceding P.Y.s, for which	- @2% of the sum, where	

	time limit u/s 139(1) has expired, the sum shall be the amt or agg. of amts, in cash > ₹ 20 lakh during the P.Y.	cash withdrawal > ₹ 20 lakhs ≤ ₹ 1 crore (₹ 3 crores, where the recipient is a co-operative society) - @5% of the sum, where cash withdrawal exceeds ₹ 1 crore (₹ 3 crores, where the recipient is a co-operative society)	
195	Any other sum payable to a non-resident	At the rates in force	
196A	Income on units of a mutual fund specified under section 10(23D) or from the specified company referred to in section 10(35) payable to non-corporate non-resident or foreign company. ***Where a DTAA applies to the payee and if the payee has furnished a TRC then, tax thereon shall be deducted @20% or at the rate or rates of income-tax provided in such agreement for such income, whichever is lower.***	20%	
196B	Income from units of a mutual fund or UTI purchased in foreign currency (including long term capital gain on transfer of such units) payable to an Offshore Fund	10%	
196C	Income by way of interest or dividend on bonds of an Indian company or public sector company sold by the Government and purchased by a non-resident in foreign currency or GDRs referred to in section 115AC (including long term capital gain on transfer of such bonds or GDRs) payable to a non-resident	10%	
196D	Income of foreign Institutional Investors from securities (not being income by way of interest referred to in section 194LD or capital gain arising from such securities).	20%	

	Where a DTAA applies to the payee and if the payee has furnished a TRC then, tax thereon shall be deducted @20% or at the rate or rates of income-tax provided in such agreement for such income, whichever is lower.		
	Income of specified fund from securities [not being income by way of interest referred to in section 194LD or capital gain arising from such securities or income exempt u/s 10(4D)]	10%	

Note: *In all the above cases, the rate of tax would be increased by surcharge, wherever applicable, and health and education cess @4% except in case of deduction u/s 196D on income of a specified fund.*

21.10 MISCELLANEOUS PROVISIONS

(1) Recovery of tax in respect of non-resident from his assets [Section 173]

In a case where the person entitled to the income arising from any business connection in India or from any property in India or through or from any asset or source of income in India or through the transfer of a capital asset situated in India is a non-resident, the tax chargeable thereon, whether in his name or in the name of his agent who is liable as a representative assessee, may be recovered by deduction under any of the provisions of Chapter XVII-B. Further, any arrears of tax may be recovered also in accordance with the provisions of the Income-tax Act from any assets of the non- resident which are, or may at any time come, within India. These provisions are without prejudice to the provisions of section 161(1) or of section 167.

(2) Recovery against the assessee's property in foreign countries [Section 228A]

Where an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may, if the assessee is a resident of a country (being a country with which the Central Government has entered into an agreement for the recovery of income tax under this Act and the corresponding law in force in that country) or has any property in that country, forward to the CBDT a certificate drawn up by him under section 222. Thereafter, the CBDT may take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country.

Similarly, the Government of the other country or any authority under that Government may send to the CBDT a certificate of recovery of any tax due under such corresponding law from a person having property in India and the CBDT may forward such certificate to Tax Recovery Officer having jurisdiction over the resident or within whose jurisdiction such property is situated, for recovery of such tax. Tax Recovery Officer can proceed to recover the amount specified in the Certificate by –

(a) attachment and sale of assesses movable or immovable property

(b) arrest of the assessee and his detention in prison.

(c) appointing a receiver for the management of assesses movable and immovable property.

He shall thereafter remit the sum so recovered to the CBDT.

(3) Submission of statement by a non-resident having liaison office [Section 285]

(i) A non-resident can operate in India through a branch or a liaison office set up after getting the approval of the Reserve Bank of India. Since the branch constitutes a permanent establishment of the non-resident, it has to file its return of income.

(ii) Such a non-resident is required to file a statement in the prescribed form [Form No.49C] to the Assessing Officer having jurisdiction, within 60 days from the end of the financial year, providing the details in respect of activities carried out by the liaison office in India during the financial year.

(iii) This requirement has to be complied with by every person, being a non-resident having a liaison office in India set up in accordance with the guidelines issued by the RBI under the Foreign Exchange Management Act, 1999.

(iv) The statement of a particular financial year should be filed on or before 30th May, of the succeeding financial year, in electronic form along with digital signature. For example, the statement for F.Y. 2023-24 should be filed on or before 30th May, 2024. Further, the statement is to be verified by a Chartered Accountant or by the Authorized Signatory i.e., the person authorized by the non-resident in this behalf.

(4) Furnishing of information or documents by an Indian Concern [Section 285A]

(i) There shall be a reporting obligation on the Indian concern through or in which the Indian assets are held by a foreign company or entity.

(ii) For the purposes of determination of any income accruing or arising in India under section 9(1)(i), an Indian concern has to furnish, within the prescribed period to the prescribed income-tax authority, the information or documents, in prescribed manner, if -

- any share of, or interest in, a company or an entity registered or incorporated outside India derives, directly or indirectly, its value substantially from the assets located in India, as referred to in *Explanation 5* to section 9(1)(i), and
- such company or, entity, holds, directly or indirectly, such assets in India through, or in, the Indian concern.

(iii) The information has to be furnished in Form No.49D electronically within a period of 90 days from the end of the financial year in which the transfer of such share or interest referred to above takes place. However, if the share or the interest has the effect of directly or indirectly transferring the rights of management or control in relation to the Indian concern, the information has to be furnished in Form No.49D within a period of 90 days of the transaction.

(iv) If any Indian concern fails to furnish the information or documents, the income-tax authority, as may be prescribed under the said section, may direct that such Indian concern shall pay, by way of penalty under section 271GA,—

(a) @2% of the value of the transaction in respect of which such failure has taken place, if such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern;

(b) ₹ 5,00,000 in any other case.

Note – *Rule 114DB prescribes the time limit and information or documents to be furnished under section 285A*[6].

(5) Statutory agent of non-residents [Section 163]

According to section 163, an agent, in relation to a non-resident person, includes any person in India:

(i) who is employed by or on behalf of the non-resident;

(ii) who is having any business connection with the non-resident;

(iii) from or through whom the non-resident is in receipt of any income, whether directly or indirectly;

(iv) who is trustee of the non-resident; and

any other person who (whether resident or non-resident) has acquired a capital asset in India by means of a transfer from the non-resident.

[6] For detailed reading of Rule 114DB of the Income-tax Rules, 1962, students may visit https://incometaxindia.gov.in/Pages/rules/income-tax-rules-1962.aspx

In the first four cases stated above, the person sought to be assessed as the agent of a non-resident must necessarily be in India whereas it need not be so in the fifth case. Thus, a non-resident may be treated as the agent of another non-resident. The appointment of the agent may be made any time before or after the expiry of the relevant previous year. An agent of a non-resident may be appointed under this section even if at the date of such appointment, the non-resident is not alive.

According to the proviso to this section, where transactions are carried on in the ordinary course of business through a broker in India and the broker does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker and such non-resident broker also carries on such transactions in the ordinary course of his business and not as a principal, the broker in India cannot be treated as statutory agent in respect of the income arising to the non-resident from such transactions. Thus, where *bona fide* hedging transactions take place through a broker in India and a foreign broker acting for an undisclosed principal, the Indian broker cannot be deemed to be agent of the foreign principal.

For the purposes of section 163(1), the expression "business connection" shall have the meaning assigned to it in *Explanation 2* to clause (i) of section 9(1) of the Income-tax Act, 1961. [*Explanation* to section 163(1)]

Before a person can be treated as an agent of a non-resident he must be given a reasonable opportunity of being heard by the Assessing Officer as to his liability to be so treated.

In certain cases, the income received by one person can be assessed in the hands of another. Persons who are liable to be assessed on behalf of other because of their association with the real recipient of the income are known as representative assessees.

In respect of Income of a non-resident which is deemed to accrue or arise to him in India under section 9(1), agent of a non-resident including a person who is treated as an agent under section 163 would be considered a representative assessee under section 160. As per the provisions of section 161, every representative assessee, shall be subject to the same duties, responsibilities and liabilities as the assessee and the taxes shall be levied upon and recovered from him in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him.

TEST YOUR KNOWLEDGE

Questions

1. *Peeyush, who returned to India on 12th June, 2023 for permanently residing in India after a stay of about 20 years in U.K., provides the sources of his various incomes and seeks your opinion to know about his liability to income tax thereon in India in assessment year 2024-25 assuming that he has exercised the option to shift out of the default tax regime under section 115BAC:*

   (i) *Income of rent of the flat in London which was deposited in a bank there. The flat was given on rent by him after his return to India since July, 2023.*

   (ii) *Dividends on the shares of three German Companies which are being collected in a bank account in London. He proposes to keep the dividend on shares in London with the permission of the Reserve Bank of India.*

   (iii) *He has got two sons, one of whom is of 12 years and other 19 years. Both his sons are staying in London and not returning to India with him. Each of his sons is having income of ₹ 75,000 in U.K. in foreign currency (not received in India) and of ₹ 20,000 in India.*

   (iv) *During the preceding accounting year when he was a non-resident, he had sold 1000 shares which were acquired by him in British Pound Sterling and the sale proceeds were repatriated. The profit in terms of British Pound Sterling on sale of these 1000 shares was 175% of the cost at ₹ 37,500 while in terms of Indian Rupee it was ₹ 50,000.*

2. *Mr. David, a citizen of India, serving in the Ministry of External Affairs in India, was transferred to Indian Embassy in Canada on 31.03.2023. He did not visit India any time during the previous year 2023-24. He has received the following income for the Financial Year 2023-24:*

S.No.	Particulars	₹
(i)	Salary (Computed)	5,00,000
(ii)	Foreign Allowance	4,00,000
(iii)	Interest on fixed deposit from bank in India	1,00,000
(iv)	Income from agriculture in Country X	2,00,000
(v)	Income from house property in Country X	2,50,000

Compute his gross total income for Assessment Year 2024-25.

3. *Mr. A, a citizen of India, left for USA for the purposes of employment on 1.5.2023. He has not visited India thereafter. Mr. A borrows money from his friend Mr. B, who also left India for employment purpose one week before Mr. A's departure, to the extent of ₹ 10 lakhs and buys shares in X Ltd., an Indian company. Discuss the taxability of the interest charged @10% in B's hands, if the said interest has been received in New York.*

4. *JJ Limited, a company incorporated in Australia has entered into an agreement with KK Limited, an Indian company for rendering technical services to the latter for setting up a fertilizer plant in Orissa. As per the agreement, JJ Limited rendered both off-shore services and on-shore services to KK Limited at fee of ₹ 1 crore and ₹ 1.5 crore, respectively. JJ Limited is of the view that it is not liable to tax in India in respect of fee of ₹ 1 crore as it is for rendering services outside India. Discuss the correctness of the view of JJ Limited.*

5. *Examine with reasons whether the following transactions attract income-tax in India, in the hands of recipients under section 9 of Income-tax Act, 1961:*

   (i) *A non-resident German company, which did not have a permanent establishment in India, entered into an agreement for execution of electrical work in India. Separate payments were made towards drawings & designs, which were described as "Engineering Fee". The assessee contended that such business profits should be taxable in Germany as there is no business connection within the meaning of section 9(1)(i) of the Income-tax Act, 1961.*

   (ii) *A firm of solicitors in Mumbai engaged a barrister in UK for arguing a case before Supreme Court of India. A payment of 5000 pounds was made as per terms of professional engagement.*

   (iii) *Amount paid by Government of India for use of a patent developed by Mr. A, who is a non-resident.*

   (iv) *Sai Engineering, a non-resident foreign company entered into a collaboration agreement on 25/6/2023, with an Indian Company and was in receipt of interest on 8% debentures for ₹ 20 lakhs, issued by Indian Company, in consideration of providing technical know-how utilised in its business in Mumbai during previous year 2023-24.*

6. *Z, an American tourist, comes to India for the first time on June 17, 2023. He leaves India on September 29, 2023. Determine his residential status for the assessment year 2024-25.*

Would your answer change if he is a person of Indian origin and his total income from Indian sources for A.Y.2024-25 is ₹ 16 lakhs?

7. *M/s. Global Airlines incorporated as a company in USA operated its flights to India and vice versa during the year 2023-24 (April, 2023 to March, 2024) and collected charges of ₹ 125 lakhs for carriage of passengers and cargo out of which ₹ 65 lakhs were received in New York in U.S Dollars for the passenger fare booked from New York to Mumbai. The total expenses for the year on operation of such flights were ₹ 95 lakhs. Compute the income chargeable to tax of the foreign airlines.*

8. *Atlant Italy, a company incorporated in France, was engaged in manufacture, trade and supply equipment and services for GSM Cellular Radio Telephones Systems. It supplied hardware and software to various entities in India. Software licensed by assessee embodied the process which is required to control and manage the specific set of activities involved in the business use of its customers, and also made available to its customers, who used it to carry out their business activities. The Assessing Officer contended that the consideration for supply of software embedded in hardware is 'royalty' under section 9(1)(vi).*

   Examine the correctness of the action of the Assessing Officer assuming that the software that was loaded on the hardware and embedded in the system does not have any independent existence.

9. *Singtel Ltd. is a company incorporated in Singapore and 55% of its shares are held by Godavari (P) Ltd., an Indian company. Singtel Ltd. has its presence in India also. The details relating to Singtel Ltd. for the P.Y.2023-24, are as under:*

Particulars	***India***	***Singapore***
Fixed assets at depreciated values for tax purposes (₹ in crores)	*120*	*80*
Intangible assets (₹ in crores)	*50*	*200*
Other assets (value as per books of account) (₹ in crores)	*40*	*120*
Income from trading operations (₹ in crores)	*25*	*50*
The above figure includes:		
(i) Income from transactions where purchases are from associated enterprises and sales are to unrelated parties	*2*	*4*
(ii) Income from transactions where sales are to associated enterprises and purchases are from unrelated parties	*3*	*5*

(iii) Income from transactions where both purchases and sales are from/to associated enterprises	*5*	*10*
Interest and dividend from investments (₹ in crores)	*20*	*15*
Number of employees (Residents in respective countries)	*70*	*90*
Payroll expenses on employees (₹ in crores)	*8*	*12*

Determine the residential status of Singtel Ltd. for A.Y.2024-25, if during the F.Y.2023-24, eight board meetings were held – 3 in India and 5 in Singapore.

10. STYLE Inc., a notified Foreign Institutional Investor (FII), derived the following incomes for the financial year 2023-24:-

(1) Interest received on investment in Rupee Denominated Bonds of ABC Ltd., an Indian company (investment was made in the F.Y.2022-23) - ₹ 8,50,000

(2) Dividend from listed shares of Indian companies – ₹ 6,20,000

(3) Interest on securities – ₹ 17,32,000 (Expenses of ₹ 26,000 has been incurred to earn such income)

(4) Income from sale of securities and shares:

(i) Bonds of J Ltd.
[Date of purchase 5 May, 2017; Date of sale 7 March, 2024]

Sale proceeds :	*₹ 47,00,000*
Cost of purchase :	*₹ 32,00,000*

Cost Inflation Index: F.Y.2017-18:272; F.Y.2023-24:348

(ii) Listed Shares of E Ltd.
[Date of purchase – 2 May, 2023; Date of sale – 9 February, 2024]

Sale Consideration	*₹ 12,40,000*
Purchase cost	*₹ 7,80,000*

[STT paid both at the time of purchase and sale]

(iii) Unlisted equity shares of M Ltd.
[Date of purchase – 1 July, 2023; Date of sale – 7 March, 2024]

Sale Consideration	*₹ 8,40,000*
Purchase cost	*₹ 3,72,000*

Compute the total income and tax liability of the FII, STYLE Inc., for the A.Y. 2024-25 as per section 115AD, assuming that no other income is derived by STYLE Inc. during the F.Y.2023-24.

Answers

1. Peeyush returned to India on 12th June 2023 for permanently residing in India after staying in UK for 20 years. During the P.Y.2023-24, he stays in India for 294 days. Since he has stayed in India for a period of 182 days or more during the previous year 2023-24, he would be a resident in India for the A.Y.2024-25. However, he would be a resident but not ordinarily resident, assuming that he was a non-resident in nine out of ten previous years preceding P.Y.2023-24/his stay in India during the seven previous years is less than 730 days. The residential status of Peeyush for A.Y.2024-25 is, therefore, **Resident but Not Ordinarily Resident.**

As per section 5(1), only income which is received/ deemed to be received/ accrued or arisen/ deemed to accrue or arise in India is taxable in case of a Resident but not Ordinarily Resident. Income which accrues or arises outside India shall not be included in his total income, unless it is derived from a business controlled in, or a profession set up in, India.

(i) Rental income from a flat in London which was deposited in a bank there shall not be taxable in the case of a resident but not ordinarily resident, since both the accrual and receipt of income are outside India.

(ii) Dividends from shares of three German Companies, collected in a bank account in London, would also not be taxable in the case of a resident but not ordinarily resident since both the accrual and receipt of income are outside India.

(iii) As per section 64(1A), all income accruing or arising to a minor child is includible in the hands of the parent, after providing for deduction of ₹ 1,500 per child under section 10(32).

Accordingly, income of ₹ 20,000 accruing to his minor son, aged 12 years, in India is includible in the income of Peeyush, after providing deduction of ₹ 1,500. Therefore, ₹18,500 is includible in the income of Peeyush. Income accruing to the minor child outside India (which is also received outside India) is **<u>not</u>** includible in the income of Peeyush.

Since the other son is major, his income is not includible in the income of Peeyush.

(iv) Repatriation of sale proceeds of 1000 shares sold in the preceding accounting year, when Peeyush was a non-resident, is not taxable in the A.Y.2024-25 since it is not the income of the P.Y.2023-24.

Consequently, only the income includible under section 64(1A) would form part of the total income of Mr. Peeyush for A.Y.2024-25. Since his total income (i.e., ₹ 18,500) is less than the basic exemption limit, there would be no liability to income-tax for A.Y.2024-25.

2. As per section 6(1), Mr. David is a non-resident for the A.Y. 2024-25, since he was not present in India at any time during the previous year 2023-24.

As per section 5(2), a non-resident is chargeable to tax in India only in respect of following incomes:

(i) Income received or deemed to be received in India; and

(ii) Income accruing or arising or deemed to accrue or arise in India.

In view of the above provisions, income from agriculture in Country X and income from house property in Country X would not be chargeable to tax in the hands of David, assuming that the same were received in Country X.

Income from 'Salaries' payable by the Government to a citizen of India for services rendered outside India is deemed to accrue or arise in India as per section 9(1)(iii). Hence, such income is taxable in the hands of Mr. David, even though he is a non-resident. However, allowances or perquisites paid or allowed as such outside India by the Government to a citizen of India for rendering service outside India is exempt under section 10(7). Hence, foreign allowance of ₹ 4,00,000 is exempt under section 10(7).

Gross Total Income of Mr. David for A.Y. 2024-25

Particulars	₹
Salaries	5,00,000
Income from other sources (Interest on fixed deposit in India)	1,00,000
Gross Total Income	**6,00,000**

3. An individual is said to be resident in India in any previous year, if he -

(i) has been in India during that year for a total period of 182 days or more, or

(ii) has been in India during the four years immediately preceding that year for a total period of 365 days or more and has been in India for at least 60 days in that year.

In the case of an Indian citizen leaving India for the purposes of employment outside India during the previous year, the period of stay during the previous year in condition (ii) above, to qualify as a resident, would be 182 days instead of 60 days.

In this case, Mr. A is an Indian citizen who left India for employment outside India on 01.05.2023. Mr. A has been in India only from 1.4.2023 to 01.05.2023 i.e. for 31 days. Since his stay in India during the previous year 2023-24 is only 31 days, he does not satisfy the minimum criterion of 182 days stay in India for being a resident. Hence, his residential status for A.Y. 2024-25 is non-resident. Mr. B, who left India one week before A's departure, is also a non-resident for the same reasons.

Section 9(1)(v) provides that income by way of interest payable by a non-resident in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India shall be deemed to accrue or arise in India.

Therefore, interest payable by a non-resident in respect of any debt incurred, or moneys borrowed and used, for the purpose of making or earning any income from any source other than a business or profession carried on by him in India, shall **not** be deemed to accrue or arise in India. Therefore, interest payable by Mr. A on money borrowed from Mr. B to invest in shares of an Indian company shall **not** be deemed to accrue or arise in India and hence, is not taxable in India in the hands of Mr. B.

4. The *Explanation* below section 9(2) clarifies that income by way of, *inter alia*, fees for technical services from services utilized in India would be deemed to accrue or arise in India under section 9(1)(vii) in case of a non-resident and be included in his total income, whether or not such services were rendered in India.

In this case, the technical services rendered by the foreign company, JJ Ltd., were for setting up a fertilizer plant in Orissa. Therefore, the services were utilized in India. Consequently, as per the *Explanation* below section 9(2), the fee of ₹ 2.5 crore for technical services rendered by JJ Ltd. (both off-shore and on-shore services) to KK Ltd. is deemed to accrue or arise in India and includible in the total income of JJ Ltd.

Therefore, the view of JJ Ltd. that it is not liable to tax in India in respect of fee of ₹ 1 crore (as it is for rendering services outside India) is **not** correct.

5. **(i)** Fees for technical services is taxable under section 9(1)(vii). In this case, the separate payments made towards drawings and designs (described as "engineering fee") are in the nature of fee for technical services and, therefore, it is taxable in India by virtue of section 9(1)(vii), since the services are utilized for execution of electrical work in India *[Aeg Aktiengesllschaft v. CIT (2004) 267 ITR 209 (Kar.)].*

As per *Explanation* below section 9(2), where income is deemed to accrue or arise in India under section 9(1)(vii), such income shall be included in the total income of the non-resident German company, regardless of whether it has a residence or place of business or business connection in India.

(ii) As per section 9(1)(i), all income accruing or arising, whether directly or indirectly, through or from any business connection in India is deemed to accrue or arise in India.

In this case, there was a professional connection between the firm of solicitors in Mumbai and the barrister in UK. The expression "business" includes not only trade and manufacture; it includes, within its scope, "profession" as well. Therefore, the existence of professional connection amounts to existence of "business connection" under section 9(1)(i). It was so held by the Supreme Court in *Barendra Prasad Roy v. ITO (1981) 129 ITR 295.*

Hence, the amount of 5,000 pounds paid to the barrister in UK as per the terms of the professional engagement constitutes income which is deemed to accrue or arise in India under section 9(1)(i). Hence, it is taxable in India.

(iii) As per section 9(1)(vi), income by way of royalty payable by the Government of India is deemed to accrue or arise in India. "Royalty" means consideration for, *inter alia*, use of patent. Therefore, the amount paid by Government of India for use of patent developed by Mr. A, a non-resident, is deemed to accrue or arise in India. Hence, it is taxable in India in the hands of Mr. A.

(iv) ₹ 20 lakhs, being the value of debentures issued by an Indian company in consideration of providing technical know-how for use in its business in India, is in the nature of fee for technical services, deemed to accrue or arise in India to Sai Engineering, a non-resident foreign company, under section 9(1)(vii). Hence, it is taxable in India.

Further, as per section 9(1)(v), income by way of interest payable by a person who is a resident of India is deemed to accrue or arise in India. Therefore, interest income from debentures of an Indian company is deemed to accrue or arise in

India in the hands of Sai Engineering by virtue of section 9(1)(v). Hence, it is taxable in India.

Note – *Since the question specifically requires the candidates to examine the taxability of the above transactions under section 9, the provisions of double taxation avoidance agreement, if any, applicable in the above cases, have not been taken into consideration.*

6. Previous year 2023-24: 105 [14+31+31+29]

Previous year 2022-23: Nil

Previous year 2021-22: Nil

Previous year 2020-21: Nil

Previous year 2019-20: Nil

He is non-resident for the assessment year 2024-25 as he does not satisfy either of the basic conditions.

Even if he is a person of Indian origin whose total income from Indian sources exceeds ₹15 lakhs, he would still be a non-resident for A.Y.2024-25. For becoming a resident but not ordinarily resident, he should have stayed in India for atleast 120 days in the previous year 2023-24 and 365 days in four immediately preceding previous years. Since his stay in India in the P.Y.2023-24 is less than 120 days, he would be **non-resident** in India for A.Y.2024-25.

7. As per section 44BBA, in case of a non-resident engaged in the business of operation of aircraft, 5% of the following amounts would be deemed to be the profits and gains from such business:

(a) paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods from any place in India; and

(b) received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods from any place outside India.

In the present case, the income chargeable to tax of M/s Global Airlines applying the provisions of section 44BBA are as follows:

Particulars	Fare booked from India to outside India whether received in India or not (₹)	Fare booked from New York to Mumbai and received outside India (₹)
Fare	60,00,000 (1,25,00,000 – 65,00,000)	65,00,000
Deemed income @5% u/s 44BBA	3,00,000 (60,00,000 × 5%)	Nil (since the amount not received in India)

8. The issue under consideration in this case is whether consideration for supply of software embedded in hardware would tantamount to 'royalty' for attracting deemed accrual of income under section 9(1)(vi).

As per section 9(1)(vi), income by way of royalty payable by a person who is a resident in India would be deemed to accrue or arise in India. However, where it is payable for the transfer of any right or the use of any property or information or for the utilization of services 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, the amount payable by way royalty would not be deemed to accrue or arise in India, in the hands of non-resident.

For this purpose, 'royalty' includes transfer of all or any right for use or right to use a computer software irrespective of the medium through which such right is transferred.

The facts of the case are similar to the facts in *CIT v. Alcatel Lucent Canada (2015) 372 ITR 476*, wherein the above issue came up before the Delhi High Court. The Court observed that the software supply is an integral part of GSM mobile telephone system and is used by the cellular operators for providing cellular services to its customers. Where payment is made for hardware in which the software is embedded and the software does not have independent functional existence, no amount could be attributed as 'royalty' for software in terms of section 9(1)(vi).

In this case, since the software that was loaded on the hardware and embedded in the system does not have any independent existence, there could not be any independent use of such software. Therefore, the rationale of the Delhi High Court ruling can be applied to the case on hand. Accordingly, the action of the Assessing Officer in treating the consideration for supply of software embedded in hardware as royalty under section 9(1)(vi) is **not** correct.

9. The residential status of a foreign company is determined on the basis of place of effective management (POEM) of the company.

For determining the POEM of a foreign company, the important criteria is whether the company is engaged in active business outside India or not.

A company shall be said to be engaged in "**Active Business Outside India"** (ABOI) for POEM, 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.

Singtel Ltd. shall be regarded as a company engaged in active business outside India for P.Y.2023-24 for POEM purpose only if it satisfies all the four conditions cumulatively.

Condition 1: The passive income of Singtel Ltd. should not be more than 50% of its total income

Total income of Singtel Ltd. during the P.Y. 2023-24 is ₹ 110 crores [(₹ 25 crores + ₹ 50 crores) + (₹ 20 crores + ₹ 15 crores)]

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;

Passive Income of Singtel Ltd. is ₹ 50 crores, being sum total of :

(i) ₹ 15 crores, income from transactions where both purchases and sales are from/to associated enterprises (₹ 5 crores in India and ₹ 10 crores in Singapore)

(ii) ₹ 35 crores, being interest and dividend from investment (₹ 20 crores in India and ₹ 15 crores in Singapore)

Percentage of passive income to total income = ₹ 50 crore/ ₹ 110 crore x 100 = 45.45%

Since passive income of Singtel Ltd. **is 45.45%, which is not more than 50%** of its total income, the first condition is satisfied.

<u>Condition 2: Singtel Ltd. should have less than 50% of its total assets situated in India</u>

Value of total assets of Singtel Ltd. during the P.Y. 2023-24 is ₹ 610 crores [₹ 210 crores, in India + ₹ 400 crores, in Singapore]

Value of total assets of Singtel Ltd. in India during the P.Y. 2023-24 is ₹ 210 crores

Percentage of assets situated in India to total assets = ₹ 210 crores/₹ 610 crores x 100 = 34.43%

Since the value of assets of Singtel Ltd. **situated in India is less than 50%** of its total assets, the second condition for ABOI test is satisfied.

<u>Condition 3: Less than 50% of the total number of employees of Singtel Ltd. should be situated in India or should be resident in India</u>

Number of employees situated in India or are resident in India is 70

Total number of employees of Singtel Ltd. is 160 [70 + 90]

Percentage of employees situated in India or are resident in India to total number of employees is 70/160 x 100 **= 43.75%**

Since employees situated in India or are residents in India of Singtel Ltd. **are less than 50%** of its total employees, the third condition for ABOI test is satisfied.

<u>Condition 4: The payroll expenses incurred on employees situated in India or resident in India should be less than 50% of its total payroll expenditure</u>

Payroll expenses on employees employed in and resident of India = ₹ 8 crores.

Total payroll expenses = ₹ 20 crores (₹ 8 crores + ₹ 12 crores)

Percentage of payroll expenses of employees situated in India or are resident in India to the total payroll expenses = 8 x 100/20 = 40%

Since the payroll expenses incurred on employees situated in India or resident in India **is less than 50% of its total payroll expenditure**, the fourth condition for ABOI test is also satisfied.

Thus, since Singtel Ltd. has satisfied all the four conditions, the company would be said to be engaged in "active business outside India" during the P.Y. 2023-24.

POEM of a company engaged in active business outside India shall be presumed to be outside India, if the majority of the board meetings are held outside India.

Since Singtel Ltd. is engaged in active business outside India in the P.Y. 2023-24 and majority of its board meetings i.e., 5 out of 8, were held outside India, POEM of Singtel Ltd. would be outside India.

Therefore, Singtel Ltd. would be non-resident in India for the P.Y. 2023-24.

10. Computation of total income of STYLE Inc., a notified FII, for A.Y.2024-25

Particulars	₹	₹
Interest on Rupee Denominated Bonds	8,50,000	
Dividend income	6,20,000	
Interest on securities [No deduction is allowable in respect of expenses incurred in respect thereof]	17,32,000	32,02,000
Long-term capital gains on sale of bonds of J Ltd.		
Sale consideration	47,00,000	
Less: Cost of acquisition	32,00,000	15,00,000
[Benefit of indexation is not allowable]		
Short-term capital gains on sale of STT paid equity shares of E Ltd.		
Sale consideration	12,40,000	
Less: Cost of acquisition	7,80,000	4,60,000
Short-term capital gains on sale on unlisted equity shares of M Ltd.		
Sale consideration	8,40,000	
Less: Cost of acquisition	3,72,000	4,68,000
Total Income		**56,30,000**

Computation of tax liability of STYLE Inc. for A.Y.2024-25

Particulars	₹
Tax@5% on interest of ₹ 8,50,000 received from an Indian company on investment in rupee denominated bonds = 5% x ₹ 8,50,000	42,500
Tax@20% on interest on securities and dividend =20% x ₹ 23,52,000	4,70,400

Tax@10% on long-term capital gains on sale of bonds of J Ltd. = 10% x ₹ 15,00,000	1,50,000
Tax @ 15% on short-term capital gains on sale of listed equity shares of E Ltd., in respect of which STT has been paid = 15% of ₹ 4,60,000	69,000
Tax @ 30% on short-term capital gains on sale of unlisted equity shares of M Ltd. = 30% of ₹ 4,68,000	1,40,400
	8,72,300
Add: HEC@4%	34,892
Tax liability	**9,07,192**
Tax liability (rounded off)	**9,07,190**

NOTES

CHAPTER 22

DOUBLE TAXATION RELIEF

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the need for double taxation relief;
- **appreciate** the types of double taxation relief available;
- **comprehend and apply** the provisions relating to double taxation relief contained in the Income-tax Act, 1961 and Income-tax Rules, 1962 in problem solving and addressing related issues;
- **comprehend** the procedure for claiming deduction where there is no double taxation avoidance agreement between India and the other country where the income has been taxed and **compute** the amount of deduction;
- **appreciate** the concept of Permanent Establishment under double taxation avoidance agreements and its relevance.

22.1 CONCEPT OF DOUBLE TAXATION RELIEF

In the present era of cross-border transactions across the globe, the effect of taxation is one of the important considerations for any trade and investment decision in other countries. One of the most significant results of globalisation is the visible impact of one country's domestic tax policies on the economy of another country. This has led to the need for continuously assessing the tax regimes of various countries and bringing about necessary reforms.

Where a taxpayer is resident in one country but has a source of income situated in another country it gives rise to possible double taxation. This arises from the two basic rules that enables the country of residence as well as the country where the source of income exists to impose tax namely, (i) the source rule and (ii) the residence rule.

Source rule of taxation

The source rule holds that income is to be taxed in the country in which it originates irrespective of whether the income accrues to a resident or a non-resident.

Residence rule of taxation

The residence rule stipulates that the power to tax should rest with the country in which the taxpayer resides.

If both rules apply simultaneously to a business entity and it were to suffer tax at both ends, the cost of operating on an international scale would become prohibitive and would deter the process of globalisation. It is from this point of view that Double Taxation Avoidance Agreements (DTAA) become very significant.

DTAAs lay down the allocation rules for taxation of the income by the source country and the residence country. Such rules are laid for various categories of income, for example, interest, dividend, royalties, capital gains, business income etc. Each such category is dealt with by separate article in the DTAA.

Double taxation means taxing the same income twice in the hands of an assessee. A particular income may be taxed in India in the hands of a person based on his/its residence. However, the same income may be taxed in his/its hands in the Source Country also, as per the domestic laws of that country. This gives rise to double taxation. It is a universally accepted principle that the same income should not be subjected to tax twice. In order to take care of such situations, the Income-tax Act, 1961 has provided for double taxation relief.

22.2 TYPES OF RELIEF

Relief from double taxation can be provided in mainly two ways:

Relief

- Bilateral
- Unilateral

(1) **Bilateral Relief**

Under this method, the Governments of two countries can enter into an agreement to provide relief against double taxation by mutually working out the basis on which the relief is to be granted. India has entered into agreements for relief against or avoidance of double taxation with almost 100 countries which include Sri Lanka, Switzerland, Sweden, Denmark, Japan, Federal Republic of Germany, Greece, etc.

Bilateral Relief may be granted in either one of the following methods:

Exemption Method

- A particular income is taxed in only one of the two countries.

Tax Credit Method

- Income is taxable in both countries in accordance with their respective tax laws read with double taxation avoidance agreement.
- The country of residence of the tax payer, however, allows him credit for the tax charged thereon in the country of source.

India follows credit method in majority of its DTAAs.

(2) **Unilateral Relief**

This method provides for double taxation relief unilaterally by a country to its resident for the taxes paid in the other country, even where no DTAA has been entered into with that country. India grants unilateral relief through credit method under section 91 to its residents for taxes paid in the country, with which India has not signed DTAA.

India has introduced foreign tax credit rules under Rule 128 which allows for granting credit to resident Indians for taxes paid in the other country.

22.3 DOUBLE TAXATION RELIEF PROVISIONS UNDER THE INCOME TAX ACT, 1961

Sections 90 and 91 of the Income-tax Act, 1961 provide for double taxation relief in India.

(1) Agreement with foreign countries or specified territories - Bilateral relief [Section 90]

(i) Section 90(1) provides that the Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

(a) for the granting of relief in respect of—

(i) income on which income-tax has been paid both in India and in that country or specified territory; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment; or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory); or

Accordingly, the Central Government has notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement *[Notification No. 91/2008, dated 28.8.2008]*.

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance; or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory.

The Central Government may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(ii) Where the Central Government has entered into such an agreement with the Government of any country outside India or specified territory outside India for granting relief of tax, or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

(iii) However, the provisions of Chapter X-A, General Anti-Avoidance Rule, shall apply to the assessee even if such provisions are not beneficial to him.

(iv) **Meaning of terms used in any DTAA with a foreign country or specified territory**

	Particulars	Meaning of the term
(1)	Term used in any DTAA with a foreign country or specified territory, and not defined in the agreement or the Act but assigned a meaning in the notification issued by the Central Government in the Official Gazette, which is still in force.	The term shall have the meaning assigned in the said notification and the meaning shall be deemed to have effect from the date on which the DTAA came into force.
(2)	Term used in any DTAA with a foreign country or specified territory, which is defined in the DTAA itself.	The term shall have the same meaning assigned to it in the DTAA.
(3)	Term used in any DTAA with a foreign country or specified territory, which is not defined in the said DTAA, but defined in the Income-tax Act, 1961.	The term shall have the meaning assigned to it in the Income-tax Act, 1961 and explanation, if any, given to it by the Central Government.

(v) The DTAAs under section 90 are intended to provide relief to the taxpayer, who is resident of one of the Contracting States to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a Contracting State also resorted to claiming the benefits under the agreement entered into by the Indian Government with the

Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, section 90(4) provides that the non-resident to whom the agreement referred to in section 90(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory, is furnished declaring his residence of the country outside India or the specified territory outside India, as the case may be. Also, section 90(1)(b) provides that treaties shall not be used for claiming reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory).

(vi) A certificate issued by the Government of a foreign country would constitute proof of tax residency, without any further conditions regarding furnishing of "prescribed particulars" therein. In addition to such certificate issued by the foreign Government, the assessee would be required to provide such other documents and information, as may be prescribed, for claiming the treaty benefits..

(vii) The charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

(viii) *Circular No. 333 dated 2.4.1982*, issued by CBDT provides that a specific provision of the DTAA will prevail over the general provisions of the Income-tax Act, 1961. However, where there is no specific provision in the treaty, then the Income-tax Act will apply. Generally, DTAA only provides for distribution of taxing rights between the residence and the source state. The computation mechanism is usually not provided under DTAA and the same is governed by the domestic tax law of each country.

(ix) *Notification No. 91/2008 dated 28.8.2008* issued by CBDT states that any income of a resident of India which "may be taxed" in the other country (Source Country) as per the DTAA shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961. Thereafter, relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

Tax treaties are generally based on certain models. The most common ones are:

Model Tax Conventions

- OECD Model Tax Convention
- U.N. Model Tax Convention

These model tax conventions will be discussed in detail in Chapter 27 "Overview of Model Tax Conventions".

ILLUSTRATION 1

Examine the correctness or otherwise of the following statement with reference to the provisions of Income-tax Act, 1961.

The double taxation avoidance treaties entered into by the Government of India override the domestic law.

SOLUTION

The statement is correct.

Section 90(2) provides that where a double taxation avoidance treaty is entered into by the Government, the provisions of the Income-tax Act, 1961 would apply to the extent they are more beneficial to the assessee.

In case of any conflict between the provisions of the double taxation avoidance agreement and the Income-tax Act, 1961, the provisions of the DTAA would prevail over the Act in view of the provisions of section 90(2), to the extent they are more beneficial to the assessee [*CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654 (SC)].*

(2) Double taxation relief to be extended to agreements between specified associations adopted by the Central Government [Section 90A]

(i) Section 90A provides that any specified association in India may enter into an agreement with any specified association in the specified territory outside India and the Central Government may, by notification in the Official Gazette, make the necessary provisions for adopting and implementing such agreement for -

(a) grant of double taxation relief,

(b) avoidance of double taxation of income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory),

(c) exchange of information for the prevention of evasion or avoidance of income- tax, or

(d) recovery of income-tax.

Section 90A(1) provides that an agreement may be entered into by any specified association in India with any specified association in the specified territory outside India which may be adopted by the Central Government by way of notification in the Official Gazette, for granting relief of tax or, as the case may be, for avoidance of double taxation.

The Central Government has, vide *Notification No.90/2008 dated 28.8.2008*, notified that where such an agreement provides that any income of a resident of India may be taxed in the other country then, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

(ii) In relation to any assessee to whom the said agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

(iii) However, the provisions of Chapter X-A, General Anti-avoidance rule, shall apply to the assesse even if such provisions are not beneficial to him.

(iv) **Meaning of terms used in any agreement which any specified association in India may enter into with any specified association in the specified territory outside India for double taxation relief**

	Particulars	Meaning of the term
(1)	Term used in any such agreement, and not defined in the agreement or the Act but assigned a meaning in the notification issued by the Central Government in the Official Gazette, which is still in force	The term shall have the meaning assigned in the said notification and the meaning shall be deemed to have effect from the date on which the agreement came into force.
(2)	Term used in any such agreement, which is defined in the agreement itself	The term shall have the same meaning assigned to it in the said agreement

(3)	Term used in any such agreement, which is not defined in the said agreement, but defined in the Income-tax Act, 1961	The term shall have the meaning assigned to it in the Income-tax Act, 1961 and explanation, if any, given to it by the Central Government

(v) The DTAAs under section 90A are intended to provide relief to the taxpayer, who is resident of one of the Contracting States to the agreement. Such tax payer can claim relief by applying the beneficial provisions of either the treaty or the domestic law. However, in many cases, taxpayers who were not residents of a Contracting State also resorted to claiming the benefits under the agreement entered into by the Indian Government with the Government of the other country. In effect, third party residents claimed the unintended treaty benefits.

Therefore, section 90A(4) provides that the non-resident to whom the agreement referred to in section 90A(1) applies, shall be allowed to claim the relief under such agreement if a Tax Residence Certificate (TRC) obtained by him from the Government of that country or specified territory is furnished, declaring his residence of the country outside India or the specified territory outside India, as the case may be. Also, section 90A(1)(b) provides that treaties shall not be used for claiming reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory).

(vi) A certificate issued by the Government of a foreign country would constitute proof of tax residency, without any further conditions regarding furnishing of "prescribed particulars" therein. In addition to such certificate issued by the foreign Government, section 90A(5) requires the assessee to provide such other documents and information, as may be prescribed, for claiming the treaty benefits.

Documents and information, to be furnished by the assessee for claiming treaty benefits, prescribed by CBDT vide *Notification No. 57/2013 dated 01.08.2013*:

(i) Status (individual, company, firm etc.) of the assessee;

(ii) Nationality (in case of an individual) or country or specified territory of incorporation or registration (in case of others);

(iii) Assessee's tax identification number in the country or specified territory of residence and in case there is no such number, then, a unique number on the basis of which the person is identified by the Government of the country or the specified territory of which the assessee claims to be a resident;

(iv) Period for which the residential status, as mentioned in the certificate referred to in section 90(4) or section 90A(4), is applicable; and

(v) Address of the assessee in the country or specified territory outside India, during the period for which the certificate, as mentioned in (iv) above, is applicable.

However, the assessee may not be required to provide the information or any part thereof, if the information or the part thereof, as the case may be, is already contained in the TRC referred to in section 90(4) or section 90A(4).

The assessee shall keep and maintain such documents as are necessary to substantiate the information provided. An income-tax authority may require the assessee to provide the said documents in relation to a claim by the said assessee of any relief under an agreement referred to in section 90(1) or section 90A(1), as the case may be.

(vii) The charge of tax at a higher rate for a company incorporated in the specified territory outside India as compared to a domestic company would not be considered as less favourable charge or levy of tax in respect of such company.

(viii) For the purpose of this section, the 'specified association' means any institution, association or body, whether incorporated or not, functioning under any law for the time being in force in India or the laws of the specified territory outside India and which may be notified as such by the Central Government and 'specified territory' means any area outside India which may be notified by the Central Government.

(3) Countries with which no agreement exists – Unilateral Agreements [Section 91]

In the case of income arising to an assessee in countries with which India does not have any double taxation agreement, relief would be granted under Section 91 provided all the following conditions are fulfilled:

(a) The assessee is a resident in India during the previous year in respect of which the income is taxable.

(b) The income accrues or arises to him outside India.

(c) The income is not deemed to accrue or arise in India during the previous year.

(d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee.

(e) The assessee has paid tax on the income in the foreign country.

(f) There is no agreement for relief from double taxation between India and the other country where the income has accrued or arisen.

In such a case, the assessee shall be entitled to a deduction from the Indian income-tax payable by him. The deduction would be a sum calculated on such doubly taxed income at the Indian rate of tax or the rate of tax in the said country, whichever is lower, or at the Indian rate of tax if both the rates are equal.

Meaning of important terms:

(i) "Indian rate of tax" means the rate determined by dividing the amount of Indian income-tax after deduction of any relief due under the provisions of the Act but before deduction of any double taxation relief due to the assessee.

(ii) "Rate of tax of the said country" means income-tax and super-tax actually paid in that country in accordance with the corresponding laws in force in the said country after deduction of all relief due, but before deduction on account of double taxation relief due in the said country, divided by the whole amount of income assessed in the said country.

(iii) The expression "income-tax" in relation to any country includes any excess profits tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

ILLUSTRATION 2

Nandita, an individual resident retired employee of the Prasar Bharati aged 60 years, is a well-known dramatist deriving income of ₹ 1,10,000 from theatrical works played abroad. Tax of ₹ 11,000 was deducted in the country where the plays were performed. India does not have any Double Tax Avoidance Agreement under section 90 of the Income-tax Act, 1961, with that country. Her income in India amounted to ₹ 6,10,000. In view of tax planning, she has deposited ₹ 1,50,000 in Public Provident Fund and paid contribution to approved Pension Fund of LIC ₹ 32,000. She also contributed ₹ 28,000 to Central Government Health Scheme during the previous year and gave payment of medical insurance premium of ₹ 26,000 to insure the health of her mother, a non-resident aged 84 years, who is not dependent on her. Compute the tax liability of Nandita for the Assessment year 2024-25, assuming that she opted out of the default tax regime under section 115BAC.

SOLUTION

Computation of tax liability of Nandita for the A.Y. 2024-25 under normal provisions of the Act

Particulars	₹	₹
Indian Income		6,10,000
Foreign Income		1,10,000
Gross Total Income		**7,20,000**
Less: **Deduction under section 80C**		
Deposit in PPF	1,50,000	
Under section 80CCC		
Contribution to approved Pension Fund of LIC	32,000	
	1,82,000	
Under section 80CCE		
The aggregate deduction under section 80C, 80CCC and 80CCD(1) has to be restricted to ₹ 1,50,000	1,50,000	
Under section 80D		
Contribution to Central Government Health Scheme ₹ 28,000 is also allowable as deduction under section 80D. Since she is a resident senior citizen, the deduction is allowable to a maximum of ₹ 50,000 **(See Note 1)**	28,000	
Medical insurance premium of ₹ 26,000 paid for mother aged 84 years. Since the mother is a non-resident in India, she will not be entitled for the higher deduction of ₹ 50,000 eligible for a senior citizen, who is resident in India. Hence, the deduction will be restricted to maximum of ₹ 25,000.	25,000	2,03,000
Total Income		**5,17,000**
Tax on Total Income		
Income-tax (See Note below)		13,400
Add: Health and Education Cess @4%		536
		13,936
Average rate of tax in India	2.696%	
(i.e. ₹ 13,936/ ₹ 5,17,000 × 100)		
Average rate of tax in foreign country	10%	
(i.e. ₹ 11,000/ ₹ 1,10,000 ×100)		
Deduction under section 91 on ₹ 1,10,000 @ 2.696% (lower of average Indian-tax rate or average foreign tax rate)		2,966
Tax payable in India (₹ 13,936 – ₹ 2,966)		**10,970**

Notes:

1. Section 80D allows a higher deduction of up to ₹ 50,000 in respect of the medical premium paid to insure the heath of a senior citizen. Therefore, Nandita will be allowed deduction of ₹ 28,000 under section 80D, since she is a resident Indian of the age of 60 years.

2. The basic exemption limit for senior citizens under the normal provisions of the Act is ₹ 3,00,000 and the age criterion for qualifying as a "senior citizen" for availing the higher basic exemption limit is 60 years. Accordingly, Nandita is eligible for the higher basic exemption limit of ₹ 3,00,000, since she is 60 years old.

3. An assessee shall be allowed deduction under section 91 provided all the following conditions are fulfilled:-

   (a) The assessee is a resident in India during the relevant previous year.

   (b) The income accrues or arises to him outside India during that previous year.

   (c) Such income is not deemed to accrue or arise in India during the previous year.

   (d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and the assessee has paid tax on such income in the foreign country.

   (e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.

   In this case, since all the above conditions are satisfied, Nandita is eligible for deduction u/s 91.

(4) Foreign Tax Credit [Rule 128 of Income-tax Rules, 1962]

(i) Year of availability of credit for foreign tax paid

An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule.

However, in a case where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.

(ii) Meaning of "Foreign tax":

	Country/Specified Territory	Foreign Tax
(i)	in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A	the tax covered under the said agreement
(ii)	in respect of any other country or specified territory outside India	the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in section 91. For this purpose, income-tax in relation to any country includes any excess profits tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

(iii) Components of income-tax in respect of which FTC is available

Foreign Tax Credit (FTC) is available against the amount of tax, surcharge and cess payable under the Income-tax Act, 1961. However, it is not available in respect of any sum payable by way of interest, fee or penalty.

(iv) Manner of computing FTC

The credit of foreign tax would be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:-

(a) the credit would be the lower of the tax payable under the Income-tax Act, 1961 on such income and the foreign tax paid on such income.

However, where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess has to be ignored.

(b) the credit would be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.

Note *– Students are advised to refer to Rule 128 of Income-tax Rules, 1961 given as Annexure 2 at the end of this module.*

Summary

DT Relief under the Income-tax Act, 1961

Bilateral Relief [Section 90/90A]

Agreement with foreign countries or specified territories

Objective

- **The Central Government may enter into an agreement with the Government of any country outside India or specified territory or specified assn outside India,—**
  - for the granting of relief in respect of doubly taxed income
  - for the avoidance of double taxation of income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance
  - for exchange of information for the prevention of evasion or avoidance of income-tax
  - for recovery of income-tax

Taxability

- Taxability of income would be detd based on DTAA or the Income-tax Act, 1961, whichever is more beneficial.

Charge of tax on foreign Company

- The charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.

Tax Residency Certificate (TRC)

- In order to claim DT relief, the non-resident to whom such DTAA applies, has to obtain a TRC from the Government of that country or specified territory.
- The non-resident to also provide such other documents and information, as may be prescribed, for claiming treaty benefits.

Unilateral Relief [Section 91]

Countries with which no agreement exists

Applicability

- Assessee, who is a resident in India during the PY

Conditions

- The income accrues or arises to him outside India.
- The income is not deemed to accrue or arise in India during the PY.
- The income in question has been subjected to income-tax in the foreign country in the hands of the assessee.
- The assessee has paid tax on the income in the foreign country.
- There is no agrmt for relief from DT between India and the other country where the income has accrued or arisen.

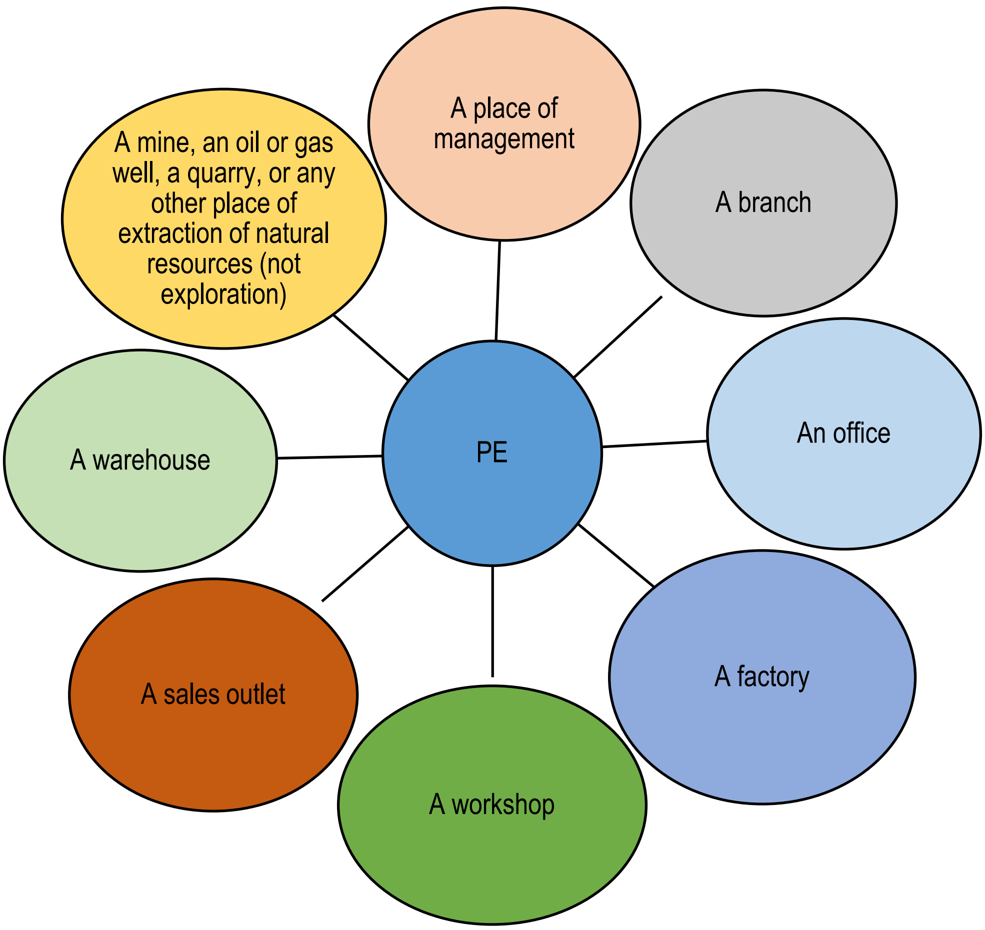
Computation of Relief

- Doubly taxed income **x** Indian rate of tax or Rate of tax in the said country, whichever is lower

22.4 CONCEPT OF PERMANENT ESTABLISHMENT

Under the Income-tax Act, 1961, the taxability of business profits is determined by existence of business connection in India under section 9(1)(i). Under the DTAA, taxability of business profits is determined by existence of a Permanent Establishment (PE) in India. It may be noted that the scope of business connection under section 9(1)(i) is wider than that of a PE. Article 5(1) of the DTAA usually provides that for the purpose of this convention, the term 'Permanent Establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term PE is also defined under section 92F(iiia) to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

According to Article 5(2), the term PE includes

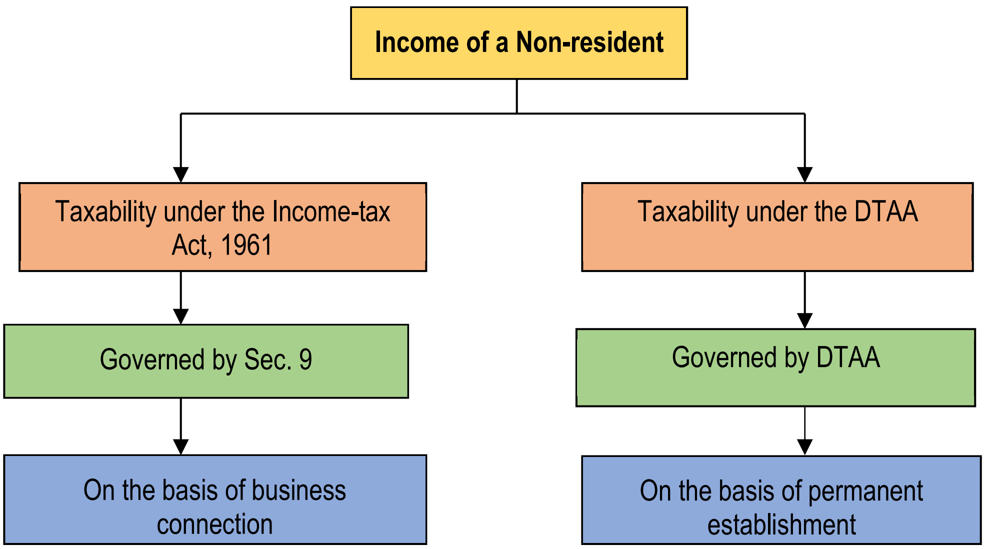


(1) Permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

(2) Every DTAA has a specific clause, which will deal with an explanation of permanent establishment for the purpose of such DTAA.

(3) Business Income of a non-resident will not be taxed in India, unless such non-resident has a permanent establishment in India.

(4) Taxability of income under business connection and permanent establishment is explained here below:



(5) **Liaison Office – Does it constitute a PE?**

(i) **Liaison Office engaged in remittance services** - In *Union of India v. UAE Exchange Center (2020) 425 ITR 30*, the Supreme Court held that an Indian liaison office of a foreign enterprise engaged in remittance services would **not** constitute a PE. In this case, no permission was given by RBI to the assessee to engage in primary business activity and establish a business connection. The liaison office downloads information (such as names and addresses of beneficiaries, amount to be remitted, etc.) by accessing the main servers of assessee in UAE, prints cheques/draft and dispatches them to the addresses of beneficiaries through courier. The Supreme Court held that even if the activities of LO are regarded as business activities, they were of preparatory or auxiliary character.

(ii) **Liaison Office as Communication Channel -** In *DIT (International Taxation) v. Samsung Heavy Industries Ltd. (2020) 426 ITR 1 (SC)*, the project office was set up solely as an auxiliary office meant to act as liaison office between ONGC and the assessee. No expenditure relating to execution of contract was incurred by the project office. Only two persons were working in the project office and they were not qualified to perform any core activity of the assessee. Therefore, the Supreme Court held that the project office is not a fixed place of business through which core business of assessee is carried on, and hence, the same would **not** constitute a PE.

Identifying new customers, marketing activities, price negotiation, discussion of commercial issues, securing and processing orders have led to the liaison office forming a PE.

22.5 TAXATION OF BUSINESS PROCESS OUTSOURCING UNITS IN INDIA

The provisions containing taxation of IT-enabled business process outsourcing units are not contained in the Income-tax Act, 1961 but are given in *Circular No.5/2004 dated 28.9.2004* issued by CBDT. The provisions are briefed hereunder –

(a) A non-resident entity may outsource certain services to a resident Indian entity. If there is no business connection between the two, the resident entity may not be a Permanent Establishment of the non-resident entity, and the resident entity would have to be assessed to income-tax as a separate entity. In such a case, the non-resident entity will not be liable under the Income-tax Act, 1961.

(b) However, it is possible that the non-resident entity may have a business connection with the resident Indian entity. In such a case, the resident Indian entity could be treated as the Permanent Establishment of the non-resident entity.

(c) The non-resident entity or the foreign company will be liable to tax in India only if the IT enabled BPO unit in India constitutes its Permanent Establishment.

(d) A non-resident or a foreign company is treated as having a Permanent Establishment in India if the said non-resident or foreign company carries on business in India through a branch, sales office etc. or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the Permanent Establishment becomes taxable in India.

(e) If a foreign enterprise carries on business in another country through a Permanent Establishment situated therein, the profits of the enterprise may be taxed in the other country but only so much of them as is attributable to the Permanent Establishment.

(f) Profits are to be attributed to the Permanent Establishment as if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a Permanent Establishment.

(g) In determining the profits of a Permanent Establishment there shall be allowed as deduction, expenses which are incurred for the purposes of the Permanent Establishment including executive and general administrative expenses so incurred, whether in the State in which the Permanent Establishment is situated or elsewhere.

(h) The expenses that are deductible would have to be determined in accordance with the accepted principles of accountancy and the provisions of the Income-tax Act, 1961.

(i) The profits to be attributed to a Permanent Establishment are those which that Permanent Establishment would have made if, instead of dealing with its Head Office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the “arm’s length principle”.

(j) Hence, in determining the profits attributable to an IT-enabled BPO unit constituting a Permanent Establishment, it will be necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by the Head office to the Permanent Establishment on the basis of “arm’s length principle”.

TEST YOUR KNOWLEDGE

Questions

1. *Cosmos Limited, a company incorporated in Mauritius, has a branch office in Hyderabad opened in April, 2023. The Indian branch has filed return of income for assessment year 2024-25 disclosing income of ₹ 50 lakhs. It paid tax at the rate applicable to domestic company i.e. 30% plus higher education cess@4% on the basis of paragraph 2 of Article 24 (Non-Discrimination) of the Double Taxation Avoidance Agreement between India and Mauritius, which reads as follows:*

   "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances."

   However, the Assessing Officer computed tax on the Indian branch at the rate applicable to a foreign company i.e. 40% plus higher education cess@4%.

   Is the action of the Assessing Officer in accordance with law?

2. *Kalpesh Kumar, a resident individual, is a musician deriving income of ₹ 7,50,000 from concerts performed outside India. Tax of ₹ 1,00,000 was deducted at source in the country where the concerts were performed. India does not have any double tax avoidance agreement with that country. His income in India amounted to ₹ 30,00,000. Compute net tax liability of Kalpesh Kumar for the assessment year 2024-25 assuming he has deposited ₹ 1,50,000 in Public Provident Fund and paid medical insurance premium in respect of his father, resident in India, aged 65 years, ₹ 52,000.*

3. *The following are the particulars of income earned by Miss Vivitha, a resident Indian aged 25, for the assessment year 2024-25:*

	(₹ In lacs)
Income from playing snooker matches in country L	*12.00*
Tax paid in country L	*1.80*
Income from playing snooker tournaments in India	*19.20*
Life Insurance Premium paid	*1.10*
Medical Insurance Premium paid for her father (resident Indian) aged 62 years (paid through credit card)	*0.54*

   Compute her total income and net tax liability for the assessment year 2024-25. There is no Double Taxation Avoidance Agreement between India and country L.

4. *The concept of Permanent Establishment is one of the most important concepts in determining the tax implications of cross border transactions. Examine the significance thereof, when such transactions are governed by Double Taxation Avoidance Agreements (DTAA).*

5. *An individual resident in India, having income earned outside India in a country with which no agreement under section 90 exists, asks you to examine whether the credit for the tax paid on the foreign income will be allowed against his income-tax liability in India.*

6. *The Income-tax Act, 1961 provides for taxation of a certain income earned in India by Mr. X, a non-resident. The Double Taxation Avoidance Agreement, which applies to Mr. X provides for taxation of such income in the country of residence. Is Mr. X liable to pay tax on such income earned by him in India? Examine.*

7. *Arif is a resident of both India and another foreign country in the previous year 2023-24. He owns immovable properties (including residential house) in both the countries. He earned income of ₹ 50 lakhs from rubber estates in the foreign country during the financial year 2023-24. He also sold some house property situated in foreign country resulting in short-term capital gain of ₹ 10 lakhs during the year. Arif has no permanent establishment of business carried on in India. However, he has derived rental income of ₹ 6 lakhs from property let out in India and he has a house in Lucknow where he stays during his visit to India.*

   Article 4 of the Double Taxation Avoidance Agreement between India and the foreign country where Arif is a resident, provides that "where an individual is a resident of both the Contracting States, then, he shall be deemed to be resident of the Contracting State in which he has permanent home available to him. If he has permanent home in both the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests)".

   You are required to examine with reasons whether the business income of Arif arising in foreign country and the capital gains in respect of sale of the property situated in foreign country can be taxed in India.

8. *Mr. Kamesh, an individual resident in India aged 52 years, furnishes you the following particulars of income earned in India, Country "X" and Country "Y" for the previous year 2023-24. India has not entered into double taxation avoidance agreement with these two countries.*

Particulars	*₹*
Income from profession carried on in India	*7,50,000*
Agricultural income in Country "X" (gross)	*50,000*
Dividend from a company incorporated in Country "Y" (gross)	*1,50,000*
Royalty income from a literary book from Country "X" (gross)	*6,00,000*
Expenses incurred for earning royalty	*50,000*
Business loss in Country "Y" (Proprietary business)	*65,000*
Rent from a house situated in Country "Y" (gross)	*2,40,000*
Municipal tax paid in respect of the above house in Country "Y" (not allowed as deduction in country "Y")	*10,000*

Note: *Business loss in Country "Y" not eligible for set off against other incomes as per law of that country.*

The rates of tax in Country "X" and Country "Y" are 10% and 20%, respectively.

Compute total income and net tax liability of Mr. Kamesh in India for Assessment Year 2024-25, assuming that he opted out of the default tax regime under section 115BAC.

9. *Mr. Anil, aged 49 years, a resident individual furnishes the following particulars of income earned by him in India and Country N for the previous year 2023-24. India does not have a double taxation avoidance agreement (DTAA) with Country N.*

Particulars	*Amount (₹)*
Income from profession carried on in Mumbai	*8,50,000*
Agricultural Income in Country N	*1,30,000*
Dividend from a company incorporated in Country N (gross)	*85,000*
Royalty income from a literary book from Country N (gross)	*6,25,000*
Expenses incurred for earning royalty	*75,000*
Business loss in Country N	*1,10,000*

The domestic tax laws of Country N does not permit set-off of business loss against any other income. The rate of income-tax in Country N is 18%. Compute total income and net tax liability of Mr. Anil in India for A.Y. 2024-25, assuming that he satisfies all conditions for the purpose of section 91 and he opted out of the default tax regime under section 115BAC.

10. *Mr. Ravi, an individual resident in India aged 45 years, furnishes you the following particulars of income earned in India, Foreign Countries "S" and "T" for the previous year 2023-24.*

Particulars	*₹*
Indian Income:	
Income from business carried on in Mumbai	*4,40,000*
Interest on savings bank with ICICI Bank	*42,000*
Income earned in Foreign Country "S" [Rate of tax – 16%]:	
Agricultural income in Country "S"	*94,000*
Royalty income from a book on art from Country "S" (Gross)	*7,80,000*
Expenses incurred for earning royalty	*50,000*
Income earned in Foreign Country "T" [Rate of tax – 20%]:	
Dividend from a company incorporated in Country "T" (Gross)	*2,65,000*
Rent from a house situated in Country "T" (Gross)	*3,30,000*
Municipal tax paid in respect of the above house (not allowed as deduction in Country "T")	*10,000*

Compute the total income and net tax liability of Mr. Ravi in India for A.Y. 2024-25 assuming that India has not entered into double taxation avoidance agreement with Countries S & T.

Answers

1. Under section 90(2), where the Central Government has entered into an agreement for avoidance of double taxation with the Government of any country outside India or specified territory outside India, as the case may be, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to the assessee. Thus, in view of paragraph 2 of Article 24 (Non-discrimination of the DTAA, it appears that the Indian branch of Cosmos Limited, incorporated in Mauritius, is liable to tax in India at the rate applicable to domestic company (30%), which is lower than the rate of tax applicable to a foreign company (40%).

However, *Explanation 1* to section 90 clarifies that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company. Therefore, in view of this *Explanation*, the action of the Assessing Officer in levying tax@40% on the Indian branch of Cosmos Ltd. is in accordance with law.

2. **Computation of net tax liability of Mr. Kalpesh for A.Y.2024-25 under the default tax regime under section 115BAC (assuming that he pays tax under the default tax regime)**

Particulars	₹	₹
Indian Income		30,00,000
Foreign Income		7,50,000
Gross Total Income		**37,50,000**
Less: **Deduction under VI-A [Not available under default tax regime]**		Nil
Total Income		**37,50,000**
Tax on total income		8,25,000
Add: Health and Education cess @4%		33,000
		8,58,000
Average rate of tax in India [i.e., ₹ 8,58,000 /₹ 37,50,000 x 100]	22.88%	
Average rate of tax in foreign country		
[i.e. ₹ 1,00,000/ ₹ 7,50,000 x 100]	13.333%	
Doubly taxed income	7,50,000	
Deduction under section 91 on ₹ 7,50,000 @13.33%		
(lower of average Indian tax rate and foreign tax rate]		1,00,000
Net tax liability in India [₹ 8,58,000 – ₹ 1,00,000]		**7,58,000**

Computation of net tax liability of Mr. Kalpesh for A.Y.2024-25 under the normal provisions of the Act (assuming that he has exercised the option to shift out of default tax regime)

Particulars	₹	₹
Indian Income		30,00,000
Foreign Income		7,50,000
Gross Total Income		**37,50,000**
Less: **Deduction under section 80C**		
PPF Contribution	1,50,000	
Deduction under section 80D		
Medical insurance premium of father, being a resident senior citizen, restricted to	50,000	2,00,000
Total Income		**35,50,000**

Tax on total income		8,77,500
Add: Health and Education cess @4%		35,100
		9,12,600
Average rate of tax in India [i.e., ₹ 9,12,600 /₹ 35,50,000 x 100]	25.71%	
Average rate of tax in foreign country		
[i.e. ₹ 1,00,000/ ₹ 7,50,000 x 100]	13.333%	
Doubly taxed income	7,50,000	
Deduction under section 91 on ₹ 7,50,000 @13.33%		
(lower of average Indian tax rate and foreign tax rate]		1,00,000
Net tax liability in India [₹ 9,12,600 – ₹ 1,00,000]		**8,12,600**

Note: An assessee shall be allowed deduction under section 91 provided all the following conditions are fulfilled:-

(a) The assessee is a resident in India during the relevant previous year.

(b) The income accrues or arises to him outside India during that previous year.

(c) Such income is not deemed to accrue or arise in India during the previous year.

(d) The income in question has been subjected to income-tax in the foreign country in the hands of the assessee and the assessee has paid tax on such income in the foreign country.

(e) There is no agreement under section 90 for the relief or avoidance of double taxation between India and the other country where the income has accrued or arisen.

In this case, Kalpesh Kumar is eligible for deduction under section 91 since all the above conditions are fulfilled.

3. Computation of total income and net tax liability of Miss Vivitha for the A.Y. 2024-25 under the default tax regime under section 115BAC (assuming that she pays tax under the default tax regime)

Particulars	₹	₹
Indian Income [Income from playing snooker tournaments in India]		19,20,000
Foreign Income [Income from playing snooker matches in country L]		12,00,000
Gross Total Income		**31,20,000**
Less: Deduction under Chapter VIA		Nil
Total Income		**31,20,000**

Tax on Total Income		
Income-tax		6,36,000
Add: Health and education cess @4%		25,440
		6,61,440
Average rate of tax in India	21.20%	
(i.e. ₹ 6,61,440/₹ 31,20,000 × 100)		
Average rate of tax in foreign country	15.00%	
(i.e. ₹ 1,80,000/ ₹12,00,000 ×100)		
Deduction under section 91 on ₹ 12 lakh @ 15% (lower of average Indian-tax rate or average foreign tax rate)		1,80,000
Net tax liability in India (₹ 6,61,440 – ₹ 1,80,000)		**4,81,440**

Computation of total income and net tax liability of Miss Vivitha for the A.Y. 2024-25 under the normal provisions of the Act (assuming that she has exercised the option to shift out of default tax regime)

Particulars	₹	₹
Indian Income [Income from playing snooker tournaments in India]		19,20,000
Foreign Income [Income from playing snooker matches in country L]		12,00,000
Gross Total Income		**31,20,000**
Less: Deduction under Chapter VIA		
Deduction under section 80C		
Life insurance premium of ₹ 1,10,000 paid during the previous year deduction, is within the overall limit of ₹ 1.5 lakh. Hence, fully allowable as deduction	1,10,000	
Deduction under section 80D		
Medical insurance premium of ₹ 54,000 paid for her father aged 62 years. Since her father is a senior citizen, the deduction is allowable to a maximum of ₹ 50,000. Further, deduction is allowable where payment is made by any mode other than cash. Here payment is made by credit card hence, eligible for deduction.	50,000	1,60,000
Total Income		**29,60,000**
Tax on Total Income		
Income-tax		7,00,500

Add: Health and education cess @4%		28,020
		7,28,520
Average rate of tax in India	24.61%	
(i.e. ₹ 7,28,520/₹ 29,60,000 × 100)		
Average rate of tax in foreign country	15.00%	
(i.e. ₹ 1,80,000/ ₹12,00,000 ×100)		
Deduction under section 91 on ₹ 12 lakh @ 15% (lower of average Indian-tax rate or average foreign tax rate)		1,80,000
Net tax liability in India (₹ 7,28,520 – ₹ 1,80,000)		**5,48,520**

Note: Miss Vivitha shall be allowed deduction under section 91, since the following conditions are fulfilled:-

(a) She is a resident in India during the relevant previous year.

(b) The income accrues or arises to her outside India during that previous year and such income is not deemed to accrue or arise in India during the previous year.

(c) The income in question has been subjected to income-tax in the foreign country L in her hands and she has paid tax on such income in the foreign country L.

(d) There is no agreement under section 90 for the relief or avoidance of double taxation between India and country L where the income has accrued or arisen.

4. Double Taxation Avoidance Agreements (DTAAs) generally contain an Article providing that business income is taxable in the country of residence, unless the enterprise has a permanent establishment in the country of source, and such income can be attributed to the permanent establishment.

As per section 92F(iiia), the term "Permanent Establishment" includes a fixed place of business through which the business of an enterprise is wholly or partly carried on.

As per this definition, to constitute a permanent establishment, there must be a place of business which is fixed and the business of the enterprise must be carried out wholly or partly through this place.

Section 9(1)(i) requires existence of business connection for deeming business income to accrue or arise in India. DTAAs, however, provide that business income is taxable only if there is a permanent establishment in India. As per section 90(2), the provisions of the Income-tax Act, 1961 or the DTAA, whichever is beneficial, shall apply. The PE concept is narrower than the business connection concept. Therefore, in a case where the Indian

Government has entered into DTAA with a country, unless and until the PE test is satisfied, the business income would not be taxable in the source country.

However, in cases not covered by DTAAs, business income attributable to business connection is taxable.

5. The assessee is a resident in India and accordingly, the income accruing or arising to him globally is chargeable to tax in India. However, section 91 specifies that if a person resident in India has paid tax in any country with which no agreement under section 90 exists, then, for the purpose of relief or avoidance of double taxation, a deduction is allowed from the Indian income-tax payable by him, of a sum calculated on such doubly taxed income at Indian rate of tax or the rate of tax of such foreign country, whichever is lower, or at the Indian rate of tax, if both the rates are equal. Accordingly, the assessee shall not be given any credit of the tax paid on the income in other country, but shall be allowed a deduction from the Indian income-tax payable by him as per section 91 read with Rule 128 on Foreign Tax Credit.

6. Section 90(2) makes it clear that where the Central Government has entered into a Double Taxation Avoidance Agreement with a country outside India, then in respect of an assessee to whom such agreement applies, the provisions of the Act shall apply to the extent they are more beneficial to the assessee. This means that where the DTAA has been entered, the assessee can opt to be governed by the provisions of DTAA if the provisions are beneficial in comparison to provisions of Act.

However, as per section 90(4), the assessee, in order to claim relief under the agreement, has to obtain a certificate [Tax Residence Certificate (TRC)] from the Government of that country, declaring the residence of the country outside India. Further, he also has to provide the following information in Form No. 10F:

(i) Status (individual, company, firm etc.) of the assessee;

(ii) PAN of the assessee, if allotted;

(iii) Nationality (in case of an individual) or country or specified territory of incorporation or registration (in case of others);

(iv) Assessee's tax identification number in the country or specified territory of residence and in case there is no such number, then, a unique number on the basis of which the person is identified by the Government of the country or the specified territory of which the assessee claims to be a resident;

(v) Period for which the residential status, as mentioned in the certificate referred to in section 90(4) or section 90A(4), is applicable; and

(vi) Address of the assessee in the country or specified territory outside India, during the period for which the certificate, as mentioned in (v) above, is applicable.

However, the assessee may not be required to provide the information or any part thereof, if the information or the part thereof, as the case may be, is already contained in the TRC referred to in section 90(4) or section 90A(4).

The Supreme Court has held, in *CIT v. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654,* that in case of any conflict between the provisions of the Double Taxation Avoidance Agreement and the Income-tax Act, 1961, the provisions of the Double Taxation Avoidance Agreement would prevail over those of the Income-tax Act, 1961. Mr. X is, therefore, not liable to pay tax on the income earned by him in India provided he submits the Tax Residence Certificate obtained from the government of the other country, and provides such other documents and information as may be prescribed.

7. Section 90(2) of the Income-tax Act, 1961 provides that where the Central Government has entered into an agreement with the Government of any other country for granting relief of tax or for avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of the Income-tax Act, 1961 shall apply to the extent they are more beneficial to that assessee.

In this case, Arif is resident of both India and the foreign country. Therefore, the DTAA provides for a tie-breaker rule wherein if a person is resident of two countries, he shall be deemed to be resident of the Contracting State in which he has permanent home available to him. If he has permanent home in both the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closer (centre of vital interests).

Arif has residential houses both in India and foreign country. Thus, he has a permanent home in both the countries.

Arif owns rubber estates in a foreign country from which he derives business income. However, Arif has no permanent establishment of his business in India. Therefore his personal and economic relations with foreign country are closer, since foreign country is the place where –

(a) the property is located and

(b) the permanent establishment (PE) has been set-up

Therefore, he shall be deemed to be resident of the foreign country for A.Y. 2024-25.

The fact of the case and issues arising therefrom are similar to that of *CIT vs. P.V.A.L. Kulandagan Chettiar (2004) 267 ITR 654*, where the Supreme Court held that if an assessee is deemed to be a resident of a Contracting State where his personal and economic relations are closer, then in such a case, the fact that he is a resident in India to be taxed in terms of sections 4 and 5 would become irrelevant, since the DTAA prevails over sections 4 and 5. Accordingly, only the income accruing or arising or deemed to accrue or arise in India shall be taxable in India in the hands of Arif.

However, as per section 90(4), in order to claim relief under the agreement, Arif has to obtain a certificate [Tax Residency Certificate (TRC)] declaring his residence of the country outside India from the Government of that country. Further, he also has to provide such other documents and information, as may be prescribed.

Therefore, in this case, Arif is not liable to income tax in India for assessment year 2024-25 in respect of business income and capital gains arising in the foreign country provided he furnishes the Tax Residency Certificate and provides such other documents and information as may be prescribed.

8. Computation of total income of Mr. Kamesh for A.Y.2024-25 under normal provisions of the Act

Particulars	₹	₹
Income from House Property [House situated in country Y]		
Gross Annual Value[1]	2,40,000	
Less: Municipal taxes	10,000	
Net Annual Value	2,30,000	
Less: Deduction under section 24 – 30% of NAV	69,000	
		1,61,000
Profits and Gains of Business or Profession		
Income from profession carried on in India	7,50,000	
Royalty income from a literary book from Country X (after deducting expenses of ₹ 50,000)	5,50,000	
	13,00,000	
Less: Business loss in country Y set-off[2]	65,000	
		12,35,000

[1] Rental Income has been taken as GAV in the absence of other information relating to fair rent, municipal value etc.
[2] As per section 70(1), inter-source set-off of income is permitted.

Income from Other Sources		
Agricultural income in country X	50,000	
Dividend from a company in country Y	1,50,000	2,00,000
Gross Total Income		**15,96,000**
***Less:* Deduction under Chapter VIA**		
Under section 80QQB – Royalty income of a resident from literary work[3]		3,00,000
Total Income		**12,96,000**

Note – Since adjusted total income (i.e., ₹ 15,96,000) does not exceed ₹ 20 lakhs, AMT would not be attracted in this case.

Computation of net tax liability of Mr. Kamesh for A.Y.2024-25

Particulars	₹
Tax on total income [30% of ₹ 2,96,000 + ₹ 1,12,500]	2,01,300
Add: Health and Education cess@4%	8,052
	2,09,352
Less: Deduction under section 91 **(See Working Note below)**	69,739
Net tax liability	**1,39,613**
Net tax liability (rounded off)	1,39,610

Working Note: Calculation of Rebate under section 91

	₹	₹
Average rate of tax in India [i.e., ₹ 2,09,352 / ₹ 12,96,000 x 100]	**16.154%**	
Average rate of tax in country X	**10%**	
Doubly taxed income pertaining to country X		
Agricultural Income	50,000	
Royalty Income [₹ 6,00,000 – ₹ 50,000 (Expenses) – ₹ 3,00,000 (deduction under section 80QQB)][4]	2,50,000	
	3,00,000	
Deduction under section 91 on ₹ 3,00,000 @10% [being the lower of average Indian tax rate (16.154%) and foreign tax rate (10%)]		30,000

[3] It is assumed that the royalty earned outside India has been brought into India in convertible foreign exchange within a period of six months from the end of the previous year.

[4] Doubly taxed income includes only that part of income which is included in the assessee's total income. The amount deducted under Chapter VIA is not doubly taxed and hence, no relief is allowable in respect of such amount – *CIT v. Dr. R.N. Jhanji (1990) 185 ITR 586 (Raj.).*

Average rate of tax in country Y	**20%**	
Doubly taxed income pertaining to country Y		
Income from house property	1,61,000	
Dividend	1,50,000	
	3,11,000	
Less: Business loss set-off	65,000	
	2,46,000	
Deduction u/s 91 on ₹ 2,46,000 @16.154% (being the lower of average Indian tax rate (16.154%) and foreign tax rate (20%)]		39,739
Total rebate under section 91 (Country X + Country Y)		**69,739**

Note: Mr. Kamesh shall be allowed deduction u/s 91, since the following conditions are fulfilled:-

(a) He is a resident in India during the relevant previous year (i.e., P.Y.2023-24).

(b) The income in question accrues or arises to him outside India in foreign countries X and Y during that previous year and such income is not deemed to accrue or arise in India during the previous year.

(c) The income in question has been subjected to income-tax in the foreign countries X and Y in his hands and it is presumed that he has paid tax on such income in those countries.

(d) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Countries X and Y where the income has accrued or arisen.

9. Computation of total income of Mr. Anil for A.Y.2024-25 under normal provisions of the Act

Particulars	₹	₹
Profits and Gains of Business or Profession		
Income from profession carried on in India	8,50,000	
Royalty income from a literary book in Country N (after deducting expenses of ₹ 75,000)	5,50,000	
	14,00,000	
Less: Business loss in Country N	1,10,000	12,90,000

Income from Other Sources		
Agricultural income in Country N [Not exempt u/s 10(1)]	1,30,000	
Dividend received from a company incorporated in Country N	85,000	
		2,15,000
Gross Total Income		**15,05,000**
***Less:* Deduction under Chapter VIA**		3,00,000
Under section 80QQB – Royalty income of a resident from a literary book[5]		
Total Income		**12,05,000**

Note – Since adjusted total income (i.e., ₹ 15,05,000) does not exceed ₹ 20 lakhs, AMT would not be attracted in this case.

Computation of net tax liability of Mr. Anil for A.Y.2024-25

Particulars		**₹**
Tax on total income [30% of ₹ 2,05,000 plus ₹ 1,12,500]		1,74,000
Add: Health and education cess @4%		6,960
Tax Liability		1,80,960
Calculation of Rebate under section 91:		
Average rate of tax in India [i.e., ₹ 1,80,960 / ₹ 12,05,000 x 100]	**15.0174%**	
Average rate of tax in Country N	**18%**	
Doubly taxed income pertaining to Country N	**₹**	
Agricultural Income	1,30,000	
Royalty Income [₹ 6,25,000 – ₹ 75,000 (Expenses) – ₹ 3,00,000 (deduction under section 80QQB)] [6]	2,50,000	
Dividend income	85,000	
	4,65,000	
Less: Business Loss set off	1,10,000	
	3,55,000	

[5] *It is assumed that the royalty earned outside India has been brought into India in convertible foreign exchange within a period of six months from the end of the previous year.*

[6] *Doubly taxed income includes only that part of income which is included in the assessee's total income. The amount deducted under Chapter VIA is not doubly taxed and hence, no relief is allowable in respect of such amount – CIT v. Dr. R.N. Jhanji (1990) 185 ITR 586 (Raj.).*

Rebate under section 91 on ₹ 3,55,000 @ 15.0174% [being the lower of average Indian tax rate (15.0174%) and foreign tax rate (18%)]	53,312
Net tax liability	**1,27,648**
Net tax liability (Rounded off)	1,27,650

10. Computation of total income of Mr. Ravi for A.Y.2024-25 under the default tax regime under section 115BAC (assuming that he pays tax under the default tax regime)

Particulars	₹	₹
Income from House Property [House situated in Country T]		
Gross Annual Value[7]	3,30,000	
Less: Municipal taxes paid in Country T	10,000	
Net Annual Value	3,20,000	
Less: Deduction under section 24 – 30% of NAV	96,000	
		2,24,000
Profits and Gains of Business or Profession		
Income from business carried on in India	4,40,000	
Royalty income from a book on art in Country S (after deducting expenses of ₹ 50,000)	7,30,000	11,70,000
Income from Other Sources		
Interest on savings bank with ICICI Bank	42,000	
Agricultural income in Country S [Not exempt]	94,000	
Dividend from a company in Country T	2,65,000	4,01,000
Gross Total Income		**17,95,000**
Less: Deduction under Chapter VIA [Not available under default tax regime]		Nil
Total Income		**17,95,000**

Computation of tax liability of Mr. Ravi for A.Y.2024-25 under the default tax regime

Particulars		₹
Tax on total income		2,38,500
Add: Health and education cess @4%		9,540
		2,48,040

[7]Rental income has been taken as GAV in the absence of other information relating to fair rent, municipal value etc.

Less: Rebate under section 91 **(See Working Note below)**		1,81,430
Net tax liability		**66,610**
Calculation of Rebate under section 91:		
Average rate of tax in India [i.e., ₹ 2,48,040 / ₹ 17,95,000 x 100]	**13.818%**	
Average rate of tax in Country S	**16%**	
Doubly taxed income pertaining to Country S	**₹**	
Agricultural Income	94,000	
Royalty Income [₹ 7,80,000 – ₹ 50,000 (Expenses)]	7,30,000	
	8,24,000	
Rebate under section 91 on ₹ 8,24,000 @13.818% [being the lower of average Indian tax rate (13.818%) and Country S tax rate (16%)]		1,13,860
Average rate of tax in Country T	**20%**	
Doubly taxed income pertaining to Country T		
Income from house property	2,24,000	
Dividend	2,65,000	
	4,89,000	
Rebate under section 91 on ₹ 4,89,000 @13.818% (being the lower of average Indian tax rate (13.818%) and Country T tax rate (20%)]		67,570
Total rebate under section 91 (Country S + Country T)		**1,81,430**

Computation of total income of Mr. Ravi for A.Y.2024-25
under the normal provisions of the Act
(assuming that he has exercised the option to shift out of default tax regime)

Particulars	₹	₹
Income from House Property [House situated in Country T]		
Gross Annual Value[8]	3,30,000	
Less: Municipal taxes paid in Country T	10,000	
Net Annual Value	3,20,000	

[8]Rental income has been taken as GAV in the absence of other information relating to fair rent, municipal value etc.

Less: Deduction under section 24 – 30% of NAV	96,000	
		2,24,000
Profits and Gains of Business or Profession		
Income from business carried on in India	4,40,000	
Royalty income from a book of art in Country S (after deducting expenses of ₹ 50,000)	7,30,000	11,70,000
Income from Other Sources		
Interest on savings bank with ICICI Bank	42,000	
Agricultural income in Country S [Not exempt]	94,000	
Dividend from a company in Country T	2,65,000	4,01,000
Gross Total Income		**17,95,000**
***Less:* Deduction under Chapter VIA**		
Under section 80QQB – Royalty income of a resident from a work of art[9]		3,00,000
Under section 80TTA – Interest on savings bank account, subject to a maximum of ₹ 10,000.		10,000
Total Income		**14,85,000**

Note – Since adjusted total income (i.e., ₹ 17,85,000) does not exceed ₹ 20 lakhs, AMT would not be attracted in this case.

Computation of tax liability of Mr. Ravi for A.Y.2024-25
under the normal provisions of the Act

Particulars		₹
Tax on total income [30% of ₹ 4,85,000 + ₹ 1,12,500]		2,58,000
Add: Health and education cess @4%		10,320
		2,68,320
Less: Rebate under section 91 **(See Working Note below)**		1,72,197
Tax Payable		**96,123**
Tax payable (rounded off)		96,120
Calculation of Rebate under section 91:		
Average rate of tax in India [i.e., ₹ 2,68,320 / ₹ 14,85,000 x 100]	**18.069%**	
Average rate of tax in Country S	**16%**	

[9] It is assumed that the royalty earned outside India has been brought into India in convertible foreign exchange within a period of six months from the end of the previous year.

Doubly taxed income pertaining to Country S[10]	₹	
Agricultural Income	94,000	
Royalty Income [₹ 7,80,000 – ₹ 50,000 (Expenses) – ₹ 3,00,000 (deduction under section 80QQB)]	4,30,000	
	5,24,000	
Rebate under section 91 on ₹ 5,24,000 @16% [being the lower of average Indian tax rate (18.069%) and Country S tax rate (16%)]		83,840
Average rate of tax in Country T	**20%**	
Doubly taxed income pertaining to Country T		
Income from house property	2,24,000	
Dividend	2,65,000	
	4,89,000	
Rebate under section 91 on ₹ 4,89,000 @18.069% (being the lower of average Indian tax rate (18.069%) and Country T tax rate (20%)]		88,357
Total rebate under section 91 (Country S + Country T)		**1,72,197**

Note: Mr. Ravi shall be allowed deduction under section 91, since the following conditions are fulfilled:-

(a) He is a resident in India during the relevant previous year i.e., P.Y.2023-24.

(b) The income in question accrues or arises to him outside India in foreign countries S & T during that previous year and such income is not deemed to accrue or arise in India during the previous year.

(c) The income in question has been subjected to income-tax in the foreign countries "S" and "T" in his hands and it is presumed that he has paid tax on such income in those countries.

(d) There is no agreement under section 90 for the relief or avoidance of double taxation between India and Countries S and T where the income has accrued or arisen.

[10]Doubly taxed income includes only that part of income which is included in the assessee's total income. The amount deducted under Chapter VIA is not doubly taxed and hence, no relief is allowable in respect of such amount – *CIT v. Dr. R.N. Jhanji (1990) 185 ITR 586 (Raj.).*

NOTES

CHAPTER 23

ADVANCE RULINGS

LEARNING OUTCOMES

After studying this Chapter, you will be able to–

- **comprehend** the meaning and scope of the term "advance ruling" and the need for obtaining advance ruling;
- **understand** the constitution of Board for Advance Rulings;
- **appreciate** the procedure for making an application to the Board for Advance Rulings and the procedure to be followed by the Board on receipt of application;
- **know** the circumstances when an advance ruling can be declared void.

23.1 BOARDS FOR ADVANCE RULINGS – AN INTRODUCTION

In order to address the concern of pendency of applications on account of vacancy of posts of Chairman and Vice-Chairman for long period of time due to non-availability of eligible persons, three Boards for Advance Rulings have been constituted for giving advance rulings on or after 1.9.2021. Every such Board shall consist of two members, each being an officer not below the rank of Chief Commissioner, as may be nominated by the Board. The ruling pronounced or order passed by the Board for Advance Rulings is appealable before the High Court. The Finance Act, 2021 has empowered the Central Government to make a scheme by notification in the Official Gazette for the purpose of giving advance ruling by Boards for Advance Rulings to impart greater efficiency, transparency and accountability by eliminating interface between the Boards for Advance Rulings and the applicants to the extent technologically feasible, by optimising utilisation of resources and introducing dynamic jurisdiction.

23.2 CONSTITUTION OF BOARD FOR ADVANCE RULINGS [SECTION 245-OB]

One or more Boards for Advance Rulings, as may be necessary, shall be constituted by the Central Government for giving advance rulings under Chapter XIX-B with effect from a date appointed by notification in the Official Gazette. Accordingly, the Central Government has, in exercise of such powers, vide Notification No.96/2021 dated 1.9.2021, constituted three Boards for Advance Rulings, for the purposes of giving advance rulings under Chapter XIX-B on or after 1.9.2021. Board for Advance Rulings – I and Board for Advance Rulings – II have their headquarters in Delhi and Board for Advance Rulings – III has its headquarters in Mumbai.

Every such Board for Advance Ruling shall consist of two members, each being an officer not below the rank of Chief Commissioner, as may be nominated by the Board.

23.3 DEFINITIONS

(1) Advance Ruling [Section 245N(a)]: The meaning of Advance Ruling is detailed hereunder:

Section	Determination by the Board for Advance Rulings
245N(a)(i)	in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant.

245N(a)(ii)	in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident and such determination shall include the determination of any question of law or of fact specified in the application.
245N(a)(iia)	in relation to the tax liability of a resident applicant, arising out of a transaction which has been undertaken or is proposed to be undertaken by such applicant and such determination shall include the determination of any question of law or of fact specified in the application.
245N(a)(iii)	in respect of an issue relating to computation of total income which is pending before any Income-tax Authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or fact in relation to such computation of total income specified in the application.
245N(a)(iv)	or decision whether an arrangement, which is proposed to be undertaken by any person being a resident or a non-resident, is an impermissible avoidance arrangement as referred to in Chapter X-A or not.

(2) Applicant [Section 245N(b)(A)]: 'Applicant' means any person who –

(i) is a non-resident referred to in section 245N(a)(i) above; or

(ii) is a resident referred to in section 245N(a)(ii) above; or

(iii) is a resident referred to in section 245N(a)(iia) above falling within any such class or category of persons as the Central Government may, by notification in the Official Gazette, specify.

[A resident in relation to his tax liability arising out of one or more transactions valuing ₹ 100 crore or more in total which has been undertaken or is proposed to be undertaken would be an applicant – Notification No.73/2014 dated 28.11.2014]; or

(iv) is a resident falling within such class or category of persons as the Central Government may, by notification in the Official Gazette, specify in this behalf *[Public sector company as defined under section 2(36A) of the Income-tax Act, 1961 – Notification No. 725(E) dated 3.8.2000]*; or

(v) is referred to in section 245N(a)(iv) above; and

who makes an application for advance ruling under section 245Q(1).

Who can be an applicant in relation to different clauses of section 245N(a) defining advance ruling?

S. No.	Applicant u/s 245N(b)	Advance Ruling u/s 245N(a) means determination by the AAR in relation to
(i)	Non-resident (NR)	A transaction which has been undertaken or is proposed to be undertaken by him.
(ii)	Resident	The tax liability of a NR arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such NR and such determination shall include the determination of any question of law or of fact specified in the application.
(iii)	Resident of class or category of persons notified by Central Government	The tax liability of a resident applicant, arising out of a transaction which has been undertaken or is proposed to be undertaken by such applicant and such determination shall include the determination of any question of law or of fact specified in the application.
	Note: *The Central Government notified a resident, in relation to his tax liability arising out of one or more transactions valuing ₹ 100 crore or more in total.*	
(iv)	Resident of class or category of persons notified by Central Government	an issue relating to computation of total income which is pending before any Income-tax Authority or the Appellate Tribunal and such determination or decision shall include the determination or decision of any question of law or fact in relation to such computation of total income specified in the application.
	Note: *A public sector undertaking has been notified by the Central Government.*	
(v)	Resident or NR	whether an arrangement, which is proposed to be undertaken by any person being a resident or a NR, is an impermissible avoidance arrangement as referred to in Chapter X-A or not.

Restrictions on Appellate Authority: Section 245RR provides that where a resident applicant has made an application to the Board for Advance Rulings in respect of an issue for decision of Board for Advance Rulings, then, no Income-tax Authority or Tribunal shall take any decision in respect of such issues. In other words, a resident assessee cannot pursue both the remedies, i.e., an appeal or revision before Income-tax Authority/Appellate Authority as well as an application for Advance Ruling to Board for Advance Rulings, in respect of an issue.

23.4 VACANCIES, ETC., NOT TO INVALIDATE PROCEEDINGS [SECTION 245P]

A proceeding before, or pronouncement of advance ruling by, the Board for Advance Rulings would not be questioned or would not be invalid on the ground merely of the existence of any vacancy or defect in the constitution of the Board for Advance Rulings.

23.5 APPLICATION FOR ADVANCE RULING [SECTION 245Q]

Section 245Q(1) provides that an applicant desirous of obtaining an advance ruling may make an application stating the question on which the advance ruling is sought in the prescribed form and in the prescribed manner.

As per section 245Q(2), the application shall be made in quadruplicate and be accompanied by a fee of ₹ 10,000 or such fee as may be prescribed, whichever is higher.

Rule 44E prescribes the fees mentioned in column (3) to be paid by the applicant mentioned in column (1) in the cases of column (2).

Category of applicant	Category of case	Fee
(1)	(2)	(3)
An applicant referred to in sub-clauses (i) or (ii) or (iia) of clause (b) of section 245N	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought does not exceed ₹ 100 crore.	₹ 2 lacs
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds ₹ 100 crore but does not exceed ₹ 300 crore.	₹ 5 lacs
	Amount of one or more transaction, entered into or proposed to be undertaken, in respect of which ruling is sought exceeds ₹ 300 crore.	₹ 10 lacs
Any other applicant	In all cases	₹ 10,000

Rule 44E prescribes the form of application for obtaining an advance ruling. Every application under Rule 44E shall be accompanied by the proof of payment of fees.

Section 245Q(3) provides that an applicant may withdraw an application within 30 days from the date of the application.

23.6 PROCEDURE ON RECEIPT OF APPLICATION [SECTION 245R]

The Board, on receipt of an application, will send a copy to the Principal Commissioner or Commissioner concerned and wherever considered necessary, also call upon the Principal Commissioner or Commissioner to furnish relevant records. Such records will be returned to the Principal Commissioner or Commissioner as soon as possible.

After examining the application and the records called for, the Board may either allow or reject an application. However, the Board **shall not allow** an application where the question raised in the application is:

Pending with income-tax authorities/ tribunal/court	is already pending before any income-tax authority, or Appellate Tribunal or any court. However, a resident falling within any class or category of persons as notified by the Central Government can seek for advance ruling even if question raised is pending before any income-tax authority or Appellate Tribunal.
Determination of Fair Market Value	involves the determination of the fair market value of any property;
Transaction designed for avoidance of income-tax	relates to a transaction or issue which is designed prima facie for avoidance of income-tax (except in case of a resident applicant falling within any class or category of persons as notified by the Central Government or in the case of resident or a non-resident for determination of whether an arrangement, which is proposed to be undertaken, is an impermissible avoidance arrangement).

However, no application shall be rejected unless an opportunity has been given to the applicant of being heard. Further, where an application is rejected, the reason for rejection shall be given in the order. A copy of every order shall be sent to the applicant and to the PCIT/CIT.

Where an application is allowed, the Board would pronounce its advance ruling on that question specified in the application, after examining such further material as may be placed before it by the applicant or obtained by the Board. Where a request is received from an applicant, the Board has to provide an opportunity of being heard, either in person or through a duly authorised representative, before pronouncing its advance ruling.

Time limit for pronouncement of advance Ruling - The Board has to pronounce the advance ruling **within 6 months** from the receipt of application by the Board. A copy of advance ruling pronounced, duly signed by the Members and certified, has to be sent to the applicant and to the PCIT/CIT, as soon as may be, after pronouncement.

Faceless Scheme for Advance Rulings - The Central Government is empowered to make a scheme by notification in Official Gazette for the purpose of giving advance rulings so as to impart greater efficiency, transparency and accountability by:

(i) eliminating the interface between the Board for Advance Rulings and the applicant in the course of proceedings to the extent technologically feasible;

(ii) optimising utilisation of the resources through economies of scale and functional specialisation;

(iii) introducing a system with dynamic jurisdiction.

Applicability or non-applicability of other provisions of the Act [Section 245R(10)] - The Central Government may, for the purpose of giving effect to the above scheme, by notification in the Official Gazette, direct that any of the provisions of the Income-tax Act, 1961 would not apply or would apply with such modification, exceptions and adaptations as specified.

Though no such direction can be issued by the Central Government after 31st March, 2023, ***the Central Government may amend any direction, issued on or before 31.3.2023, by notification.***

Notification issued above to be laid before each House of Parliament [Section 245R(11)] - Every such notification issued by the Central Government either under sub section (9) or (10) of the section 245R has to be laid before each House of Parliament as soon as may be after issue of such notification.

23.7 ADVANCE RULING TO BE VOID IN CERTAIN CIRCUMSTANCES [SECTION 245T]

Where the Board for Advance Rulings finds, on a representation made to it by the PCIT/CIT or otherwise, that an advance ruling pronounced has been obtained by the applicant by fraud or misrepresentation of facts, the Board may, by order, declare such ruling to be *void ab initio*.

The provisions of the Income-tax Act, 1961 would apply (after excluding the period beginning with the date of such advance ruling and ending with the date of order under this section) to the applicant as if such advance ruling had never been made.

A copy of this order has to be sent to the applicant and the Principal Commissioner or Commissioner.

23.8 POWERS OF THE BOARD FOR ADVANCE RULINGS [SECTION 245U]

The Board for Advance Rulings shall have all the powers of the Civil Court in respect of discovery and inspection, enforcing the attendance of any person, including any officer of a banking company and examining on oath, issuing commissions and compelling the production of books of accounts and other documents. The Board shall be deemed to be a Civil Court for the purposes of section 195 of the Code of Criminal Procedure, 1973 which provides for prosecution for contempt of lawful authority of public servants, for offences against public justice. Every proceeding before the Board shall be deemed to be a judicial proceeding under the Indian Penal Code.

However, the Board shall not be deemed to a Civil Court for the purpose of Chapter XXVI of the Code of Criminal Procedure, 1973 containing the provisions as to offences affecting the administration of justice.

23.9 APPEAL [SECTION 245W]

Appeal to High Court by applicant [Section 245W(1)] - The applicant who is aggrieved by any ruling pronounced or order passed by the Board for Advance Rulings or the Assessing Officer, on the directions of the Principal Commissioner or Commissioner, may appeal to the High Court against such ruling or order of the Board of Advance Rulings. He has to do so within **sixty days from the date of the communication** of that ruling or order, in the prescribed form and manner.

However, where the High Court is satisfied, on an application made by the appellant in this behalf, that the appellant was prevented by sufficient cause from presenting the appeal within the 60 day period as specified above, it may grant further period of 30 days for filing such appeal.

Appeal to High Court by Assessing Officer [Section 245W(2)] - For the purpose of appeal to the High Court by the Assessing Officer, the Central Government is empowered to make a scheme by notification in Official Gazette so as to impart greater efficiency, transparency and accountability by:

(i) optimising utilisation of the resources through economies of scale and functional specialisation;

(ii) introducing a team-based mechanism with dynamic jurisdiction.

Applicability or non-applicability of other provisions of the Act [Section 245W(3)] - The Central Government may, for the purpose of giving effect to the above scheme, by notification in the Official Gazette, direct that any provision of the Income-tax Act, 1961, would not apply or would apply with such modification, exceptions and adaptations as specified.

No such direction can, however, be issued by the Central Government after 31st March, 2023.

Notification issued above to be laid before each House of Parliament [Section 245W(4)] - Every such notification issued by the Central Government either under section 245W(2)/(3) has to be laid before each House of Parliament as soon as may be after issue of the said notification.

TEST YOUR KNOWLEDGE

Questions

1. *Q, a non-resident, made an application to the Board for Advance Rulings on 3.4.2023 in relation to a transaction proposed to be undertaken by him. On 1.5.2023, he decides to withdraw the said application. Can he withdraw the application on 1.5.2023?*

2. *Examine when can an advance ruling pronounced by the Board for Advance Rulings be declared void. What is the consequence?*

3. *The Board for Advance Rulings has the powers of compelling the production of books of account – Examine the correctness or otherwise of this statement.*

4. *The term 'Advance Ruling' includes within its scope, a determination by the Board for Advance Rulings only in relation to a transaction undertaken by a non-resident applicant. Examine the correctness of this statement, with reference to the provisions of the Income-tax Act 1961.*

5. *What is the remedy available to an applicant who is aggrieved by the ruling of Board for Advance Rulings? Also, state the time limit within which he should exercise this remedy.*

Answers

1. Section 245Q(3) of the Income-tax Act, 1961 provides that an applicant, who has sought for an advance ruling, may withdraw the application within 30 days from the date of the application. Since the 30 day period from the date of application by Q to the Board for Advance Rulings has not lapsed, he can withdraw the application.

2. As per section 245T, an advance ruling can be declared to be *void ab initio* by the Board for Advance Rulings if, on a representation made to it by the Principal Commissioner or Commissioner or otherwise, it finds that the ruling has been obtained by fraud or misrepresentation of facts. Thereafter, all the provisions of the Act will apply (after excluding the period beginning with the date of such advance ruling and ending with the date of order under this section) as if no such advance ruling has been made. A copy of such order shall be sent to the applicant and the Principal Commissioner or Commissioner.

3. **The statement is correct.**

Under section 245U, the Board for Advance Rulings shall have all the powers vested in the

Civil Court under the Code of Civil Procedure, 1908 as are referred to in section 131.

Accordingly, the Board for Advance Rulings shall have the same powers as are vested in a court under the Code of Civil Procedure, 1908, when trying a suit in respect of the following matters, namely -

(1) discovery and inspection;

(2) enforcing the attendance of any person, including any officer of a banking company and examining him on oath;

(3) compelling the production of books of account and other documents; and

(4) issuing commissions.

Therefore, the Board for Advance Ruling has the powers of compelling the production of books of account.

4. The statement is **not** correct. As per section 245N, advance ruling not only includes a determination by the BAR in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant, but also includes, *inter alia*, determination by the BAR –

(i) in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident and such determination shall include the determination of any question of law or of fact specified in the application

(ii) in relation to the tax liability of a resident applicant, arising out of a transaction which has been undertaken or is proposed to be undertaken by such applicant and such determination shall include the determination of any question of law or of fact specified in the application.

5. An applicant who is aggrieved by any ruling pronounced by the Board for Advance Rulings may appeal to the High Court against such ruling or order of the Board of Advance Rulings. He has to do so within sixty days from the date of the communication of that ruling, in the prescribed form and manner.

However, where the High Court is satisfied, on an application made by the appellant in this behalf, that the appellant was prevented by sufficient cause from presenting the appeal within the 60 day period as specified above, it may grant further period of 30 days for filing such appeal.

NOTES

CHAPTER 24

TRANSFER PRICING

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **appreciate** the need for incorporation of transfer pricing provisions in the Income-tax Act, 1961;
- **comprehend** the meaning and significance of arm's length principle and the practical difficulties in application of arm's length principle;
- **appreciate** the meaning and significance of the terms "associated enterprise", "international transaction" and "specified domestic transaction";
- **determine** the arm's length price using different methods prescribed under the income-tax law;
- **appreciate** the meaning of safe harbour and rules for safe harbor incorporated in the income-tax law;
- **appreciate** the benefits of entering into advance pricing agreements;
- **identify** the cases where secondary adjustments have to be made;
- **pinpoint** the responsibilities of a person entering into an international transaction to keep and maintain prescribed information and documents;

- **identify** the circumstances when the Assessing Officer can invoke the power to determine the arm's length price;
- **comprehend and appreciate** the country-by-country reporting requirements and related matters incorporated in the income-tax law in compliance with BEPS Action Plan 13;
- **appreciate** the specific anti-avoidance measures incorporated in the Income-tax Act, 1961 in respect of transactions with persons located in notified jurisdictional areas;
- **appreciate** the provisions incorporated in the Income-tax Act, 1961 restricting interest deduction claimed by an entity in respect of borrowings from an associated enterprise in line with BEPS Action Plan 4.

24.1 INTRODUCTION

In the present age of globalisation, Multinational Companies (MNCs) have branches/subsidiaries/divisions operating in more than one country. There is a possibility that two or more entities belonging to the same multinational group can fix up their prices for goods and services and allocate profits among the enterprises within the group in such a way that there may be either no profit or negligible profit in the jurisdiction which taxes such profits and substantial profit in the jurisdiction where the tax liability is minimum. This results in base erosion of the high tax jurisdiction by shifting the profits to the low tax jurisdiction, thereby minimizing the taxes. This may adversely affect a country's share of due revenue. The increasing participation of multinational groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group.

In order to curb such tax avoidance measures, Arm's Length Principle (ALP) is used internationally to substitute the transfer price adopted by the MNCs to price the intra-group transfer of goods or provision of services. Generally, the arm's length price refers to the price an unrelated enterprise would be willing to pay in comparable circumstances.

The OECD guidelines define the "Transfer prices" as the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. Two enterprises are "associated enterprises" if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if both enterprises are under common control. Since international transfer pricing involves more than one tax jurisdiction, any adjustment to the transfer price in one jurisdiction requires a corresponding adjustment in the other jurisdiction. If a corresponding adjustment is not made, double taxation will result.

24.2 MEANING OF "ARM'S LENGTH PRINCIPLE"

The Arm's Length Price (ALP) of a transaction between two associated enterprises is the price that would be paid if the transaction had taken place between two comparable independent and unrelated parties.

The Arm's Length Principle, in the context of taxation, is explained in the OECD Model Tax Convention as under:

Arm's Length Principle

"Where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The OECD transfer pricing guidelines provides guidance on the application of the arm's length principle in order to arrive at the proper transfer pricing range between associated enterprises. Market forces determine business relations between independent parties. The arm's length principle seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises. It treats each enterprise as a separate independent entity rather than as inseparable parts of a single unified business.

24.3 SIGNIFICANCE OF ARM'S LENGTH PRINCIPLE

There are several reasons as to why the OECD member countries and other countries have adopted the arm's length principle.

Parity between MNCs and independent enterprises – A major reason is that the ALP provides broad parity of tax treatment for MNCs and independent enterprises. Since the ALP puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. The ALP, thus promotes the growth of international trade and investment by removing these tax considerations from economic decisions.

Determines real taxable profits - The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price is needed to determine real taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if they were an independent enterprise.

Reduction of artificial price distortion - If the ALP is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax jurisdiction at a high price (which exceeds the market price) and to an entity in a low-tax jurisdiction or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market.

Accurate measurement of economic contribution – The ALP provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of the ALP is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed.

24.4 PRACTICAL DIFFICULTIES IN APPLICATION OF ALP

There are, however, certain practical difficulties in applying the ALP, which are described hereunder:

True comparison difficult in certain cases – The commercial and financial conditions governing a transaction between independent enterprises are, by and large, never similar to those existing between associated enterprises. As a result, there cannot be a true comparison. The economies of scale and integration of various business activities of the associated enterprise may not be truly appreciated by arm's length principle. Further, associated enterprises may enter into transactions which independent enterprises may not enter into, like say, licensing of valuable intangible or sharing the benefits of research. The owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, he may be prepared to offer terms that are less restrictive to associated enterprises because the use of the intangible can be closely monitored. Further, there is no risk to the overall group's profit from a transaction of this kind between members of an MNC group. In such situations, where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the ALP is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.

Availability of data and reliability of available data – There may be difficulty in getting adequate and reliable information and data in order to apply arm's length principle. The information regarding the comparable companies, their profit margins, the pricing charged by them in independent and comparable circumstances may be difficult to obtain. Further, the differences in the accounting of the data could result in difficulty as the reliable adjustments may not be possible to be made.

Absence of comparable market price for "intangible" transactions - The ALP reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions where the price range is narrow and market price is certain. However, the ALP generally fails to achieve a comparable market price for transactions involving intangibles because they are unique. The unique nature of these transactions creates a very wide price range.

Administrative burden – Due to the subjectivity in selection of comparables and the methods, the application of arm's length principle results in administrative burden for the tax administration as well as the taxpayers.

Time lag - Although an associated enterprise normally establishes the conditions for a transaction at the time it is undertaken, at some point the enterprise may be required to demonstrate that these are consistent with the arm's length principle. The tax administration may also have to engage in the verification process perhaps some years after the transactions have taken place. It may result in substantial cost being incurred by the tax payer and the tax administration. It is also difficult to appreciate the business realities which prevailed at the time when the transactions were entered into. This may lead to bias against the tax payer.

In spite of the practical difficulties listed above, OECD member countries are of the view that the ALP does provide a sound basis to appreciate the transfer pricing between associated enterprises. It has so far provided acceptable solutions to both taxpayers and the tax administrations. The experience gained so far should be effectively used to remove the practical difficulties and improve the administration.

24.5 THE INDIAN SCENARIO

(1) Transfer pricing in relation to International Transactions

Finance Act, 2001 has introduced Chapter X to the Income-tax Act, 1961 with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India so as to curb the pricing strategies adopted by the MNCs resulting in base erosion and profit shifting.

These provisions are contained in sections 92 to 92F of the Income-tax Act, 1961. Rules 10A to 10E have been inserted in the Income-tax Rules, 1962. These sections and rules of the Income-tax Act, 1961 and the Income-tax Rules, 1962, respectively, will affect all non-corporate and corporate assessees who have dealings with non-residents for import or export of goods, properties or services.

The following conditions must be satisfied in order to attract the special provisions of Chapter X relating to avoidance of tax:

(i) There must be an international transaction;

(ii) Such international transaction should be between two or more associated enterprises either or both of whom are non-residents;

(iii) Such international transaction should be in the nature of:

  (a) purchase, sale or lease of tangible or intangible property; or

  (b) provision of service; or

  (c) lending or borrowing money; or

  (d) any other transaction having a bearing on the profits, income, losses or assets of such enterprise.

(iv) Further, such transaction can also involve allocation or apportionment of, or any contribution to any cost or expenses incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of the associated enterprises on the basis of mutual agreement or arrangement between such associated enterprises.

(v) Such international transaction must be done at arm's length price and if such international transaction has been done at less than the arm's length price, it shall require determination of income or apportionment of cost or expense on the basis of arm's length price.

(vi) The above adjustment should either result in an increase of income or decrease of loss returned by the assessee. In other words, the adjustment should not have the effect of reducing the income chargeable to tax or increasing the loss.

I. Computation of income from transaction with non-resident [Section 92]: Section 92 provides that any income arising from an "international transaction" shall be computed having regard to "the arm's length price". For this purpose, the allowance for any expense or interest shall be determined on the basis of arm's length price.

Transactions with associate enterprises should be at ALP

The section further provides that in an international transaction between two or more 'associated enterprises" when there is a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expenses in connection with a benefit, service or facility provided to any one or more of such enterprises, the allocation of cost, expenses etc. shall be determined having regard to arm's length price of such benefit, service or facility.

The objective of transfer pricing provisions is to protect the tax base of India and to ensure that due to inter-company transactions, there is no reduction in the taxable profits or the taxes paid by the Indian taxpayer.

It is, however, pertinent to note that the transfer pricing provisions would not be applicable if substitution of the ALP has the effect of reducing the income chargeable to tax or increasing the loss.

The Assessing Officer will have wide powers to determine what is an arm's length price for such transactions and make adjustments for computation of income. The keywords in section 92 are

(i) associated enterprises,

(ii) international transactions and

(iii) arm's length price.

These terms are defined in sections 92A, 92B and 92C.

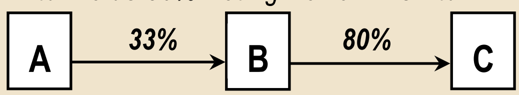
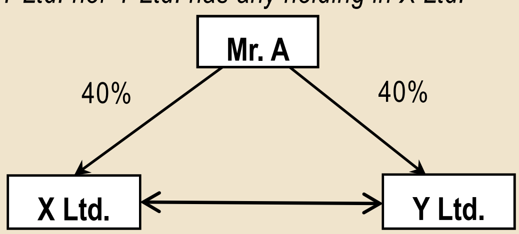
II. Associated Enterprises [Section 92A]: Section 92A(1) defines the associated enterprises generally. Section 92A(2) provides 13 relationships between the enterprises which constitutes deemed associated enterprises.

The term "associated enterprise" in relation to another enterprise is defined in section 92A(1). Associated enterprises are those which are owned or controlled by the same or common entity/ person.

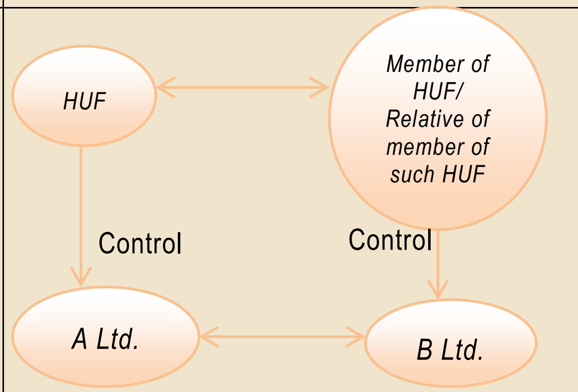
Associated Enterprises [Section 92A(1)]		
	Condition	**Example**
(1)	An enterprise which participates, directly or indirectly, or through one or more intermediaries, in: • management of the other enterprise, or • control of other enterprise, or • capital of other enterprise	*Where A Ltd. directly participates in the management of B Ltd. and B Ltd. directly participates in the management of C Ltd. In such situation, A Ltd. has direct participation in management of B Ltd. but has an indirect participation in management of C Ltd.* A → B → C *In such scenario, both B Ltd. and C Ltd. would be associated enterprises of A Ltd.*
(2)	If one or more persons participates, directly or indirectly, or through one or more intermediaries in:	*Mr. A directly has control in A Ltd. and B Ltd. In such a scenario, both A Ltd. & B Ltd. are associated enterprises since there is a*

	• management/control/capital of the two different enterprises Then, those two enterprises are AEs.	*common person i.e., Mr. A, who controls both entities A Ltd. & B Ltd.*

Two enterprises are deemed to be associated enterprises if they fall under any one or more of the situations contained in section 92A(2). This section provides 13 such situations during which associated enterprise relationship is deemed to be established. Two enterprises are deemed to be associated enterprise if:

Deemed Associated Enterprises [Section 92A(2)]		
Condition	**Situation**	**Example**
Enterprise ownership	**One enterprise holds 26% or more of the voting power,** directly or indirectly, in the **other enterprise.**	*A Ltd. holds 33% of Voting Power in B Ltd. and B Ltd. holds 80% Voting Power in C Ltd.*  *In above situation, A Ltd. holds 26% or more voting power in B Ltd., directly and in C Ltd. indirectly (i.e. through B Ltd.). Therefore, both B Ltd. & C Ltd. are deemed associated enterprises of A Ltd.*
Substantial voting power in two entities by common person	Any person or enterprise **holds 26% or more of the voting power,** directly or indirectly, in each of **two different enterprises.**	*Mr. A holds 40% of voting power in both X Ltd. and Y Ltd. where neither X Ltd. has any holding in Y Ltd. nor Y Ltd. has any holding in X Ltd.*  *In this situation, since Mr. A directly holds 40% of voting power in both X Ltd. and Y Ltd., X Ltd. & Y Ltd. will be deemed associated enterprises.*
Advancing of substantial sum of money	One enterprise advances loan to the other enterprise of an amount of **51% or more** of the book value of **the total assets of other enterprise**	*Book Value of total assets of Y Ltd. is ₹ 100 crores. X Ltd. advances loan of ₹ 60 crores to Y Ltd.* *In this case, X Ltd. advances loan of ₹ 60 crores to Y Ltd, which is 60% of the book value of total assets of Y Ltd. Hence, X Ltd. & Y Ltd. are deemed associated enterprises.*

Guaranteeing borrowings	One enterprise guarantees **10% or more** of the **total borrowings** of the **other enterprise**.	*P Inc. has total loan of 1 million dollars from XYZ Bank of America. Out of that, A Ltd., an Indian company, guarantees 20% of total borrowings in case of any default made by P Inc. In such case, since A Ltd. guarantees 20% of total borrowings of P Inc., P Inc. and A Ltd. are deemed associated enterprises.*
Appointment of majority directors of other enterprise	One enterprise appoints **more than half of the board of directors or members** of the governing board, or one or more executive directors or executive members of the governing board of **other enterprise**.	*X Ltd. has 15 directors on its Board. Out of that, Y Ltd. has appointed 8 directors. In such case, X Ltd. and Y Ltd. are deemed associated enterprises.*
Appointment of majority directors of two different enterprises by same person(s)	**More than half of the directors** or members of the governing board, or one or more of the executive directors or members of the governing board of each of the **two** enterprises are appointed **by the same person(s).**	*Mr. A appointed 9 directors out of 15 directors of X Ltd. and appointed 2 executive directors on the board of Y Ltd. In such case, since a common person i.e. Mr. A appointed more than half of the directors in X Ltd. and appointed 2 executive directors in Y Ltd., both X Ltd. and Y Ltd. are deemed associated enterprises.*
Dependence on intangibles w.r.t which other enterprise has exclusive rights	The **manufacture or processing of goods** or articles or business carried out by one enterprise is **wholly dependent (i.e. 100%) on the know-how**, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other entity is the owner or in respect of which the other enterprise has exclusive rights.	
Dependence on raw material supplied by other enterprise	**90% or more of raw materials and consumables** required for the manufacture or processing of goods or articles carried out by one enterprise, **are supplied by the other enterprise**, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.	
Dependence on sale	The **goods or articles manufactured** or processed by one enterprise, **are sold to the other enterprise** or to persons specified by the other enterprise, and the **prices and other conditions** relating thereto are **influenced by such other enterprise.**	

<table>
<tr><td>Control by common individual</td><td>Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and his relatives.</td><td>Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.</td></tr>
<tr><td>Control by HUF or member thereof</td><td>Where one enterprise is controlled by a HUF and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative.</td><td>

A Ltd & B Ltd are deemed associated enterprises</td></tr>
<tr><td>Interest in a firm, AOPs or BOIs</td><td colspan="2">Where one enterprise is a firm, AOPs or BOIs, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.</td></tr>
<tr><td>Mutual interest relationship</td><td colspan="2">There exists b/w the two enterprises, any relationship of mutual interest, as may be prescribed.</td></tr>
</table>

Meaning of Enterprise

The term "enterprise" is defined in section 92F(iii) to mean a person (including its certain specified Permanent Establishment) who is, or has been, or is proposed to be, engaged in any activity,

- relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copy rights, trade-marks, licences, franchises or any other business or commercial rights of similar nature or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or

- the provision of services of any kind, or in carrying out any work in pursuance of a contract, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate,

whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

Meaning of PE

"Permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

III. Definition of International Transaction [Section 92B]

International Transaction

- As per section 92B, an international transaction means:
  - (i) a transaction between two or more associated enterprises, either or both of whom are non-residents; and
  - (ii) transaction in the nature of:
    - (a) sale/purchase/lease of tangible property; or
    - (b) sale/purchase/lease of intangible property; or
    - (c) provision of services; or
    - (d) lending/borrowing money; or
    - (e) any other transaction having a bearing on profits, income, losses or assets of such enterprises; or
    - (f) mutual agreement or arrangement between two or more associated enterprise for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

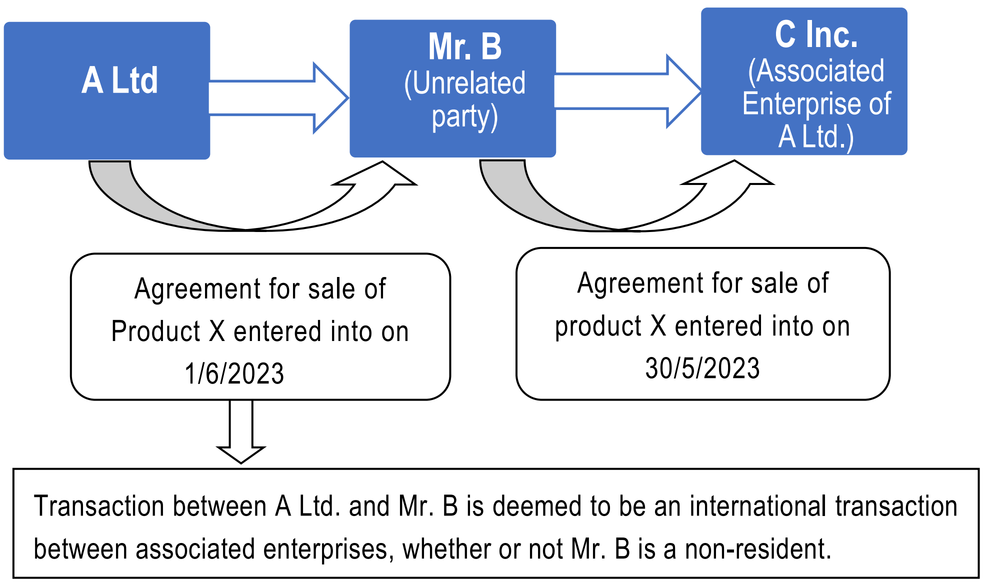
Deemed International Transaction

- Where, in respect of a transaction entered into by an enterprise with a person other than an associated enterprise (hereinafter referred to as "other person"),
  - ♦ there exists a prior agreement in relation to the relevant transaction between the other person and the associated enterprise **or**,
  - ♦ where the terms of the relevant transaction are determined in substance between such other person and the associated enterprise; **and**
  - ♦ either the enterprise or the associated enterprise or both of them are non-residents,

then such transaction entered into between the enterprise and the other person shall be **deemed to be an international transaction** entered into between two associated enterprises, **whether or not such other person is a non-resident.**

Example:

If A Ltd., an Indian company, has entered into an agreement for sale of product X to Mr. B, an unrelated party, on 1/6/2023 and Mr. B has entered into an agreement for sale of product X with C Inc., a non-resident entity, which holds 27% of the voting power in A Ltd., on 30/5/2023, then, the transaction between A Ltd. and Mr. B shall be deemed to be an international transaction entered into between two associated enterprises, irrespective of whether or not Mr. B is a non-resident.



Note – *C Inc. is deemed to be an associated enterprise of A Ltd. since it holds 26% or more of the voting power A Ltd.*

- The scope of **"international transaction"** shall include:

	Transactions	Amplification of scope of terms used
(1)	Purchase, sale, transfer, lease or use of tangible property	Tangible property includes - • building, • transportation vehicle, • machinery, equipment, tools, plant, • furniture,

		• commodity or • any other article, product or thing;
(2)	Purchase, sale, transfer, lease or use of intangible property, including transfer of ownership or the provision of use of certain rights	"Use of certain rights" refer to – • land use, • copyrights, patents, trademarks, licences, franchises, • customer list, marketing channel, brand, commercial secret, • know-how, • industrial property right, • exterior design or practical and new design or • any other business or commercial rights of similar nature.
(3)	Capital financing	• any type of long-term or short-term borrowing, • lending or guarantee, • purchase or sale of marketable securities or • any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.
(4)	Provision of services	• provision of market research, • market development, • marketing management, • administration, • technical service, • repairs, • design, • consultation, • agency, • scientific research, • legal or accounting service.

(5)	Business restructuring or reorganization entered into by an enterprise with an associated enterprise	All such transactions are included in the definition of "international transaction", whether or not it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

- The expression "**intangible property"** shall include:

	Type of intangible asset in relation to	**Examples of each type of intangible asset**
(1)	Marketing	• Trademarks • trade names • brand names • logos
(2)	Technology	• Process patents • patent applications • technical documentation such as laboratory notebooks • technical know-how
(3)	Artistic	• literary works and copyrights • musical compositions • copyrights • maps • engravings
(4)	Data processing	• proprietary computer software • software copyrights • automated databases • integrated circuit masks and masters
(5)	Engineering	• industrial design • product patents • trade secrets • engineering drawing and schematics • blueprints • proprietary documentation
(6)	Customer	• customer lists

		• customer contracts • customer relationship • open purchase orders
(7)	Contract	• favourable supplier • contracts, • licence agreements • franchise agreements • non-compete agreements
(8)	Human capital	• trained and organised work force • employment agreements • union contracts
(9)	Location	• leasehold interest • mineral exploitation rights • easements • air rights • water rights
(10)	Goodwill	• institutional goodwill • professional practice goodwill • personal goodwill of professional • celebrity goodwill • general business going concern value
(11)	methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, or technical data;	
(12)	any other similar item that derives its value from its intellectual content rather than its physical attributes.	

❑ **Transaction:** The word "transaction" has been defined in section 92F to include an arrangement, understanding or action in concert

(i) whether or not such arrangement, understanding or action is formal or in writing; or

(ii) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings."

Section 92F(v) provides an inclusive definition of the term "transaction". Based on the reading of the section, it is evident that it is not necessary that for a transaction undertaken between two enterprises there needs to be a formal written agreement between them. It is only relevant whether a transaction has been entered into in substance. The section also negates the requirement as to the legal enforceability of agreement or understanding.

It may be noted that one of the parties to the international transaction should be a non-resident. Therefore, transactions between a resident assessee ("A" Ltd.) and its foreign branches or between its two or more foreign branches will not be considered as international transactions. This is for the reason that when "A" Ltd. is a resident in India, all its foreign branches will be deemed to be resident in India and transactions between Head Office and branches or between branches *inter se* will be considered as transactions between residents. Even otherwise there can be no avoidance of income in the transactions between Indian Head Office and foreign branches.

On the other hand, if an Indian branch of a foreign company ("B" Ltd.) is having a transaction with the Head Office, the same will be covered by the definition of international transaction between associated enterprises. This is because the Indian branch (permanent establishment of "B" Ltd.) will be liable to tax in India in respect of its Indian operations and, therefore, any transaction between the Indian branches of "B" Ltd. with its head office in foreign country or with any of the branches of "B" Ltd. outside India will be considered as an international transaction and it will have to establish that the transaction is at an arm's length price. This will be the position even in respect of transactions between a parent company ("A" Ltd.) and its foreign subsidiary and, therefore, such transactions will have to comply with the provisions of transfer pricing regulations.

IV. **Arm's Length Price [Section 92C]:** "Arm's length price" is defined in section 92F(ii) to mean price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions. Section 92C deals with the method for determining arm's length price and the factors which are to be considered for applicability or non-applicability of a particular method to a given situation. The factors as well as methods incorporated in this section are not exhaustive and the CBDT may prescribe further factors and methods. It provides that the arm's length price in relation to an international transaction would be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the CBDT may prescribe, namely -

(a) comparable uncontrolled price method;

(b) resale price method;

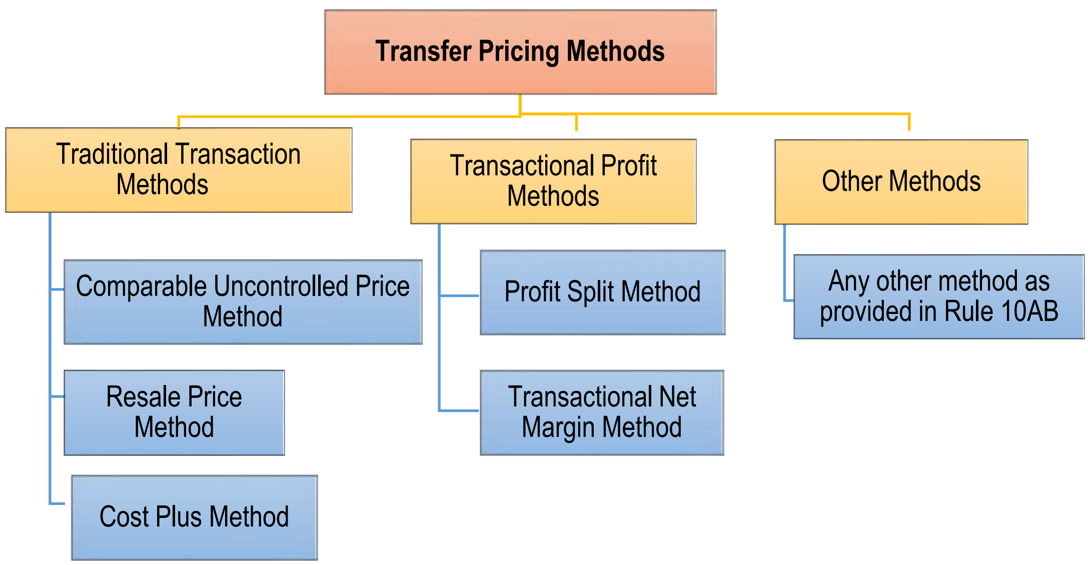
(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

Accordingly, the CBDT has prescribed that the other method for determination of arm's length price in relation to an international transaction would be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts [Rule 10AB].



Section 92C(2) provides that the most appropriate method out of the above methods has to be applied for determination of arm's length price, in the prescribed manner.

Rule 10B(1) prescribed the manner to determine the arm's length price under the five methods as stated in above diagram in respect of any goods, property or services purchased or sold under any international transaction.

(a) **Comparable Uncontrolled Price Method**

Under this method the price charged or paid for property transferred or services provided under any comparable uncontrolled transaction or transactions should be identifiable.

→

Adjustment to account for differences between the international transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions which could materially affect the price in the open market can be made.

→

The adjusted price as worked out under (b) will be considered as an arm's length price in respect of the property transferred or services provided in the international transaction.

ILLUSTRATION 1

US Ltd., a US company has a subsidiary, IND Ltd. in India. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells computer monitors to CMI Ltd., another computer reseller. It sells 50,000 computer monitors to IND. Ltd. at ₹ 11,000 per unit. The price fixed for CMI Ltd. is ₹ 10,000 per unit. The warranty in case of sale of monitors by IND Ltd. is handled by IND Ltd. However, for sale of monitors by CMI Ltd., US Ltd. is responsible for the warranty for 3 months. Both US Ltd. and IND Ltd. offer extended warranty at a standard rate of ₹ 1,000 per annum. On these facts, how is the assessment of IND Ltd. going to be affected?

SOLUTION

US Ltd., the foreign company and IND Ltd., the Indian company are associated enterprises since US Ltd. is the holding company of IND Ltd. US Ltd. sells computer monitors to IND Ltd. for resale in India. US Ltd. also sells identical computer monitors to CMI Ltd., which is not an associated enterprise. The price charged by US Ltd. for a similar product transferred in comparable uncontrolled transaction is, therefore, identifiable. Therefore, Comparable Uncontrolled Price (CUP) method for determining arm's length price can be applied.

While applying CUP method, the price in comparable uncontrolled transaction needs to be adjusted to account for difference, if any, between the international transaction (i.e. transaction between US Ltd. and IND Ltd.) and uncontrolled transaction (i.e. transaction between US Ltd. and CMI Ltd.) and the price so adjusted shall be the arm's length price for the international transaction.

For sale of monitors by CMI Ltd., US Ltd. is responsible for warranty for 3 months. The price charged by US Ltd. to CMI Ltd. includes the charge for warranty for 3 months. Hence arm's length price for computer monitors being sold by US Ltd. to IND Ltd. would be:

Particulars	No.	₹
Sale price charged by US Ltd. to CMI Ltd.		10,000
Less: Cost of warranty included in the price charged to CMI Ltd. (₹ 1,000 x 3 /12)		250
Arm's length price		**9,750**
Actual price paid by IND Ltd. to US Ltd.		11,000
Difference per unit		**1,250**
No. of units supplied by US Ltd. to IND Ltd.	50,000	
Addition required to be made in the computation of total income of IND Ltd. (₹ 1,250 × 50,000)		6,25,00,000

No deduction under Chapter VI-A would be allowable in respect of the enhanced income of ₹ 6.25 crores.

Note: *It is assumed that IND Ltd. has not entered into an advance pricing agreement or opted to be subject to Safe Harbour Rules.*

(b) Resale Price Method

Under this method, the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise should be identifiable.

The following adjustments can be made to such resale price.

- For normal gross profit margin
- For expenses incurred in connection with the purchase of property or obtaining of services.
- For functional and other differences, including differences in accounting practices which could materially affect the gross profit margin in the open market.

The adjusted price as stated in (b) above will be considered as the arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise.

ILLUSTRATION 2

Earth (P) Ltd., Calcutta is engaged in trading of electronic goods. It purchased goods from its associated enterprise Sun Pte. Ltd., Singapore, and also from unrelated party, Oceania Ltd., UK. For the F.Y.2023-24, the gross profit margin was 15% on the sale of goods of Sun Pte Ltd., *whereas it was 20% in the case of Oceania Ltd. After-sales warranty of 6 months was provided by Sun Pte Ltd. whereas Oceania Ltd. gave after-sales warranty of 1 year. The cost of warranty may be taken as 2% of the sale price. The Sun Pte. Ltd.'s brand value is internationally known and the benefit of the brand value can be taken as 1% of sale price. During the F.Y.2023-24, it sold goods of Sun Pte Ltd. for ₹ 20 crores and of Oceania Ltd. for ₹ 15 crores. As regards transport cost of the goods purchased, there was no difference between related and unrelated party. Compute the ALP of the transaction between Earth (P) Ltd. and Sun Pte Ltd., Singapore by applying the Resale Price Method, considering the facts of the case.*

SOLUTION

As per section 92B, the transactions entered into between Earth (P) Ltd., an Indian company, and Sun Pte. Ltd., Singapore, being associated enterprises, for purchase of electronic goods would be international transaction.

Since Earth (P) Ltd. purchased similar electronic goods from Oceania Ltd., an unrelated entity, and sold the same to unrelated parties, this transaction can be considered as uncontrolled transaction and the gross profit margin of 20% earned on sale of such goods can be considered for the purpose of determining the arm's length price of the transactions between Earth (P) Ltd. and Sun Pte. Ltd. However, functional adjustments need to be given effect to in arriving at the ALP.

Computation of ALP of transaction between Earth (P) Ltd. and Sun Pte. Ltd.

Particulars	Amount (In ₹)
Resale price of goods purchased from Sun Pte. Ltd.	20,00,00,000
Less: Profit margin with reference to uncontrolled transaction between Earth (P) Ltd. and Oceania Ltd. (20% on sale)	4,00,00,000
	16,00,00,000
Add: Adjustment for benefit of brand value of Sun Pte. Ltd. [Sun Pte. Ltd has its brand value internationally. Therefore, adjustment of benefit of brand value has to be carried out to arrive at ALP (1% of sale price)]	20,00,000
***Less**:* Adjustment of cost of warranty [Sun Pte. Ltd. provides warranty for 6 months whereas unrelated party has provided warranty of 12 months. Therefore, adjustment for the cost of such warranty has to be carried out to arrive at arm's length price (2% of sale price x 6/12)]	(20,00,000)
Arm's length price	**16,00,00,000**

(c) Cost Plus Method

Under this method, the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise should be determined.

The amount of a normal gross profit mark-up to such costs arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise in comparable uncontrolled transaction or transactions should be determined.

The above normal gross profit mark-up can be adjusted to take into account the functional and other differences which could materially affect such profit mark-up in the open market.

Costs referred to in (a) above should be increased by the adjusted profit mark-up as stated in (c) above and the price so arrived at will be considered as the arm's length price.

ILLUSTRATION 3

ABC Ltd., Canada holds 35% shares in LMN Ltd., India. LMN Ltd. develops software and does both onsite and offsite consultancy services for the customers. LMN Ltd. during the year billed ABC Ltd. Canada for 120 man-hours at the rate of ₹ 1,800 per man hour. The total cost (direct and indirect) for executing this work amounted to ₹ 2,25,000.

However, LMN Ltd. billed XYZ Ltd., India at the rate of ₹ 2,800 per man hour for the similar level of manpower and earned a Gross Profit of 50% on its cost.

The transactions of LMN Ltd. with ABC Ltd. and XYZ Ltd. are comparable, subject to the following differences:

- *While LMN Ltd. derives technology support from the ABC Ltd., there is no such support from XYZ Ltd. The value of technology support received from ABC Ltd. may be put at 18% of normal gross profits.*
- *As ABC Ltd. gives business in large volumes, LMN Ltd. offered to ABC Ltd., a quantity discount which may be valued at 10% of normal gross profits.*
- *In the case of rendering services to ABC Ltd., LMN Ltd. neither runs any risk nor incurs any marketing costs. On the other hand, in the case of services to XYZ Ltd., LMN Ltd. has to*

assume all the risk and costs associated with the marketing function which may be estimated at 12% of the normal gross profits.

- *LMN Ltd. offered one month credit to ABC Ltd. The cost of providing such credit may be valued at 2% of the gross profits. No such credit was given to XYZ Ltd.*

Compute the Arm's Length Price along with income to be increased under the Cost Plus Method.

SOLUTION

LMN Ltd, an Indian company and ABC Ltd., a Canadian company, are deemed to associated enterprises as per section 92A(2), since ABC Ltd. holds shares carrying 35% of the voting power (i.e., not less than 26% of voting power) in LMN Ltd. Further, the transaction of developing software and providing consultancy services (both onsite and offsite) fall within the meaning of "international transaction" under section 92B. Hence, transfer pricing provisions would be attracted in this case.

Computation of Arm's Length Price as per Cost Plus Method		
Gross Profit mark-up on cost in case of XYZ Ltd. [an unrelated party]		50%
Less: Adjustments for functional and other differences		
- Value of technology support [ABC Ltd. provides technology support, but XYZ Ltd. does not provide such support. Therefore, value of technology support shall be adjusted] [18% of 50%, being gross profit]	9%	
- Quantity discount to ABC Ltd. [Quantity discount is allowed to ABC Ltd. as it gives business in large volumes, but the same is not provided to XYZ Ltd. Therefore, it shall be adjusted] [10% of 50%, being gross profit]	5%	
- Risk and cost associated with marketing [LMN Ltd. has to bear all the risk and costs associated with the marketing function in case of XYZ Ltd., while there is no such risk in case of services to ABC Ltd. Therefore, market risk and cost shall be adjusted] [12% of 50%, being gross profit]	6%	20%
		30%
Add: Cost of credit to ABC Ltd. [LMN Ltd has provided credit of 1 month to ABC Ltd. but not to the unrelated party. Therefore, adjustment for the cost of such credit has to be carried out to arrive at the ALP] [(2% of 50%, being gross profit]		1%
Arm's length gross profit mark up to cost		**31%**

Cost incurred by LMN Ltd. for executing ABC Ltd.'s work		2,25,000
Add: Adjusted gross profit (₹ 2,25,000 x 31%)		69,750
Arm's length billed value		**2,94,750**
Less: Actual Billed Income from ABC Ltd. (₹ 1800 x 120 man hours)		2,16,000
Total Income of LMN Ltd to be increased by		**78,750**

(d) Profit Split Method

This is a method which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so inter-related that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction.

Under this method, combined net profit of the associated enterprises arising from the international transactions in which they are engaged is first determined.

The relative contribution of each associated enterprise to the earning of such combined net profit is then evaluated on the basis of the functions performed, assets employed and risks assumed by each enterprise. This evaluation is to be made on the basis of reliable external market data which can indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances.

The combined net profit is then split amongst the enterprises in proportion to their relative contributions. The profit thus apportioned to the assessee is taken into consideration to arrive at an arm's length price in relation to the international transaction.

In certain cases the combined net profit referred to in (b) above may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged. This has to be determined with reference to market returns achieved for similar types of transactions by independent enterprises. Thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises as stated in (c) and (d) above. In such a case the aggregate of net profit allocated in the first instance together with the residual profit apportioned should be considered for arriving at the arm's length price of the international transaction.

(e) Transactional Net Margin Method

In this method, the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed having regard to costs incurred or sales effected or assets employed or having regard to any other relevant base.

↓

The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction by applying the same base as in (a) above is computed. This profit margin is adjusted to take into account the differences which could materially affect the net profit margin in the open market having regard to international transaction and comparable uncontrolled transactions or having regard to the enterprise entering into such transactions.

↓

If the net profit margin realised by the enterprise as in (a) above is established to be the same as the net profit margin as in (b) above, then the same is taken into consideration to arrive at an arm's length price in relation to the international transaction.

ILLUSTRATION 4

Andes Inc. having its business in Malaysia has advanced a loan of MD 1,60,000 to Andes Ltd, India. Book value of total assets of Andes Ltd was ₹ 125 lakhs. Andes Ltd provides software backup support to Andes Inc. Andes Ltd has spent 50,000 man hours during the financial year 2023-24 for the services rendered to Andes Inc. The cost for Andes Ltd is MD 75/manhour. Andes Ltd has billed Andes Inc. at MD 90.75/manhour.

Gama Ltd. in India which has a similar business model, provides software backup support to Olive Inc. in Penang, Malaysia. Gama Ltd.'s cost and operating profits are as hereunder:

Particulars	***₹ in lakhs***
Direct costs	*600*
Indirect costs	*200*
Operating profits	*200*

(1) Calculate Arm's Length Price for the transaction between Andes Ltd. and Andes Inc. based on the above data of Gama Ltd. using the Transactional Net Margin Method. Assume 1 MD = ₹ 45.

(2) Explain, if there is any adjustment to be made to the total income of Andes Ltd.

Note: *MD = Malaysia Dollars*

SOLUTION

Two enterprises are deemed to be associated enterprises where one enterprise advances loan constituting not less than 51% of the book value of the total assets of the other enterprise.

In this case, since Andes Inc., a foreign company, has advanced loan to Andes Ltd., an Indian company, and such loan constitutes 57.6% [(₹ 45 x 1,60,000 x 100/1,25,00,000] of the book value of total assets of Andes Ltd., Andes Inc and Andes Ltd. are deemed to be associated enterprises. Since the transaction of provision of software backup support by Andes Ltd. to Andes Inc. is an international transaction between associated enterprises the provisions of transfer pricing would be attracted in this case.

Determination of Operating Margin of transaction of provision of software backup support by Andes Ltd. to Andes Inc

Particulars	₹
Billing per manhour [MD 90.75/hour x ₹45]	4,083.75
Cost per man hour [MD 75/hour x ₹45]	3,375.00
Operating profit per manhour	**708.75**
Operating profits to cost (%) **[708.75 x 100/3375] = 21%**	

Determination of Operating Margin of Comparable Uncontrolled transaction i.e., provision of software backup support. by Gama Ltd. to Olive Inc.

Particulars	₹ in lakhs
Direct Cost	600
Indirect Cost	200
Total cost	**800**
Operating profits	200
Operating profits to cost (%) **[200 x 100/800] = 25%**	

(1) Computation of Arm's Length Price of provision of software backup support provided by Andes Ltd. to Andes Inc. by applying TNMM

Particulars	₹
Cost for Andes Ltd. (per man hour) [MD 75 x ₹ 45/MD]	3,375.00
Add: Arm's length operating profit margin as % of cost (25% of ₹ 3,375)	843.75
Arm's length price (per manhour) in ₹	**4,218.75**
Arm's length price of total manhours spent by Andes Ltd. for providing software backup support to Andes Inc. [₹ 4,218.75 x 50,000 man hours] = ₹ 21,09,37,500	

(2) Adjustment to be made to the total income of Andes Ltd.

Particulars	₹
Arm's length price of total manhours spent by Andes Ltd. for providing software backup support to Andes Inc.	21,09,37,500
Less: Amount actually billed [90.75 MD x ₹ 45/MD x 50,000 manhours]	20,41,87,500
Arm's length adjustment to be made to the total income of Andes Ltd.	**67,50,000**

(f) Other Method as may be prescribed by the CBDT

The Other method allows the use of 'any method' which takes into account

(i) the price which has been charged or paid or

(ii) would have been charged or paid for the same or similar uncontrolled transactions with or between non-associated enterprises, under similar circumstances.

The various data which may possibly be used for comparability purposes under this method could be third party quotations, valuation reports, tender/Bid documents, documents relating to the negotiations, standard rate cards, commercial & economic business models; etc.

Methods for computing ALP [Section 92C]

CUP Method	Resale Price Method(RPM)	Cost Plus Method (CPM)	Profit Split Method (PSM)	Transactional Net Margin Method (TNMM)
This method is applied where there are similar transaction(s) b/w unconnected parties	This method is applied where item obtained from AE is resold to unrelated party	This method is generally applied where semi-finished goods are sold to AEs	This method is applied where there is transfer of unique intangibles or in multiple International Transaction	Compute Net Profit (NP) margin of the enterprise from International Transaction with AE having regard to cost incurred/sales effected/ assets employed
Identify price in a comparable uncontrolled transaction (CUCT)	Identify the Resale Price (RP) at which the item is resold to unrelated party	Identify direct & indirect cost of production incurred for property transferred or services provided to AE	Determine combined NP of the AEs arising out of International Transaction	Compute the NP margin realised by the enterprise or unrelated enterprise in a CUCT by applying the same base
	Reduce the RP by the normal Gross Profit (GP) margin on CUCT & expenditure incurred (customs duty) w.r.t. purchase	Determine normal GP mark up to such costs by an unrelated enter in CUCT	Evaluate the relative contribution of each enterprise to the earning of combined NP on the basis of FAR	Adjust NP margin realised from CUCT to a/c for differences affecting NP margin in the OM
Adjust the price for material differences in terms of contract, credit, transport etc.	Adjust the price for functional & other differences materially affecting GP margin in open market (OM)	Adjust the normal GP mark-up for functional and other differences materially affecting GP mark-up in OM	Split the combined NP amongst the enterprise in proportion to market returns; & residual profits in proportion to their relative contribution	Compare NP margin relative to costs/sales/assets of the AE with NP margin of uncontrolled party in comparable transactions
Adjusted price is ALP	Adjusted price is ALP	Total Costs ↑d by adjusted mark up = ALP	ALP to be detd. on the basis of profit apportioned.	Adjusted NP margin taken into A/c to arrive at ALP

Determination of the most appropriate method: Rule 10C deals with the determination of most appropriate method. Under this Rule, the method which is best suited to the facts and circumstances and which provides the most reliable measure of an arm's length price in relation to the international transaction will be considered to be the most appropriate method.

For the purpose of selecting the most appropriate method, the following factors should be taken into account.

(i) The nature and class of the international transaction;

(ii) The class, or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(iii) The availability, coverage and reliability of data necessary for application of the method;

(iv) The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

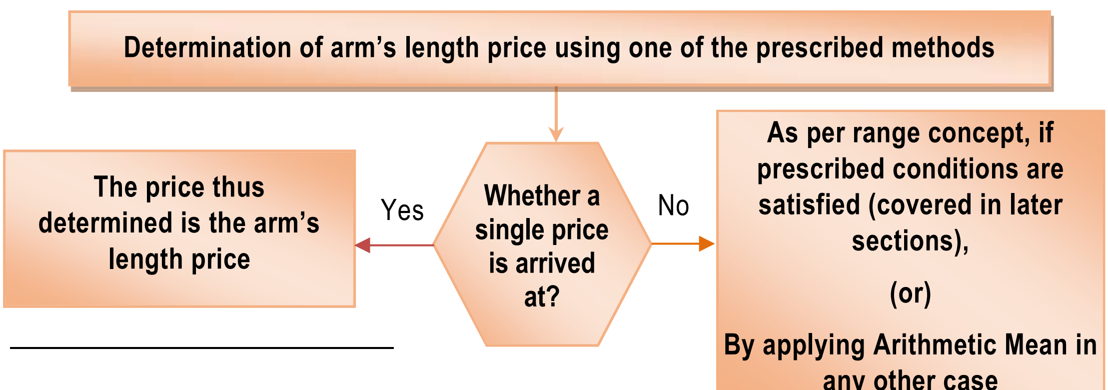
(v) The extent to which reliable and accurate adjustments can be made to account for difference, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(vi) The nature, extent and reliability of assumptions required to be made in application of a method.

Manner of computation of Arm's length price (Applicable for international transactions and specified domestic transactions undertaken on or after 1.4.2014) [Third proviso to section 92C(2)]

In case of an international transaction or specified domestic transaction[1] undertaken on or after 1.4.2014, where more than one price is determined by the most appropriate method, the ALP would be computed in the prescribed manner specified in Rule 10CA.

Computation of arm's length price in certain cases [Rule 10CA]



[1] discussed later in this Chapter

Rule 10CA(1) provides that where in respect of an international transaction or a specified domestic transaction, the application of the most appropriate method referred to in section 92C(1) results in determination of more than one price, then, the arm's length price in respect of such international transaction or specified domestic transaction has to be computed on the basis of the dataset constructed by placing such prices in an ascending order as provided in Rule 10CA(2).

Application of multiple year data for construction of dataset

Multiple year data allowed only in cases where determination of ALP is done using TNMM, RPM or CPM

Data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction

The data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction should relate to the financial year (current year) in which the international transaction has been entered into.

In case the most appropriate method for determination of ALP of a transaction entered into on or after 1.4.2014 is the **resale price method** or **cost plus method** or **the transactional net margin method**, then, the data to be used for analyzing the comparability of an uncontrolled transaction with an international transaction shall be –

(a) the data relating to the current year; or

(b) the data relating to the financial year immediately preceding the current year, if the data relating to the current year is not available at the time of furnishing the return of income by the assessee, for the assessment year relevant to the current year.

However, where the data relating to the **current year is subsequently available** at the time of determination of arm's length price of an international transaction **during the course of any assessment proceeding** for the assessment year relevant to the current year, then, **such data shall be used** for such determination **irrespective of the fact that the data was not available** at the time of furnishing the return of income of the relevant assessment year.

For the data relating to the current year, where the comparable uncontrolled transaction has been identified and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic transaction referred to in sub-rule (1)], has in either or both of the two financial years immediately preceding the current year undertaken the same or similar comparable uncontrolled transaction then,-

(i) the most appropriate method used to determine the price of the comparable uncontrolled transaction undertaken in the aforesaid period and the price in respect of such uncontrolled transactions has to be determined; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the current year and in the aforesaid period preceding it has to be included in the dataset instead of the price referred to in sub-rule (1).

Further, where the comparable uncontrolled transaction has been identified **on the basis of the data relating to the financial year immediately preceding the current year** and the enterprise undertaking the said uncontrolled transaction, [not being the enterprise undertaking the international transaction or the specified domestic transaction referred to in sub-rule (1)], has in the financial year immediately preceding the said financial year undertaken the same or similar comparable uncontrolled transaction then, -

(i) the price in respect of such uncontrolled transaction shall be determined by applying the most appropriate method in a similar manner as it was applied to determine the price of the comparable uncontrolled transaction undertaken in the financial year immediately preceding the current year; and

(ii) the weighted average of the prices, computed in accordance with the manner provided in sub-rule (3), of the comparable uncontrolled transactions undertaken in the aforesaid period of two years shall be included in the dataset instead of the price referred to in sub-rule (1).

Also, in such cases, where the use of data relating to the current year for determination of ALP subsequently at the time of assessment establishes that,-

(i) the enterprise has not undertaken same or similar uncontrolled transaction during the current year; or

(ii) the uncontrolled transaction undertaken by an enterprise in the current year is not a comparable uncontrolled transaction,

then, irrespective of the fact that such an enterprise had undertaken comparable uncontrolled transaction in the financial year immediately preceding the current year or the financial year immediately preceding such financial year, the price of comparable uncontrolled transaction or the weighted average of the prices of the uncontrolled transactions, as the case may be, undertaken by such enterprise shall **not** be included in the dataset.

Rule 10CA(3) provides that where an enterprise has undertaken comparable uncontrolled transactions in more than one financial year, then for the purposes of constructed the dataset, the weighted average of the prices of such transactions would be computed in the following manner, namely:-

	Method used to determine the prices	**Manner of computation of weighted average of the prices**
(i)	The resale price method	By assigning weights to the quantum of sales which has been considered for arriving at the respective prices
(ii)	The cost plus method	By assigning weights to the quantum of costs which has been considered for arriving at the respective prices
(iii)	The transactional net margin method	By assigning weights to the quantum of costs incurred or sales effected or assets employed or to be employed, or as the case may be, any other base which has been considered for arriving at the respective prices.

Range Concept: Rule 10CA(4) provides that where the most appropriate method applied is –

(i) a method other than the profit split method or a method prescribed by the CBDT under section 92C(1)(d)/(f); and

(ii) the dataset constructed in accordance with sub-rule (2) consists of six or more entries,

an arm's length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset would be constructed.

If the price at which the international transaction or the specified domestic transaction has actually been undertaken is within the said range, then, the price at which such international transaction or the specified domestic transaction has actually been undertaken would be deemed to be the arm's length price [Rule 10CA(5)].

If the price at which the international transaction or the specified domestic transaction has actually been undertaken is outside the said arm's length range, the arm's length price shall be taken to be the median of the dataset [Rule 10CA(6)].

When to apply range concept?	• Most appropriate method selected is Comparable uncontrolled price method, resale price method, cost plus method or transactional net margin method and • The dataset constructed has six or more entries.
How to apply?	• Arrange the values in the dataset in the ascending order. • Where the actual transaction price falls within 35th and 65th percentile of the dataset, the value of transaction will be accepted to be arm's length price. • Where the transfer price does not fall within the above range, then median of dataset shall be taken as the Arm's Length price.

Range concept not applicable:

In a case where the provisions of Rule 10CA(4) are not applicable [i.e. most appropriate method is profit split method or any other method or the dataset has less than 6 entries], the arm's length price shall be the arithmetical mean of all the values included in the dataset. However, if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed such percentage not exceeding 3% of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price [Rule 10CA(7)].

Meaning of certain terms [Rule 10CA(8)]

	Term	Meaning
(a)	the thirty-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 35% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the thirty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(b)	the sixth-fifth percentile of a dataset (having values arranged in an ascending order)	The lowest value in the dataset such that at least 65% of the values included in the dataset are equal to or less than such value. However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the sixty-fifth percentile shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.
(c)	the median of the dataset (having values	The lowest value in the dataset such that at least 50% of the values included in the dataset are equal to or less than such value.

	arranged in an ascending order)	However, if the number of values that are equal to or less than the aforesaid value is a whole number, then, the median shall be the arithmetic mean of such value and the value immediately succeeding it in the dataset.

Comparability Analysis

The comparability of the international transaction with an uncontrolled transaction is to be judged with reference to the following factors:

(i) The specific characteristics of the property transferred or services provided in either transaction;

(ii) The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

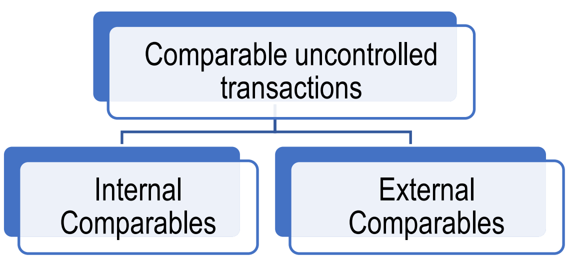
(iii) The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(iv) Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

As per Rule 10B(3), an uncontrolled transaction should be considered comparable to the international controlled transaction only if there are no material differences (in terms of functions, assets and risks) between the transactions being compared or the enterprises entering into such transactions which would materially affect the prices or costs charged or paid in, or the profit arising from, such transactions in the open market.

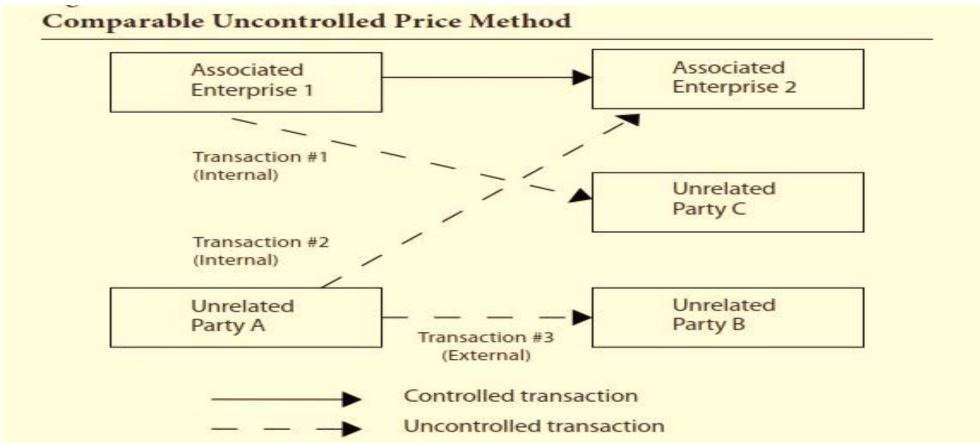
It, further, provides that in a case there are any such material differences, reasonably accurate adjustments should be made to eliminate such material differences in order to compare the controlled and the uncontrolled transactions.

Comparable uncontrolled transactions could be of two types - Internal or external.



(a) **Internal comparables:** These are the comparable transactions between one of the parties to the controlled transaction, (taxpayer or the AE) and an independent third party. These comparables are considered a good measure of comparability as it is likely that the Functions, Assets, Risks analysis (FAR analysis) of the comparable transaction would be similar to that of the controlled transaction due to the involvement of a common entity to the said two transactions. Even though internal comparables may offer a higher degree of comparability, there is a need of rigorous scrutiny like in external comparables and suitable adjustments should be made, wherever necessary.

(b) **External comparables:** These are the comparable transactions between two independent parties, neither of which is a party to the controlled transaction. Generally, the level of comparability offered in the external comparables is not as precise as internal comparables; however, this rule is not absolute. For instance, it may so happen that an entity offers a certain variation of its product exclusively to its AE and a slightly different variation to unrelated parties. In such a situation, preference should be given to external comparables involving the identical product and identical contractual terms than accepting the internal comparable.



In the above example, Transaction between AE1 and AE2 are subject to transfer pricing. AE1 and AE2 are parties to a controlled transaction. Transaction #1 and #2 are internal uncontrolled transactions since it is entered by AEs with unrelated parties.

Transaction #3 is external uncontrolled transactions since it is entered between unrelated parties.

Process for identification and selection of external comparables:

Wherever internal comparables are available, preference should be given to internal comparables in the process of determination of ALP. However, in the absence of the same, recourse has to be taken to search for external comparables. The transfer pricing legislation in India does not prescribe a particular process for selection of such comparables. However, various decisions of the judicial authorities have provided guidance on how to carry out such process based on the data available in public domain. The major steps involved in the search process are discussed hereunder:

Step 1: Selection of database

A database is a domain where information (financial and non-financial) about companies is maintained in an organised manner so as to facilitate easy search for data and also for the application of the relevant filters. Some of the commonly used databases in India are as under:

(a) **Capitaline Plus/ Capitaline TP:** It contains digital database of over 35,000 companies. It includes information of public, private, co-operative and joint sector companies, listed or otherwise.

(b) **Prowess:** Prowess is a database of the financial performance of Indian companies. Audited Annual Reports of companies and information submitted to the MCA; and in the case of listed companies, company filings with stock exchanges and prices of securities listed on the major stock exchanges are the sources of the database. The database contains information on all listed companies and a larger set of unlisted companies.

(c) **ACE TP Database:** ACE TP database contains information, both financial and non-financial of companies and sectors. It also contains information regarding equity and commodity and derivative markets.

There are other available Indian and foreign databases also like Prowess Pro, Amadeus, Royalty Stat, Compustat Global, Osiris, ktmine, Oriana, Bloomberg etc. which can be referred.

Step 2: Application of quantitative filters

The application of the quantitative filters help in filtering the companies available in the database based on the similarity of the quantitative information between the tested party and the potential comparables. Some of the commonly used quantitative filters are:

(a) **Availability of financial data:** The companies whose financial information for the relevant period (financial year of the controlled transaction or the preceding two years as the case may be) are not available in the public domain should not be considered in the comparability analysis.

(b) **Industry of the tested party:** The appropriate industry head should be selected. For instance, if the tested party operates in the seed segment, it should be ensured that various industry heads which could include comparable companies should be chosen, i.e. seeds, agriculture etc. Therefore, while applying this filter, the parameters should be fairly broad.

(c) **Turnover filter:** This is perhaps the most commonly used quantitative filter in the search process. This is for the reason that companies which are operating in the same range of turnover would have similar share in the market and thus are more likely to have somewhat similar margins. On the other hand, companies with extremely high or low turnover would not provide an effective base for comparison since their margins would not only reflect the efficiency of their business but also the scale of the operations. The range of the filter is very subjective and varies with the facts of each case.

(d) **Net worth filter:** Net worth of a company can be used to determine the creditworthiness of the company. Negative net worth would indicate that the debts of the company have surpassed its assets. Therefore, a company with consistent negative net worth should be rejected in the comparability analysis since its margins would be adversely affected and it would ordinarily be difficult to quantify and adjust the effect of its negative worth on the margins. Companies with negative net worth are usually rejected in this filter.

(e) **Export filter:** The parameter of 'geographic location of market' has lead to adoption of 'export turnover filter' whereby Transfer Pricing Officers ('TPOs') insist that if the taxpayer is an exporter then the comparables should also have export earnings of a certain degree. The export activity levels, by itself, cannot be a valid filter unless it is established that the market to which the exports are made are materially different from the domestic market.

(f) **Employee expense filter:** The employee expense ratio helps to analyse the level of activities and intensity of employee dependence.

(g) **Related party transactions:** As already discussed, a transaction between two related parties cannot be taken as a comparable uncontrolled transaction for the purpose of benchmarking a controlled transaction. This filter finds its application on the same principle, i.e., if a potential comparable has substantial related party transactions, it can be inferred that its margins are contaminated with transactions which are not entirely governed by the market forces and thus such a company should be rejected in the search process.

(h) **Consistently loss making companies:** The companies which are incurring losses on a consistent basis cannot be considered as good comparables as their profitability is adversely impacted by factors which are not specific to the industry but to the entity. However, loss in just one year would not be indicative of any extra ordinary factors surrounding the company and therefore such a company should not be rejected on that count alone.

Step 3: Application of qualitative filters

The entities remaining after the application of the quantitative filters are further narrowed down by applying the qualitative filters. Some of the commonly used qualitative filters are as under:

(a) **Product filter:** Although the industry filter excludes the companies not operating in the same industry but at the same time there are entities producing a variety of products in the same industry and therefore in order to reach a precise measure of comparability, the list of companies should be further shortlisted to exclude the companies not dealing in the same/similar products as that of the tested party. For instance, for a tested party trading in seeds, the industry filter to be applied could be agri-trading. However, this filter might result in companies engaged in various types of agricultural products such as fertilizers, pesticides etc. In order to remedy this, product criteria would be applied to only select the companies engaged in trading of seeds in the agriculture industry.

(b) **Functional filter:** The chosen companies must be further analyzed to select only those companies which are functionally similar to the tested party. The functions could be in the form of manufacturing of goods, rendering of services, trading in goods etc. Thus, the filter to be applied depends on the functions performed by the tested party to find transactions which are functionally similar.

(c) **Ownership (Government or private):** Generally, entities in the private sector exist for generating profits. Government owned entities on the other hand, function to serve the society and are not necessarily driven by the profit motive. Accordingly, such companies should be included/ excluded based on their comparability analysis like the other private companies.

V. Reference to Transfer Pricing Officer [Section 92CA]: This section provides for a procedure for reference to a Transfer Pricing Officer (TPO) of any issue relating to computation of arm's length price in an international transaction. The procedure is as under -

Reference to TPO

(1) The option to make reference to TPO is given to the Assessing Officer. Where the assessee has entered into an international transaction in any previous year and if Assessing Officer considers it necessary or expedient to do so, he may refer the computation of the arm's length price in relation to the said international transaction to the TPO. This option is not, however, available to the assessee.

(2) The Assessing Officer has to take the approval of the Principal Commissioner of Income-tax (PCIT)/Commissioner of Income-tax (CIT) before making such a reference.

(3) Any Joint/Deputy/Assistant Commissioner of Income-tax, authorised by CBDT, can be appointed as TPO.

(4) When such reference is made, TPO would serve a notice to the assessee requiring him to produce on a date specified in the notice, any evidence on which the assessee relied in support of the computation of arm's length price made by him in relation to the international transaction.

(5) The TPO can also determine the ALP of other international transactions identified subsequently in the course of proceedings before him as if such transaction is referred to the TPO by the Assessing Officer under section 92CA(1) [Sub-section (2A)].

(6) Where in respect of an international transaction, the assessee has not furnished the report under section 92E and such transaction comes to the notice of the TPO during the course of proceeding before him, the transfer pricing provisions shall apply as if such transaction is referred to the TPO by the Assessing Officer under section 92CA(1) [Sub-section (2B)].

(7) The TPO has to pass an order determining the arm's length price after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. He has to send a copy of his order to Assessing Officer as well as the assessee.

(8) The order of the Transfer Pricing Officer determining the arm's length price of an international transaction is binding on the Assessing Officer and the Assessing Officer shall proceed to compute the total income in conformity with the arm's length price determined by the Transfer Pricing Officer [Sub-section (4)].

(9) In order to provide sufficient time to the Assessing Officer to complete the assessment in a case where reference is made to the Transfer Pricing Officer, section 92CA(3A) provides for determination of arm's length price of international transactions by the Transfer Pricing Officer at least 60 days before the expiry of the time limit under section 153 or section 153B for making an order of assessment by the Assessing Officer.

(10) In many cases, it becomes necessary to seek information from foreign jurisdictions for the purpose of determining the arm's length price by the TPO. At times, proceedings before the TPO may also be stayed by a court order.

Taking into consideration such cases, it has been provided that where assessment proceedings are stayed by any court or where a reference for exchange of information has been made by the competent authority under an agreement referred to in section 90 or 90A, the time available to the Transfer Pricing Officer for making an order after excluding the time for which assessment proceedings were stayed or the time taken for receipt of information, as the case may be, is less than 60 days, then, such remaining period shall be extended to 60 days.

(11) The TPO has power to rectify his order under section 154 if any mistake apparent from the record is noticed. If such rectification is made, the Assessing Officer has to rectify the assessment order to bring it in conformity with the same.

(12) The TPO can exercise all or any of the powers specified in clause (a) to (d) of section 131(1) or section 133(6) or section 133A for determination of arm's length price once the above reference is made to him.

(13) The Central Government may make a scheme, by way of notification for the purposes of determination of the arm's length price, so as to impart greater efficiency, transparency and accountability by –

(a) eliminating the interface between the Transfer Pricing Officer and the assessee or any other person to the extent technologically feasible;

(b) optimising utilisation of the resources through economies of scale and functional specialisation;

(c) introducing a team-based determination of arm's length price with dynamic jurisdiction [Sub-section (8)].

(14) The Central Government may, for the purpose of giving effect to the scheme made, direct that any of the provisions of this Act would not apply or would apply with such exceptions, modifications and adaptations as may be specified.

However, no direction shall be issued after 31st March, 2024.

(15) Every notification so issued shall, as soon as may be after the notification is issued, be laid before each House of Parliament [Sub-section (10)].

VI. Safe Harbour Rules for determination of arm's length price in case of international transactions [Section 92CB]

Section 92CB provides that determination of

- income referred to in section 9(1)(i); or
- arm's length price under section 92C or Section 92CA

shall be subject to Safe Harbour rules. Section 92CB(2) empowers the CBDT to prescribe safe harbour rules[2].

Safe Harbour means circumstances in which the income-tax authorities shall accept the transfer price or income, deemed to accrue or arise under section 9(1)(i), as the case may be, declared by the assessee.

VII. Introduction of Advance Pricing Agreements [Sections 92CC & 92CD]

(1) An Advance Pricing Agreement (APA) is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future. They offer better assurance on transfer pricing methods and provide certainty and unanimity of approach.

Advance Pricing Agreements

(2) Keeping in mind the benefits offered by the APAs, sections 92CC and section 92CD have been introduced in the transfer pricing regime to provide a framework for formulation of APAs between the tax payer and the income-tax authorities.

(3) Section 92CC enables the CBDT (with the approval of the Central Government), to enter into an APA with any person determining the –

- arm's length price or specifying the manner in which the arm's length price is to be determined, in relation to an international transaction to be entered into by that person;
- income referred to in section 9(1)(i), or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident.

(A) Purpose of APA: The APA shall relate to an international transaction to be entered into by such person. The APA shall be entered into for the purpose of determination of the

(a) arm's length price or specifying the manner in which arm's length price shall be determined, in relation to such international transaction.

(b) income referred to in section 9(1)(i), or specifying the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident.

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[2] The Safe Harbour Rules relevant for A.Y. 2024-25 are yet to be notified by the CBDT as on the date of release of the Study Material. These rules, when notified, will form part of the webhosted Statutory Update.

(B) Manner of determination of Arm's Length Price in APA: The manner of determination of arm's length price or the income referred above may include methods referred to in section 92C(1) or any other method provided by rules made under the Act with necessary adjustments or variations.

(C) Provisions of APA to apply notwithstanding anything contained in sections 92C or 92CA: In case an APA has been entered, the arm's length price in relation to that transaction or the income referred to in section 9(1)(i) shall be determined in accordance with that APA notwithstanding any contrary provisions contained in section 92C or section 92CA i.e., the provisions of the APA shall override the provisions of section 92C or section 92CA, which are normally applicable for determination of arm's length price.

(D) Validity of APA: The APA shall be valid for such period as specified in the agreement, which shall in no case exceed five consecutive previous years.

(E) Binding nature of APA: The APA so entered into shall be binding on:

(a) the person in whose case, and in respect of the transaction in relation to which, the APA has been entered into; and

(b) the Principal Commissioner or Commissioner and the income-tax authorities subordinate to him, in respect of the said person and the said transaction.

(F) Not binding of APA: The APA shall not be binding if there is any change in law or facts having bearing on such APA.

(G) Conditions to declare APA as *void ab initio*: In case the Board finds that the APA so entered into has been obtained by the person by way of fraud or misrepresentation of facts, the Board is empowered to pass an order declaring any such APA to be *void ab initio*, with the approval of Central Government.

(H) Consequences of declaration of an APA as *void ab initio*: As a result of declaration of an APA as *void ab initio*:

(a) all the provisions of the Act shall apply to such person as if such APA had never been entered into.

(b) The period beginning with the date of such APA and ending on the date of order declaring the APA as *void ab initio*, shall be excluded for the purpose of computation of any period of limitation under this Act (for example period of limitation specified in the section 153, 153B etc). This is irrespective of anything contained in any other provision of the Act.

(c) In case the period of limitation after exclusion of the above mentioned period is less than 60 days, such remaining period of limitation shall be extended to 60 days.

(I) If an application is made by a person for entering into an APA, then, the proceeding, in respect of such person for the purpose of the Act, shall be deemed to be pending.

(J) **Prescribed scheme for APA:** The Board is empowered to prescribe a scheme specifying the manner, form, procedure and any other matter generally in respect of the APA[3].

Prescribed Advance Pricing Agreement Scheme for the purpose of section 92CC [Rule 10F to 10T]: In exercise of the powers conferred in section 92CC(9) read with section 295 of the Income-tax Act, 1961, the CBDT has prescribed rules specifying an Advance Pricing Agreement (APA) Scheme. Some of the important provisions of the scheme are briefed hereunder –

(1) Persons eligible to apply [Rule 10G]: Any person who has undertaken an international transaction or is contemplating to undertake an international transaction, shall be eligible to enter into an agreement under these rules.

(2) Pre-filing Consultation [Rule 10H]:

(a) Any person proposing to enter into an agreement under these rules may, by an application in writing, make a request for a pre-filing consultation in the prescribed form to the Director General of Income-tax (International Taxation).

(b) The pre-filing consultation shall, among other things,-

(i) determine the scope of the agreement;

(ii) identify transfer pricing issues;

(iii) determine the suitability of international transaction for the agreement;

(iv) discuss broad terms of the agreement.

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[3] *Rules prescribing the scheme to enter into an APA for the purpose of determining income referred to in section 9(1)(i), or the manner in which said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident are yet to be notified by the CBDT as on the date of release of the Study Material. These rules, when notified, will form part of the webhosted Statutory Update.*

(c) The pre-filing consultation shall –

(i) not bind the Board or the person to enter into an agreement or initiate the agreement process;

(ii) not be deemed to mean that the person has applied for entering into an agreement.

(3) Application for advance pricing agreement [Rule 10-I]

(a) Any person who is eligible to enter into agreement may, if he desires to enter into an agreement furnish an application in the prescribed form along with proof of payment of requisite fee as specified, to the Director General of Income-tax (International Taxation) in case of unilateral agreement and to the competent authority in India in case of bilateral or multilateral agreement.

(b) The application may be filed at any time -

(i) before the first day of the previous year relevant to the first assessment year for which the application is made, in respect of transactions which are of a continuing nature from dealings that are already occurring; or

(ii) before undertaking the transaction in respect of remaining transactions.

ILLUSTRATION 5

XYZ (P) Ltd. has been supplying goods to its Associate Enterprise (AE) in foreign country. It has applied for Advance Pricing Agreement ('APA') in respect of the transactions with its AE. Application for APA was filed on 15th March, 2023 and the APA was signed on 2nd June, 2023. Discuss from which previous year APA would be applicable.

SOLUTION

XYZ (P) Ltd. has filed APA application in respect of transactions with its AE which are of a continuing nature from dealings that are already occurring. Since the application was filed on 15th March, 2023 i.e., before 1.4.2023, APA would be applicable from P.Y. 2023-24.

(4) Applicable Fee: The application has to be accompanied by proof of payment of fees as given below:

Amount of international taxation entered into or proposed to be undertaken in respect of which agreement is proposed during the proposed period of agreement	Fee
Amount ≤ ₹ 100 crores	₹ 10 lakhs
Amount > ₹ 100 crores but not exceeding ≤ ₹ 200 crores	₹ 15 lakhs
Amount > ₹ 200 crores	₹ 20 lakhs

(5) Withdrawal of application for agreement [Rule 10J]

The applicant may withdraw the application for agreement at any time before the finalisation of the terms of the agreement. However, application fees paid shall not be refunded on withdrawal of application by the applicant.

(6) Approval of Central Government: The agreement shall be entered into by the Board with the applicant after its approval by the Central Government.

(7) Terms of the agreement [Rule 10M]

(a) An agreement may among other things, include –

(i) the international transactions covered by the agreement;

(ii) the agreed transfer pricing methodology, if any;

(iii) determination of arm's length price, if any;

(iv) definition of any relevant term to be used in item (ii) or (iii);

(v) critical assumptions i.e., the factors and assumptions that are so critical and significant that neither party entering into an agreement will continue to be bound by the agreement, if any of the factors or assumptions is changed;

(vi) rollback provision referred to in Rule 10MA;

(vii) the conditions, if any, other than provided in the Act or these rules.

(b) The agreement shall not be binding on the Board or the assessee if there is a change in any of critical assumptions or failure to meet conditions subject to which the agreement has been entered into.

(c) The binding effect of agreement shall cease only if any party has given due notice of the concerned other party or parties.

(d) In case there is a change in any of the critical assumptions or failure to meet the conditions subject to which the agreement has been entered into, the agreement can be revised or cancelled, as the case may be.

(8) Furnishing of Annual Compliance Report [Rule 10-O]: The assessee shall furnish an annual compliance report in quadruplicate in the prescribed form to Director General of Income-tax (International Taxation) for each year covered in the agreement, within 30 days of the due date of filing income-tax return for that year, or within 90 days of entering into an agreement, whichever is later.

(9) Compliance Audit of the agreement [Rule 10P]:

(a) The Transfer Pricing Officer having the jurisdiction over the assessee shall carry out the compliance audit of the agreement for each of the year covered in the agreement. For this purpose, the Transfer Pricing Officer may require –

(i) the assessee to substantiate compliance with the terms of the agreement, including satisfaction of the critical assumptions, correctness of the supporting data or information and consistency of the application of the transfer pricing method;

(ii) the assessee to submit any information, or document, to establish that the terms of the agreement has been complied with.

(b) The compliance audit report shall be furnished by the Transfer Pricing Officer within six months from the end of the month in which the Annual Compliance Report is received by the Transfer Pricing Officer.

(10) Revision of an agreement [Rule 10Q]:

(a) An agreement, after being entered, may be revised by the Board either *suo moto* or on request of the assessee or the competent authority in India or the Director General of Income-tax (International Taxation), if –

(i) there is a change in critical assumptions or failure to meet a condition subject to which the agreement has been entered into;

(ii) there is a change in law that modifies any matter covered by the agreement but is not of the nature which renders the agreement to be non-binding; or

(iii) there is a request from competent authority in the other country requesting revision of agreement, in case of bilateral or multilateral agreement.

(b) Except when the agreement is proposed to be revised on the request of the assessee, the agreement shall not be revised unless an opportunity of being heard has been provided to the assessee and the assessee is in agreement with the proposed revision.

(c) The revised agreement shall include the date till which the original agreement is to apply and the date from which the revised agreement is to apply.

(11) Cancellation of an agreement [Rule 10R]:

(a) An agreement shall be cancelled by the Board for any of the following reasons:

(i) the compliance audit has resulted in the finding of failure on the part of the assessee to comply with the terms of the agreement;

(ii) the assessee has failed to file the annual compliance report in time;

(iii) the annual compliance report furnished by the assessee contains material errors; or

(iv) the assessee is not in agreement with the revision proposed in the agreement or the agreement is to be cancelled under rule 10RA(7);.

(b) The Board shall give an opportunity of being heard to the assessee, before proceeding to cancel an application.

(c) The order of cancellation of the agreement shall be in writing and shall provide reasons for cancellation and for non-acceptance of assessee's submission, if any.

(d) The order of cancellation shall also specify the effective date of cancellation of the agreement, where applicable.

(e) The order under the Act, declaring the agreement as void ab initio, on account of fraud or misrepresentation of facts, shall be in writing and shall provide reason for such declaration and for non-acceptance of assessee's submission, if any.

(12) Mere filing of an application for an agreement under these rules shall not prevent the operation of Chapter X of the Act for determination of arms' length price under that Chapter till the agreement is entered into. [Rule 10T(1)].

(13) The negotiation between the competent authority in India and the competent authority in the other country or countries, in case of bilateral or multilateral agreement, shall be carried out in accordance with the provisions of the tax treaty between India and the other country or countries. [Rule 10T(2)].

(K) Provision for Roll back in APA Scheme [Section 92CC(9A)]

(a) In order to reduce current pending as well as future litigation, section 92CC(9A) provides roll back mechanism in the APA scheme

(b) Accordingly, the APA may, subject to such prescribed conditions, procedure and manner, provide for determining the

- ALP or for specifying the manner in which ALP is to be determined in relation to an international transaction entered into by the person
- income referred to in section 9(1)(i), or specifying the manner in which the said income is to be determined, as is reasonably attributable to the operations carried out in India by or on behalf of that person, being a non-resident,

during any period not exceeding four previous years preceding the first of the previous years for which the APA applies in respect of the international transaction to be undertaken.

The CBDT has, vide *Notification No.23/2015 dated 14.3.2015*, in exercise of the powers conferred by 92CC(9A) read with section 295, notified following conditions, procedure and manner for determining the arm's length price or for specifying the manner in which arm's length price is to be determined in relation to an international transaction:

Rule	Particulars	Conditions, Procedure & Manner of determination of ALP
10F(ba)	**Definition of Applicant**	A person who has made an application.

10F(ha)	**Definition of Rollback year**	Any previous year, falling within the period **not exceeding four previous years,** preceding the first of the five consecutive previous years referred to in section 92CC(4).
10MA	**Roll back of the agreement**	The said rule provides the following: **1.** The agreement may provide for determining the arm's length price or specify the manner in which arm's length price shall be determined in relation to the international transaction entered into by the person during the rollback year (hereinafter referred as "rollback provision"). **2. Conditions for applying for rollback provisions:** The agreement shall contain rollback provision in respect of an international transaction subject to the following, namely:- (i) the international transaction is same as the international transaction to which the agreement (other than the rollback provision) applies; (ii) the return of income for the relevant rollback year has been or is furnished by the applicant before the due date as specified in *Explanation 2* of section 139(1). (iii) the report in respect of the international transaction had been furnished in accordance with section 92E; (iv) the applicability of rollback provision, in respect of an international transaction, has been requested by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant; and (v) the applicant has made an application seeking rollback in Form 3CEDA in accordance with sub-rule (5); **3. Non-applicability of Rollback provision**: Rollback provision shall not be provided in respect of an international transaction for a rollback year, if,- (i) the determination of arm's length price of the said international transaction for the said year has been subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement; or

		(ii) the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year. **4. Manner for determining arm length price to be the same for rollback years and other previous years:** Where the rollback provision specifies the manner in which arm's length price shall be determined in relation to an international transaction undertaken in any rollback year then such manner shall be the same as the manner which has been agreed to be provided for determination of arm's length price of the same international transaction to be undertaken in any previous year to which the agreement applies, not being a rollback year. **5. Time limit for filling application for rollback provision:** The applicant may furnish along with the application for advance pricing agreement, the request for rollback provision in Form No. 3CEDA with proof of payment of an additional fee of ₹ 5 lakh.
10RA	**Procedure for giving effect to rollback provision of an Agreement**	Rule 10RA lays down the "Procedure for giving effect to rollback provision of an Agreement" as follows: (i) The applicant shall furnish modified return of income referred to in section 92CD in respect of a rollback year to which the agreement applies along with the proof of payment of any additional tax arising as a consequence of and computed in accordance with the rollback provision. (ii) The modified return in respect of rollback year shall be furnished along with the modified return to be furnished in respect of first of the previous years for which the agreement has been requested for in the application. (iii) If any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is the subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant before furnishing the modified return for the said year. (iv) If any appeal filed by the Assessing Officer or the Principal Commissioner or Commissioner is pending before the Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that

		year, the said appeal to the extent of the subject covered under the agreement, shall be withdrawn by the Assessing Officer or the Principal Commissioner or the Commissioner, as the case may be, within three months of filing of modified return by the applicant. (v) The applicant, the Assessing Officer or the Principal Commissioner or the Commissioner, shall inform the Dispute Resolution Panel or the Commissioner (Appeals) or the Appellate Tribunal or the High Court, as the case may be, the fact of an agreement containing rollback provision having been entered into along with a copy of the same as soon as it is practicable to do so. (vi) In case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled.

Subsequent to the notification of the rules, the CBDT has issued *Circular No. 10/2015 dated 10.6.2015* adopting a Question and Answer format to clarify certain issues arising out of the said Rules. The questions raised and answers to such questions as per the said Circular are given hereunder:

Question 1

Under rule 10MA(2)(ii) there is a condition that the return of income for the relevant roll back year has been or is furnished by the applicant before the due date specified in Explanation 2 to section 139(1). It is not clear as to whether applicants who have filed returns under section 139(4) or 139(5) of the Act would be eligible for roll back.

Answer

The return of income under section 139(5) can be filed only when a return under section 139(1) has already been filed. Therefore, the return of income filed under section 139(5) of the Act, replaces the original return of income filed under section 139(1). Hence, if there is a return which is filed under section 139(5) to revise the original return filed before the due date specified in *Explanation 2* to sub-section (1) of section 139, the applicant would be entitled for rollback on this revised return of income.

However, rollback provisions will not be available in case of a return of income filed under section 139(4) because it is a return which is not filed before the due date.

Note – *A belated return filed under section 139(4) can also be revised under section 139(5). In such a case, the revised return would replace the belated return. Therefore, an applicant would not be entitled for roll back provisions on a revised return which replaces a belated return.*

Question 2

Rule 10MA(2)(i) mandates that the rollback provision shall apply in respect of an international transaction that is same as the international transaction to which the agreement (other than the rollback provision) applies. It is not clear what is the meaning of the word "same". Further, it is not clear whether this restriction also applies to the Functions, Assets, Risks (FAR) analysis.

Answer

The international transaction for which a rollback provision is to be allowed should be the same as the one proposed to be undertaken in the future years and in respect of which the agreement has been reached. There cannot be a situation where rollback is finalised for a transaction which is not covered in the agreement for future years. The term same international transaction implies that the transaction in the rollback year has to be of same nature and undertaken with the same associated enterprise(s), as proposed to be undertaken in the future years and in respect of which agreement has been reached. In the context of FAR analysis, the restriction would operate to ensure that rollback provisions would apply only if the FAR analysis of the rollback year does not differ materially from the FAR validated for the purpose of reaching an agreement in respect of international transactions to be undertaken in the future years for which the agreement applies.

The word "materially" is generally being defined in the Advance Pricing Agreements being entered into by CBDT. According to this definition, the word "materially" will be interpreted consistently with its ordinary definition and in a manner that a material change of facts and circumstances would be understood as a change which could reasonably have resulted in an agreement with significantly different terms and conditions.

Question 3

Rule 10MA(2)(iv) requires that the application for rollback provision, in respect of an international transaction, has to be made by the applicant for all the rollback years in which the said international transaction has been undertaken by the applicant. Clarification is required as to whether rollback has to be requested for all four years or applicant can choose the years out of the block of four years.

Answer

The applicant does not have the option to choose the years for which it wants to apply for rollback. The applicant has to either apply for all the four years or not apply at all. However, if the covered international transaction(s) did not exist in a rollback year or there is some disqualification in a rollback year, then the applicant can apply for rollback for less than four years. Accordingly, if the covered international transaction(s) were not in existence during any of the rollback years, the applicant can apply for rollback for the remaining years. Similarly, if in any of the rollback years for the covered international transaction(s), the applicant fails the test of the rollback conditions contained in various provisions, then it would be denied the benefit of rollback for that rollback year. However, for other rollback years, it can still apply for rollback.

Question 4

Rule 10MA(3) states that the rollback provision shall not be provided in respect of an international transaction for a rollback year if the determination of arm's length price of the said international transaction for the said year has been the subject matter of an appeal before the Appellate Tribunal and the Appellate Tribunal has passed an order disposing of such appeal at any time before signing of the agreement. Further, Rule 10 RA(4) provides that if any appeal filed by the applicant is pending before the Commissioner (Appeals), Appellate Tribunal or the High Court for a rollback year, on the issue which is subject matter of the rollback provision for that year, the said appeal to the extent of the subject covered under the agreement shall be withdrawn by the applicant.

There is a need to clarify the phrase "Tribunal has passed an order disposing of such appeal" and on the mismatch, if any, between Rule 10MA(3) and Rule 10RA(4).

Answer

The reason for not allowing rollback for the international transaction for which Appellate Tribunal has passed an order disposing of an appeal is that the ITAT is the final fact finding authority and hence, on factual issues, the matter has already reached finality in that year. However, if the ITAT has not decided the matter and has only set aside the order for fresh consideration of the matter by the lower authorities with full discretion at their disposal, the matter shall not be treated as one having reached finality and hence, benefit of rollback can still be given.

There is no mismatch between Rule 10MA(3) and Rule 10RA(4).

Question 5

Rule 10MA(3)(ii) provides that rollback provision shall not be provided in respect of an international transaction for a rollback year if the application of rollback provision has the effect of reducing the total income or increasing the loss, as the case may be, of the applicant as declared in the return of income of the said year. It may be clarified whether the rollback provisions in such situations can be applied in a manner so as to ensure that the returned income or loss is accepted as the final income or loss after applying the rollback provisions.

Answer

It is clarified that in case the terms of rollback provisions contain specific agreement between the Board and the applicant that the agreed determination of ALP or the agreed manner of determination of ALP is subject to the condition that the ALP would get modified to the extent that it does not result in reducing the total income or increasing the total loss, as the case may be, of the applicant as declared in the return of income of the said year, the rollback provisions could be applied. For example, if the declared income is ₹ 100, the income as adjusted by the TPO is ₹ 120, and the application of the rollback provisions results in reducing the income to ₹ 90, then the rollback for that year would be determined in a manner that the declared income ₹ 100 would be treated as the final income for that year.

Question 6

Rule 10RA(7) states that in case effect cannot be given to the rollback provision of an agreement in accordance with this rule, for any rollback year to which it applies, on account of failure on the part of applicant, the agreement shall be cancelled. It is to be clarified as to whether the entire agreement is to be cancelled or only that year for which roll back fails.

Answer

The procedure for giving effect to a rollback provision is laid down in Rule 10RA. Sub-rules (2), (3), (4) and (6) of the Rule specify the actions to be taken by the applicant in order that effect may be given to the rollback provision. If the applicant does not carry out such actions for any of the rollback years, the entire agreement shall be cancelled.

This is because the rollback provision has been introduced for the benefit of the applicant and is applicable at its option. Accordingly, if the rollback provision cannot be given effect to for any of the rollback years on account of the applicant not taking the actions specified in sub-rules (2), (3), (4) or (6), the entire agreement gets vitiated and will have to be cancelled.

Question 7

If there is a Mutual Agreement Procedure (MAP) application already pending for a rollback year, what would be the stand of the APA authorities? Further, what would be the view of the APA Authorities, if MAP has already been concluded for a rollback year?

Answer

If MAP has been already concluded for any of the international transactions in any of the rollback year under APA, rollback provisions would not be allowed for those international transactions for that year but could be allowed for other years or for other international transactions for that year, subject to fulfilment of specified conditions in Rules 10MA and 10RA. However, if MAP request is pending for any of the rollback year under APA, upon the option exercised by the applicant, either MAP or application for roll back shall be proceeded with for such year.

Question 8

Rule 10MA(1) provides that the agreement may provide for determining ALP or manner of determination of ALP. However, Rule 10MA(4) only specifies that the manner of determination of ALP should be the same as in the APA term. Does that mean the ALP could be different?

Answer

Yes, the ALP could be different for different years. However, the manner of determination of ALP (including choice of Method, comparability analysis and Tested Party) would be same.

Question 9

Will there be compliance audit for roll back? Would critical assumptions have to be validated during compliance audit?

Answer

Since rollback provisions are for past years, ALP for the rollback years would be agreed after full examination of all the facts, including validation of critical assumptions. Hence, compliance audit for the rollback years would primarily be to check if the agreed price or methodology has been applied in the modified return.

Question 10

Whether applicant has an option to withdraw its rollback application? Can the applicant accept the rollback results without accepting the APA for the future years?

Answer

The applicant has an option to withdraw its roll back application even while maintaining the APA application for the future years. However, it is not possible to accept the rollback results without accepting the APA for the future years. It may also be noted that the fee specified in Rule 10MA(5) shall not be refunded even where a rollback application is withdrawn.

Question 11

For already concluded APAs, will new APAs be signed for rollback or earlier APAs could be revised?

Answer

The second proviso to Rule 10MA(5) provides for revision of APAs already concluded to include rollback provisions.

Question 12

For already concluded APAs, where the modified return has already been filed for the first year of the APA term, how will the time-limit for filing modified return for rollback years be determined?

Answer

The time to file modified return for rollback years will start from the date of signing the revised APA incorporating the rollback provisions.

Question 13

In case of merger of companies, where one or more of those companies are APA applicants, how would the rollback provisions be allowed and to which company or companies would it be allowed?

Answer

The agreement is between the Board and a person. The principle to be followed in case of merger is that the person (company) who makes the APA application would only be entitled to enter into the agreement and be entitled for the rollback provisions in respect of international transactions undertaken by it in rollback years. Other persons (companies) who have merged with this person (company) would not be eligible for the rollback provisions.

To illustrate, if A, B and C merge to form C and C is the APA applicant, then the agreement can only be entered into with C and only C would be eligible for the rollback provisions. A and B would not be eligible for the rollback provisions. To illustrate further, if A and B merge to form a new company C and C is the APA applicant, then nobody would be eligible for rollback provisions.

Question 14

In case of a demerger of an APA applicant or signatory into two or more companies (persons), who would be eligible for the rollback provisions?

Answer

The same principle as mentioned in the previous answer, i.e., the person (company) who makes an APA application or enters into an APA would only be entitled for the rollback provisions, would continue to apply. To illustrate, if A has applied for or entered into an APA and, subsequently, demerges into A and B, then only A will be eligible for rollback for international transactions covered under the APA. As B was not in existence in rollback years, availing or grant of rollback to B does not arise.

(4) Section 92CD provides for the following procedure for giving effect to an APA -

(i) In case a person has entered into an APA and prior to the date of entering into such APA, he has furnished the return of income under the provisions of section 139 in respect of any assessment year relevant to a previous year to which the APA applies, then, such person shall, within a period of three months from the end of the month in which the said agreement was entered into, furnish a modified return, notwithstanding any contrary provision contained in section 139.

(ii) Such modified return shall be in accordance with and limited to the provisions of such APA i.e., modifications can only be made on account of such APA in the return to be filed.

(iii) All other provisions of this Act shall apply as if the modified return is a return furnished under section 139, unless anything to the contrary is provided in this section.

(iv) If the assessment or reassessment proceedings for an assessment year relevant to a previous year to which the APA applies have been completed before the expiry of period allowed for furnishing of modified return, the Assessing Officer shall, in a case where modified return is filed in accordance with the provisions of this section, pass an order modifying the total income of the relevant assessment year determined in such assessment or reassessment, as the case may be, having regard to and in accordance with the APA, instead of proceeding to assess or reassess the total income.

Such order for assessment or reassessment or re-computation of total income shall be passed within a period of 1 year from the end of the financial year in which the modified return was furnished. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

The appeal against such order shall lie to Commissioner (Appeals) [Section 246A]

(v) Where the assessment or reassessment proceedings for an assessment year relevant to the previous year to which the APA applies, are pending on the date of filing of modified return, the Assessing Officer shall proceed to complete the assessment or reassessment proceedings in accordance with the APA taking into consideration the modified return so furnished.

In this case, the time period of completion of pending assessment or reassessment mentioned under section 153 or 153B or 144C shall be extended by 12 months. This shall apply notwithstanding the period of limitation contained under section 153 or 153B or 144C.

(vi) The assessment or reassessment proceedings for an assessment year shall be deemed to have been completed where -

(a) an assessment or reassessment order has been passed; or

(b) no notice has been issued under section 143(2) till the expiry of the limitation period provided under the said section.

VIII. Secondary Adjustment [Section 92CE]

(1) Meaning of Primary Adjustment and Secondary Adjustment

"Primary adjustment" to a transfer price means the determination of transfer price in accordance with the arm's length principle resulting in an increase in the total income or reduction in the loss, as the case may be, of the assessee.

"Secondary adjustment" means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined as a result of primary adjustment, thereby removing the imbalance between cash account and actual profit of the assessee.

(2) Forms of Secondary Adjustment - As per the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD transfer pricing guidelines), secondary adjustment may take the form of constructive dividends, constructive equity contributions, or constructive loans.

(3) Alignment of economic benefit of the transaction with the arm's length position - The provisions of secondary adjustment are internationally recognised and are already part of the transfer pricing rules of many leading economies in the world. Whilst the approaches to secondary adjustments by individual countries vary, they represent an internationally recognised method to align the economic benefit of the transaction with the arm's length position.

(4) Cases where secondary adjustment has to be made - In order to align the transfer pricing provisions in line with OECD transfer pricing guidelines and international best practices, section 92CE provides that the assessee shall be required to carry out secondary adjustment where the primary adjustment to transfer price:

(a) has been made *suo motu* by the assessee in his return of income; or

(b) made by the Assessing Officer has been accepted by the assessee; or

(c) is determined by an advance pricing agreement entered into by the assessee under section 92CC on or after the 1.4.2017; or

(d) is made as per the safe harbour rules framed under section 92CB; or

(e) is arising as a result of resolution of an assessment by way of the mutual agreement procedure under an agreement entered into under section 90 or 90A for avoidance of double taxation.

(5) No requirement of secondary adjustment in certain cases - Such secondary adjustment, however, shall not be carried out if, the amount of primary adjustment made in the case of an assessee in any previous year does not exceed ₹ 1 crore **or** the primary adjustment is made in respect of A.Y.2016-17 or an earlier assessment year.

(6) Non-repatriation of excess money by the associated enterprise deemed to be an advance - Where, as a result of primary adjustment to the transfer price, there is an increase in the total income or reduction in the loss, as the case may be, of the assessee, the excess money or part thereof, as the case may be, which is available with its associated enterprise, if not repatriated to India within the time as may be prescribed, shall be deemed to be an advance made by the assessee to such associated enterprise and the interest on such advance, shall be computed as the income of the assessee, in the prescribed manner.

Such excess money or part thereof may be repatriated from any of the associated enterprises of the assessee which is not resident in India.

"Excess money" means the difference between the arm's length price determined in primary adjustment and the price at which the international transaction has actually taken place.

(7) Time limit for repatriation of excess money or part thereof

Rule 10CB(1) prescribes the time limit for repatriation of excess money or part thereof i.e., on or before **90 days** from the date given in column (3) in the cases mentioned in column (2) of the table below. The period from which interest is chargeable on the excess money or part thereof which is not repatriated in such cases is given in column (4).

	Case	Date	Period
(1)	**(2)**	**(3)**	**(4)**
(i)	Where primary adjustments to transfer price has been made *suo-motu* by the assessee in his return of income	the due date of filing of return u/s 139(1)	the due date of filing of return u/s 139(1)
(ii)	If primary adjustments to transfer price as determined in the order of the Assessing Officer or the appellate authority has been accepted by the assessee	the date of the said order	the date of the said order
(iii)	Where primary adjustment to transfer price is determined by an advance pricing agreement (APA) entered into by the assessee under section 92CC in respect of a previous year -		
	• If the APA has been entered into on or before the due date of filing of return for the relevant P.Y.	the date of filing of return u/s 139(1)	the due date of filing of return u/s 139(1)

	• If the APA has been entered into on or after the due date of filing of return for the relevant P.Y.	The end of the month in which the APA has been entered into	The end of the month in which the APA has been entered into
(iv)	Where option has been exercised by the assessee as per the safe harbour rules under section 92CB	the due date of filing of return u/s 139(1)	the due date of filing of return u/s 139(1)
(v)	Where the primary adjustment to the transfer price is determined by a resolution arrived at under Mutual Agreement Procedure under a DTAA has been entered into u/s 90 or 90A	the date of giving effect by the A.O. under Rule 44H to such resolution	the date of giving effect by the A.O. under Rule 44H to such resolution

(8) Rate of interest for the purpose of computation on interest on excess money or part thereof, if not repatriated within the prescribed time

Rule 10CB(2) prescribes the rate at which the per annum interest income shall be computed in case of failure to repatriate the excess money or part thereof within the above time limit. The interest would be computed at the rates mentioned in column (3) in respect of the cases mentioned in column (2) of the table below:

	Case	Rate
(1)	**(2)**	**(3)**
(i)	Where the international transaction is denominated in Indian rupee	At the one year marginal cost of fund lending rate of SBI as on 1st April of the relevant previous year + 3.25%
(ii)	Where the international transaction is denominated in foreign currency	At six month London Interbank Offered Rate (LIBOR) as on 30th September of the relevant previous year + 3.00%

***Note** – In case (ii) above, the rate of exchange for the calculation of the value of international transaction denominated in foreign currency shall be the telegraphic transfer buying rate of such currency on the last day of the previous year in which such international transaction was undertaken.*

(9) Option to pay additional income-tax, if the excess money not repatriated: In a case where the excess money or part thereof has not been repatriated within the prescribed time as mentioned above, the assessee has the option to pay additional income-tax @ **20.9664%** (i.e., tax@18% plus surcharge@12% plus cess@4%) on such excess money or part thereof, as the case may be.

Where additional income-tax is so paid by the assessee, he will **not** be required to make secondary adjustment and compute interest from the date of payment of such tax. This implies that he would, in any case, be required to compute interest upto the date of payment of such additional tax.

The additional income-tax so paid by the assessee shall be treated as the final payment of tax in respect of excess money or part thereof not repatriated and no further credit would be allowed to the assessee or to any other person in respect of the amount of additional income-tax so paid.

Further, no deduction in respect of the amount on which such additional income-tax has been paid, would be allowed under any other provision of the Act.

ILLUSTRATION 6

On 1.4.2023, PQR Ltd., an Indian company, advanced a loan of ₹ 6 crores to XYZ Inc., a company resident in Singapore. As on the date of loan, the book value of total assets in the books of XYZ Inc. was ₹ 10 crores. XYZ Inc. paid the entire loan along with interest thereon on 31st August, 2023. During the Financial Year 2023-24, PQR Ltd. also entered into an agreement with XYZ Inc. to provide 20,000 medical equipments at a cost of ₹ 7,400 per unit. The Assessing Officer treats them as associate enterprises and wants to re-compute the income of PQR Ltd. at arms' length price. You are required to answer the following questions in this respect:

(1) Would PQR Ltd. and XYZ Inc. be treated as associate enterprises for the purpose of transfer pricing adopted by the Assessing Officer? If yes, why?

(2) Calculate the arms length price of PQR Ltd. which sells the same equipment at the rate of ₹ 9,000 per unit to Y Ltd. and at the rate of ₹ 9,500 per unit to X LLP (both of them are unrelated parties in respect of PQR Ltd.). PQR Ltd. is not a wholesale dealer.

(3) What are the options available to PQR Ltd. in respect of such increase in transfer price by income tax authorities, if PQR Ltd. accepts such transfer price?

SOLUTION

(1) Two enterprises are deemed to be associated enterprises as per section 92A(2)(c), if a loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of total assets of the other enterprise at any time during the previous year. Since PQR Ltd., an Indian company, advanced loan of an amount of ₹ 6 crores to XYZ Inc., a

Singapore company, which is 60% of the book value of the total assets of XYZ Inc. (i.e., 60% of ₹ 10 crores), PQR Ltd. and XYZ Inc. are deemed to be associated enterprises.

(2) PQR Ltd. sells equipment at the rate of ₹ 9,000 per unit to Y Ltd. and at ₹ 9,500 per unit to X LLP, both of them being unrelated parties. Since the transactions can be considered as comparable uncontrolled transactions for the purpose of determining the arm's length price, Comparable Uncontrolled Price (CUP) method would be most appropriate method.

Since two prices are determined by the most appropriate method, and data set comprises of only two entries, the arm's length price shall be the arithmetical mean of both the values included in the dataset.

Accordingly, arm's length price would be ₹ 9,250 [(₹ 9,000 + ₹ 9,500)/2]. Since the deviation between the arm's length price and actual sale price of the equipment to XYZ Inc. i.e., ₹ 7,400 per unit is 25%, which far exceeds the maximum percentage deviation which can be notified by the Central Government[4], the arm's length price would be ₹ 9,250 per unit and the total income would increase by ₹ 3.7 crores [i.e. ₹ 1,850 (₹ 9,250 – ₹ 7,400) x 20,000 units]

(3) On account of the primary adjustment of ₹ 3.7 crores (₹ 1850 x 20,000 units) made by the Assessing Officer, in the total income of PQR Ltd. for A.Y.2024-25, secondary adjustment has to be made under section 92CE, since –

(1) The company has accepted the primary adjustment made by the Assessing Officer;

(2) The primary adjustment is in respect of A.Y.2024-25; and

(3) The primary adjustment exceeds ₹ 100 lakhs.

Accordingly, the excess money i.e., ₹ 3.7 crores available with the XYZ Inc. has to be repatriated to India within 90 days of the date of the order of the Assessing Officer.

Alternatively, PQR Ltd. can opt to pay additional income-tax @20.9664% (tax @18% *plus* surcharge @12% *plus* cess@4%) on ₹ 3.7 crores, which amounts to ₹ 77,57,568.

IX. Records to be maintained [Section 92D]: A taxpayer undertaking international transaction with the associated enterprise has to compute the income, expense or allocation of cost arising from such international transaction having regard to the arm's length price. To substantiate the arm's length price, the taxpayer is required to maintain the three tier documentation i.e. a Master

[4] Which cannot exceed 3% in any case

file, a local file as prescribed under section 92D of the Act and Country by country report as prescribed under section 286 of the Act.

(1) Persons responsible for keeping and maintaining prescribed information and document - Section 92D imposes responsibility on every person

(i) who **enters into an international transaction** to keep and maintain such information and documents in respect thereof as may be prescribed;

(ii) being a **constituent entity of an international group**, to keep and maintain the prescribed information and document **in respect of an international group**.

The constituent entity is required to keep and maintain the information and document irrespective of the fact **whether or not any international transaction is undertaken** by such constituent entity.

The constituent entity has to furnish the information and document to the authority prescribed under section 286(1), i.e., *Joint Director as designated by PDGIT (Systems) or DGIT(Systems)* in the prescribed manner, on or before prescribed date.

(2) Information and documents to be kept and maintained for prescribed period - The CBDT is empowered to prescribe the period for which the information and documents shall be kept and maintained.

(3) Assessing Officer & Commissioner (Appeals) empowered to require persons entering into international transaction to furnish prescribed information and documents - The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceedings under the Income-tax Act, require any person who has entered into an international transaction to furnish any such prescribed information or documents within a period of ***10 days*** from the date of receipt of a notice issued in this regard. The requisition period may, on request, be extended further for a period not exceeding thirty days by the Assessing Officer or the Commissioner (Appeals).

Information to be kept and maintained under section 92D [Rule 10D]

Records to be maintained

Rule 10D (1) provides for the information and documents to be kept and maintained by the assessee under section 92D(1)(i). Under this Rule, the following information and documents have to be maintained:

(i) A description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;

(ii) A profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them;

(iii) A broad description of the business of the assessee and the industry in which the assessee operates, and the business of the associated enterprises with whom the assessee has transacted;

(iv) The nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;

(v) A description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transactions;

(vi) A record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;

(vii) A record of uncontrolled transactions taken into account for analysing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;

(viii) A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

(ix) A description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanation as to why such method was so selected, and how such method was applied in each case;

(x) A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used to apply the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

(xi) The assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;

(xii) Details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under the Income-tax Rules and consequent adjustment made to the total income for tax purposes;

(xiii) Any other information, data or documents, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

Threshold limit for maintenance of prescribed information and documents [Rule 10D(2)]

Rule 10D(2) provides that in a case where the aggregate value of international transactions does not exceed ₹ 1 crore, it will not be obligatory for the assessee to maintain the above information and documents.

Threshold limit for maintenance of records

However, it is provided that in the above cases also the assessee will have to substantiate that the income arising from the international transactions with associated enterprises, as disclosed by the accounts, is in accordance with section 92. This will mean that, even if the aggregate value of the international transactions is less than ₹ 1 crore, the assessee will have to maintain adequate records and evidence to show that the international transactions with associated enterprises are on the basis of arm's length principle.

Information to be supported by authentic documents [Rule 10D(3)]

The information to be maintained by the assessee, is to be supported by authentic documents. These documents may include the following:

(i) Official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;

(ii) Reports of market research studies carried out and technical publications brought out by institutions of national or international repute;

(iii) Price publications including stock exchange and commodity market quotations;

(iv) Published accounts and financial statements relating to the business affairs of the associated enterprises;

(v) Agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

(vi) Letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

(vii) Documents normally issued in connection with various transactions under the accounting practices followed.

It is also provided that the information and documents to be maintained should be contemporaneous and should exist latest by the specified date.

Meaning of specified date

The date one month prior to the due date for furnishing the return of income under section 139(1) for the relevant assessment year i.e., 31st October of the relevant assessment year.

In the case of international transactions which continue to have effect over more than one financial year, fresh documents will not be required to be maintained for each year if there are no significant change which may affect the determination of arm's length price.

The above information and documents are required **to be maintained for a period of eight years** from the end of the relevant assessment year.

X. Audit Report [Section 92E]

Under section 92E, every person who enters into an international transaction during a previous year is required to obtain a report from a chartered accountant and furnish such report on or before the specified date in the prescribed form.

Rule 10E provides that the auditor's report shall be in Form No.3CEB. It requires the auditor to state that he has examined the accounts and records of the assessee relating to the international transactions entered into by the assessee during the relevant year. He has also to give his opinion whether the prescribed information and documents relating to the above transactions have been kept by the assessee. Further, he has to state that the particulars stated in the Annexure to his report are true and correct. The Annexure is in two parts.

In Part A of the Annexure, general information of the assessee (Name of the assessee, address, PAN or Aadhaar No., nature of business etc.) is required to be reported.

In Part B of the Annexure, the particulars about the international transactions are required to be stated. Broadly, these particulars include list of associated enterprises, particulars and description of transactions in tangible property, intangible property, particulars in respect of lending or borrowing of money, particulars of deemed international transaction etc.

In Part C of the Annexure, particulars related to list of associated enterprises with whom the assessee has entered into specified domestic transactions, particulars in respect of transactions in the nature of transfer or acquisition of goods or services, etc. are required to be reported.

"Specified date" means the date one month prior to the due date for furnishing the return of income under section 139(1) for the relevant assessment year. The due date for filing of transfer pricing report under section 92E in Form 3CEB is 31st October of the assessment year.

XI. Power of Assessing Officer: Section 92C(3) and (4) gives power to the Assessing Officer to determine the arm's length price under the following circumstances and also empowers the Assessing Officer to re-compute total income of the assessee having regard to arm's length price determined by him. It also provides that deduction under section 10AA and Chapter VI-A shall not be allowed from the additional income computed by him.

For example, if the total income declared by the assessee in his return of income is, say ₹ 7 lakhs and the total income computed by the Assessing Officer applying the arm's length principle is, say ₹ 9 lakhs, the difference of ₹ 2 lakhs will not qualify for deduction under section 10AA or Chapter VI-A.

The Assessing Officer may invoke the power to determine arm's length price, if during the course of any proceeding, he is of the opinion that, on the basis of material or information or documents in his possession:

(a) The price charged or paid in an international transaction has not been determined in accordance with section 92C(1) and (2); or

(b) Any information and documents relating to an international transaction has not been kept and maintained by the assessee in accordance with the provisions contained in section 92D(1) and the rules made in this behalf (Rule 10D); or

(c) The information or data used in computation of the arm's length price is not reliable or correct; or

(d) The assessee has failed to furnish within the specified time, any information or documents which he was required to furnish by a notice issued under section 92D(3).

Before invoking the power to determine arm's length price, an opportunity of being heard is to be given to the assessee.

Second proviso to section 92C(4) provides that if the total income of an associated enterprise is computed under this section on the determination of arm's length price paid to another associated enterprise, from which tax is deducted or deductible at source, the income of the other associated enterprise shall not be recomputed on this count.

For example, if "A" Ltd. has paid royalty to "B" Ltd. (Non-Resident) @10% of sales and tax is deducted at source, "B" Ltd. cannot claim refund if the Assessing Officer has determined 8% as arm's length price in the case of "A" Ltd. and disallowed 2% of the royalty amount.

Bright Line Test – To cater to the Indian market, MNC sets up subsidiaries in India. The Indian subsidiaries act as a distributor/provider of goods/services and generally incurred certain expenses for promoting the brand or product of the foreign company, which are popularly known as Advertisement, marketing and sale promotion expenditure (**"AMP expenses"**). The intellectual property rights (**"IPR"**) in products/services and the brands lies with the parent entities. To test that whether the transaction is at ALP or not and to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India, Revenue Authorities' sometimes adopt the Bright Line Test (**"BLT"**). The issue under consideration is whether bright line test can be used by the Assessing Officer to determine the excess/non-routine advertising, marketing and promotion (AMP) expenditure incurred by the taxpayer for building brand of its associated enterprises in India.

The Delhi High Court, in *Bausch & Lomb Eyecare (India) (P.) Ltd. v. Addl. CIT [2016] 381 ITR 227*, held that advertisement expense is not an international transaction and there is no machinery provision for computation of AMP expense adjustment.

In *Sony Ericsson Mobile Communications India (P) Ltd v. CIT (2015) 374 ITR 118*, the Delhi High Court held that bright line test has no statutory mandate and a broad-brush approach is not mandated or prescribed. It further opined that the exercise to separate "routine" and "non-routine" advertising, marketing and promotion or brand building exercise by applying the bright line test of non-comparables should not be sanctioned.

Applying the rationale of the above rulings of the High Court, the Revenue Authorities' are not justified in adopting the "Bright Line Test" for disallowing or adjusting the advertisement expenditure in computing arm's length price.

XII. Penalties

Stringent penalties are provided in various sections for non-compliance with the requirements provided under the transfer pricing provisions. These are as under:

Penalty for failure to report any international transaction or any transaction deemed to be an international transaction: Under section 270A, penalty@50% of tax payable on under-reported income is leviable. However, the amount of under-reported income represented by any addition made in conformity with the arm's length price determined by the Transfer Pricing Officer would not be included within the scope of under-reported income under section 270A, where the assessee had maintained information and documents, as prescribed under section 92D, declared the international transactions under Chapter X and disclosed all material facts relating to the transaction.

Interestingly, clause (d) of section 270A(6) does not provide similar immunity from penalty if the addition/disallowance is made by TPO in relation to a specified domestic transaction.

Further, failure to report any international transaction or any transaction deemed to be an international transaction or specified domestic transaction to which the provisions of Chapter X applies would constitute **'misreporting of income'** under section 270A(9), in respect of which penalty@200% would be attracted.

Penalty for failure to keep and maintain information and documentation [Section 271AA]: In order to ensure compliance with the transfer pricing regulations, section 271AA provides that, the Assessing Officer or Commissioner (Appeals) may direct the person entering into an international transaction to pay a penalty@2% of the value of each international transaction entered into by him, if the person:

(1) fails to keep and maintain any such document and information as required by section 92D(1) or section 92D(2);

(2) fails to report such international transaction which is required to be reported; or

(3) maintains or furnishes any incorrect information or document.

Penalty for failure to furnish information or document under section 92D [Section 271G]

Section 271G provides that if any person who has entered into an international transaction fails to furnish any such information or document as required by Assessing Officer or TPO or Commissioner (Appeals) within a period of ***10 days*** from the date of receipt of a notice issued in this regard, then such person shall be liable to a penalty up to 2% of the value of each international transaction.

Penalty for failure to furnish report under section 92E [Section 271BA]

If any person fails to furnish a report from an accountant, the Assessing Officer may direct that such person shall pay, by way of penalty, a sum of ₹ 1 lakh.

Penalty for failure to comply with TP provisions : A Summary		
Section	**Nature of default**	**Penalty**
270A(9)	Failure to report any International transaction or deemed International transaction to which the provision of Chapter X applies would constitute 'misreporting of income'	200% of the tax payable on under-reported income
271BA	Failure to furnish a report from an accountant as required under section 92E	₹ 1 lakh

271G	Failure to furnish info or doc as required by Assessing Officer or CIT(A) u/s 92D(3) within 10 days from the date of receipt of notice or extended period not exceeding 30 days, as the case may be.	2% of the value of the international transaction for each failure
271AA	(1) Failure to keep and maintain any such document and information as required by section 92D(1)/(2); (2) Failure to report such international transaction which is required to be reported; or (3) Maintaining or furnishing any incorrect information or document.	2% of the value of each such international transaction

Notes:

- ***The penalty u/s 271AA is in addition and not in substitution of penalty u/s 271BA.***
- ***If the assessee proves that there was reasonable cause for the failure, no penalty would be leviable under section 271BA, 271G and 271AA.***

(2) Furnishing of report in respect of international group in line with BEPS Action Plan – Country by Country Report and Master File

(i) Transfer Pricing provisions under the Income-tax Act, 1961

Chapter X of the Income-tax Act, 1961 comprising sections 92 to 92F contain provisions relating to transfer pricing regime.

Section 92D requires maintenance of prescribed information and document relating to the international transaction and specified domestic transaction.

(ii) Requirements as per OECD report on Action 13 of BEPS Action Plan

In order to tackle the base erosion and profit shifting by the MNCs, the OECD/G20 BEPS Action Plan 13 report provides for:

(a) detailed transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

This measure is recommended to ensure that the MNEs are reporting the profits in the jurisdiction where the economic activities are performed.

(iii) Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

	Document	Information
(1)	Master File	Standardised information relevant for all multinational enterprises (MNE) group members
(2)	Local file	Specific reference to material transactions of the local taxpayer
(3)	Country-by-country report	Information relating to the global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group.

(iv) Advantages of the three tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;

(b) Tax administrations would get useful information to assess transfer pricing risks;

(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

(v) Country-by-country Report: Reporting Requirements of MNEs

The Country-by-Country (CbC) report has to be submitted by parent entity of an international group to the prescribed authority in its country of residence. This report is to be based on consolidated financial statement of the group.

(a) MNEs have to report annually and for each tax jurisdiction in which they do business:

(1) the amount of revenue;

(2) profit before income tax; and

(3) income tax paid and accrued.

(b) MNEs have to report their total employment, capital, accumulated earnings and tangible assets in each tax jurisdiction.

(c) MNEs have to identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities each entity engages in.

(vi) Master File: Objective & Features

(a) The master file would provide an overview of the MNE groups business, including:

(1) the nature of its global business operations,

(2) its overall transfer pricing policies, and

(3) its global allocation of income and economic activity

in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

(b) The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

(c) The master file shall contain information which may not be restricted to transaction undertaken by a particular entity situated in particular country.

(d) Thus, information in master file would be more comprehensive than the existing regular transfer pricing documentation.

(e) The master file shall be furnished by each entity to the tax authority of the country in which it operates.

(vii) Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961.

(viii) Elements relating to CbC reporting requirement and related matters which have been incorporated in the Income-tax Act, 1961 [Section 286]

(a) Threshold limit for applicability of CbC reporting [Sub-section (7)]: The reporting provision shall apply in respect of an international group for an accounting year, if the total consolidated group revenue as reflected in the consolidated financial statement (CFS) for the accounting year preceding such accounting year is above a threshold to be prescribed ***i.e., ₹ 6,400 crore***.

Where the total consolidated group revenue of the international group, as reflected in the consolidated financial statement, is in foreign currency, the rate of exchange for the calculation of the value in rupees of such total consolidated group revue shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year preceding the accounting year [Rule 10DB(7)].

(b) Time limit for furnishing CbC report [Sub-section (2)]: The parent entity of an international group or the alternate reporting entity, if it is resident in India shall be required to furnish the report in respect of the group to the Joint Director, designated by the Principal Director General of Income-tax (Systems) or the Director General of Income-tax (Systems), as the case may be, for every reporting accounting year, within a period of twelve months from the end of the said reporting accounting year for which the report is being furnished, in Form No. 3CEAD.

(c) Details to be furnished by constituent entity resident in India [Sub-section (1)]: Every constituent entity, resident in India, of an international group having parent entity that is not resident in India, shall notify the Joint Director, designated by the Principal Director General of Income-tax (Systems) or the Director General of Income-tax (Systems), as the case may be, at least two months prior to the due date for furnishing CbC report –

(1) whether it is the alternate reporting entity of the international group; or

(2) the details of the parent entity or the alternate reporting entity, if any of the international group, and the country of territory of which the said entities are resident.

The report shall be furnished in Form No.3CEAC.

(d) Details/ information to be included in CbC report [Sub-section (3)]: It should contain aggregate information in respect of:

(1) the amount of revenue,

(2) profit and loss before income-tax,

(3) amount of income-tax paid and accrued,

(4) details of stated capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent's incorporation country and residential status, nature and details of main business activity or activities of each constituent entity and any other information as may be prescribed.

This shall be based on the template provided in the OECD BEPS report on Action Plan 13.

(e) Furnishing of CbC report by resident constituent entity [Sub-section (4): A constituent entity of an international group resident in India, other than the parent entity or the alternate reporting entity, shall be required to furnish CbC report within the twelve months from the end of the reporting accounting year to the Joint Director, designated by the Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems), if the parent entity of the group is resident of a country or territory,-

(1) in which it is not obligated to file report of the nature of CbC report;

(2) with which India does not have an arrangement for exchange of the CbC report; or

(3) there has been a systemic failure of the country or territory i.e., such country is not exchanging information with India even though there is an agreement and this fact has been intimated to the entity by the prescribed authority.

However, in case the parent entity of the constituent entity is resident of a country or territory, where, there has been a systemic failure of the country or territory and the said failure has been intimated to such constituent entity, the period for submission of the report would be **six months from the end of the month in which said systemic failure has been intimated**.

(f) Nomination of one constituent entity for furnishing CbC report [Proviso to sub-section (4)]: If there are more than one such constituent entity of the group, resident in India, other than the parent entity or the alternate reporting entity, then, the report shall be furnished by any one constituent entity, if the group has nominated such entity on behalf of all the constituent entities resident in India and information has been conveyed in writing on behalf of the group to the prescribed authority in Form No. 3CEAE.

(g) No obligation to furnish CbC report in certain cases [Sub-section (5)]: If an international group, having parent entity which is not resident in India, had designated an alternate entity for filing its report with the tax jurisdiction in which the alternate entity is resident and such alternate entity has furnished such report on or before the date specified by that country or territory, then, the entities of such group operating in India would not be obliged to furnish report if -

- the report is required to be furnished under the law for the time being in force in the said country or territory
- the report can be obtained under the agreement of exchange of such reports by Indian tax authorities
- No systemic failure in respect of the said country or territory has been conveyed to any constituent entity of the group that is resident in India
- the said country or territory has been informed in writing by the constituent entity that it is the alternative reporting entity on behalf of the international group
- the same has been informed to the prescribed authority by the entity in accordance with section 286(1).

(h) Entity to furnish documents and information called for [Sub-section (6)]: The Joint Director, designated by the PDGIT (Systems) or DGIT (Systems) may call for such document and information from the entity furnishing the report as it may specify in notice in writing for the purpose of verifying the accuracy. The entity shall be required to make submission within thirty days of receipt of notice or further period if extended by the prescribed authority, but extension shall not be beyond a further period of 30 days.

(ix) Penalty for non-furnishing of the report by any reporting entity which is obligated to furnish such report [Section 271GB(1) & (3)]

	Period of delay/ default	Penalty
(a)	Not more than a month	₹ 5,000 per day
(b)	beyond one month	₹ 15,000 per day for the period exceeding one month
(c)	Continuing default even after service of order levying penalty either under (a) or under (b)	₹ 50,000 per day of continuing failure beginning from the date of service of order

(x) Penalty for failure to produce information and documents within prescribed time [Section 271GB(2) & (3)]

	Default	Penalty
(a)	Failure to produce information and documents before prescribed authority within the period allowed u/s 286(6)	₹ 5,000 per day of continuing failure, from the day immediately following the day on which the period for furnishing the information and document expires.
(b)	Continuing default even after service of penalty order	₹ 50,000 per day for the period of default beyond the date of service of order.

(xi) Penalty for submission of inaccurate information in the CBC report [Section 271GB(4)]

If the reporting entity has provided any inaccurate information in the report, the penalty would be ₹ 5,00,000 if ,-

(a) the entity has knowledge of the inaccuracy at the time of furnishing the report but does not inform the prescribed authority; or

(b) the entity discovers the inaccuracy after the report is furnished and fails to inform the prescribed authority and furnish correct report within a period of fifteen days of such discovery; or

(c) the entity furnishes inaccurate information or document in response to notice of the prescribed authority under section 286(6).

(xii) Non-levy of penalty if reasonable cause for failure is proved [Section 273B]

Section 273B provides for non-levy of penalty under various sections if the assessee proves that there was reasonable cause for such failure. Section 271GB has been included within the scope of section 273B. Therefore, the entity can offer reasonable cause defence for non-levy of penalties mentioned above.

(xiii) Maintenance and furnishing of Master file: Consequent amendments in the Income-tax Act, 1961

	Section	Provision
(1)	92D(1)(ii)	Every person, being constituent entity of an international group, has to keep and maintain the prescribed information and document in respect of the international group. Constituent entity has to keep and maintain such prescribed information and document irrespective of the fact whether or not any international transaction is undertaken by such constituent entity. The rules shall, thereafter, prescribe the information and document as mandated for master file under OECD BEPS Action 13 report;
(2)	92D(4)	The information and document shall also be furnished to the prescribed authority u/s 286(1) within such period as may be prescribed and the manner of furnishing may also be provided for in the rules
(3)	271AA(2)	For non-furnishing of the information and document to the prescribed authority, a penalty of ₹ 5 lakh shall be leviable.
(4)	273B	Reasonable cause defence against levy of penalty shall be available to the entity.

(xiv) Maintenance and furnishing of information and documents by certain person under section 92D [Rule 10DA]

Rule	Particulars
10DA(1)	Persons required to keep and maintain the information and documents: Every person, being a constituent entity of an international group shall – (i) if the consolidated group revenue of the international group, of which such person is a constituent entity, as reflected in the consolidated financial statement of the international group for the accounting year, exceeds ₹ 500 crore; and (ii) the aggregate value of international transactions – (A) during the accounting year, as per the books of accounts, exceeds ₹ 50 crore, or (B) in respect of purchase, sale, transfer, lease or use of intangible

	property during the accounting year, as per the books of accounts, exceeds ₹ 10 crore keep and maintain information and documents of the international group. **Note –** The rate of exchange for the calculation of the value in rupees of the consolidated group revenue in foreign currency shall be the telegraphic transfer buying rate (TTBR) of such currency on the last day of the accounting year. [Rule 10DA(7)] Part A of Form No. 3CEAA **(Master File)**, however, shall be furnished by every person, being a constituent entity of an international group, whether or not the above conditions are satisfied [Rule 10DA(3)].
	Information and documents required to be kept and maintained: The constituent entity shall keep and maintain the following information and documents of the international group, namely:- (a) a list of all entities of the international group along with their addresses; (b) a chart depicting the legal status of the constituent entity and ownership structure of the entire international group; (c) a description of the business of international group during the accounting year including,- (I) the nature of the business or businesses; (II) the important drivers of profits of such business or businesses; (III) a description of the supply chain for the five largest products or services of the international group in terms of revenue and any other products including services amounting to more than five per cent. of consolidated group revenue; (IV) a list and brief description of important service arrangements made among members of the international group, other than those for research and development services; (V) a description of the capabilities of the main service providers within the international group; (VI) details about the transfer pricing policies for allocating service costs and determining prices to be paid for intra-group services; (VII) a list and description of the major geographical markets for the products and services offered by the international group; (VIII) a description of the functions performed, assets employed and risks assumed by the constituent entities of the international group that contribute at least ten per cent. of the revenues or assets or profits of such group; and (IX) a description of the important business restructuring transactions, acquisitions and divestments;

	(d) a description of the overall strategy of the international group for the development, ownership and exploitation of intangible property, including location of principal research and development facilities and their management; (e) a list of all entities of the international group engaged in development and management of intangible property along with their addresses; (f) a list of all the important intangible property or groups of intangible property owned by the international group along with the names and addresses of the group entities that legally own such intangible property; (g) a list and brief description of important agreements among members of the international group related to intangible property, including cost contribution arrangements, principal research service agreements and license agreements; (h) a detailed description of the transfer pricing policies of the international group related to research and development and intangible property; (i) a description of important transfers of interest in intangible property, if any, among entities of the international group, including the name and address of the selling and buying entities and the compensation paid for such transfers; (j) a detailed description of the financing arrangements of the international group, including the names and addresses of the top ten unrelated lenders; (k) a list of group entities that provide central financing functions, including their place of operation and of effective management; (l) a detailed description of the transfer pricing policies of the international group related to financing arrangements among group entities; (m) a copy of the annual consolidated financial statement of the international group; and (n) a list and brief description of the existing unilateral advance pricing agreements and other tax rulings in respect of the international group for allocation of income among countries.
10DA(2)	**Due date for furnishing report:** The information and document shall be furnished in Form No. 3CEAA to the Joint Director as may be designated by PDGIT (Systems) or DGIT (Systems), as the case may be, and it shall be furnished on or before the due date for furnishing the return of income specified under section 139(1).
10DA(4)/ (5)	**Furnishing of report in case of more than one constituent entity:** Where there are more than ***one constituent entities of an international group required to file the information and document under sub-rule (2)***, then, the Form No 3CEAA may be furnished by any one constituent entity, if, -

	(a) the international group has designated such entity for this purpose and (b) the information has been conveyed to the Joint Director as may be designated by PDGIT (Systems) or DGIT (Systems), as the case may be, in Form No 3CEAB, in this behalf at least 30 days before the due date of furnishing the Form No. 3CEAA.
10DA(6)	**Period for which such information and document to be kept or maintained:** The information and documents shall be kept and maintained for a period of eight years from the end of the relevant assessment year.

(xv) Meaning of certain terms [Section 286(9)]

	Term	Meaning
(a)	**Accounting year**	<table><tr><th>Case</th><th>Accounting year</th></tr><tr><td>In a case where the parent entity is resident in India; or</td><td>A previous year</td></tr><tr><td>In any other case</td><td>An annual accounting period, with respect to which the parent entity of the international group prepares its financial statements under any law for the time being in force or the applicable accounting standards of the country or territory of which such entity is resident.</td></tr></table>
(b)	**Agreement**	A combination of all of the following agreements, namely – (i) an agreement referred to in section 90(1) or section 90A(1); or (ii) an agreement for exchange of the CbC report referred to in section 286(2) as may be notified by the Central Government.
(c)	**Alternate reporting entity**	Any constituent entity of the international group that has been designated by such group, in the place of the parent entity, to furnish the CbC report in the country or territory in which the said constituent entity is resident on behalf of such group.
(d)	**Constituent entity**	(i) any separate entity of an international group that is included in the consolidated financial statement of the said group for financial reporting purposes, or may be so included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange; (ii) any such entity that is excluded from the consolidated financial statement of the international group solely on the basis of size or materiality; or (iii) any permanent establishment of any separate business entity of the international group included in sub clause (i) or sub clause (ii),

		if such business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting or internal management control purposes
(e)	**Group**	This includes a parent entity and all the entities in respect of which, for the reason of ownership or control, a consolidated financial statement for financial reporting purposes,— (i) is required to be prepared under any law for the time being in force or the accounting standards of the country or territory of which the parent entity is resident; or (ii) would have been required to be prepared had the equity shares of any of the enterprises were listed on a stock exchange in the country or territory of which the parent entity is resident.
(f)	**Consolidated financial statement**	The financial statement of an international group in which the assets, liabilities, income, expenses and cash flows of the parent entity and the constituent entities are presented as those of a single economic entity
(g)	**International group**	Any group that includes,— (i) two or more enterprises which are resident of different countries or territories; or (ii) an enterprise, being a resident of one country or territory, which carries on any business through a permanent establishment in other countries or territories;
(h)	**Parent entity**	A constituent entity, of an international group holding, directly or indirectly, an interest in one or more of the other constituent entities of the international group, such that,— (i) it is required to prepare a consolidated financial statement under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or (ii) it would have been required to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange, and, there is no other constituent entity of such group which, due to ownership of any interest, directly or indirectly, in the first mentioned constituent entity, is required to prepare a consolidated financial statement, under the circumstances referred to in sub clause (i) or sub clause (ii), that includes the separate financial statement of the first mentioned constituent entity.
(i)	**Permanent establishment**	Meaning assigned to it in clause (iiia) of section 92F i.e., includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

(j)	**Reporting accounting year**	The accounting year in respect of which the financial and operational results are required to be reflected in the report to be furnished every year by the parent entity or the alternate reporting entity, resident in India, in respect of the international group of which it is a constituent under section 286(2) or by a constituent entity of an international group referred to in section 286(4).
(k)	**Reporting entity**	The constituent entity including the parent entity or the alternate reporting entity, that is required to furnish a report referred to in section 286(2).
(l)	**Systemic failure**	Systemic failure, with respect to a country or territory, means that the country or territory has an agreement with India providing for exchange of report of the nature referred to in section 286(2), but— (i) in violation of the said agreement, it has suspended automatic exchange; or (ii) has persistently failed to automatically provide to India the report in its possession in respect of any international group having a constituent entity resident in India

(3) Transfer pricing for Specified Domestic Transactions

(i) Income from domestic related party transactions to be subject to transfer pricing [Section 92(2A)]: Section 92 provides that any income arising from an international transaction shall be computed having regard to the arm's length price. Even in case of certain domestic transaction, the tax arbitrage takes place due to differences in tax rates. For example, if the entity has two units – one in DTA and other in non-DTA, the entity can undertake the transfer of goods at price which results in lower profits in taxable unit and higher profits in non-taxable unit. In order to ensure objectivity in determination of income from domestic related party transactions and determination of reasonableness of expenditure between related domestic parties, the provisions of section 92 have been extended to include within its ambit the specified domestic transactions. Section 92(2A) provides that, any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction shall be computed having regard to the arm's length price. However, as per section 92(3), the provisions of this section would not apply if such allowance for expense or interest under section 92(2A) has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be.

(ii) Meaning of "specified domestic transaction" [Section 92BA]: Section 92BA provides the meaning of "specified domestic transaction". As per section 92BA, for the purpose of sections 92, 92C (Computation of arm's length price), 92D (Maintenance and keeping of information and documents) and 92E (Furnishing of report from an accountant), in case of an assessee the specified domestic transaction shall mean any of the following transactions, not being an international transaction, namely,-

(1) any transaction referred to in section 80A i.e., inter-unit transfer of goods and services by an undertaking or unit or enterprise or eligible business to other business carried on by the assessee or *vice versa*, for consideration not corresponding to the market value on the date of transfer;

(2) any transfer of goods or services referred to in section 80-IA(8) i.e., inter-unit transfer of goods or services between eligible business and other business, where the consideration for transfer does not correspond with the market value of goods and services;

(3) any business transacted between the assessee carrying on eligible business and other person as referred to section 80-IA(10);

(4) any transaction, referred to in any other section under Chapter VI-A or section 10AA, to which provisions of section 80-IA(8) or section 80-IA(10) are applicable; or

(5) any business transacted between a company opting for section 115BAB and person with whom the company has close connection; or

(6) any business transacted between a co-operative society opting for section 115BAE and person with whom the co-operative society has close connection; or

(7) any other transaction as may be prescribed,

However, the above mentioned transactions shall not be treated as specified domestic transaction in case the aggregate of such transactions entered into by the assessee in the previous year does not exceed a sum of ₹ 20 crore.

(iii) Arm's length price and income of a specified domestic transaction to be computed in the same manner as applicable to an international transaction [Sections 92 & 92C]: In order to determine the arm's length price in respect of the specified domestic transaction, the provisions of section 92 and 92C shall apply to the specified domestic transaction as they apply to the international transaction. Accordingly, the methods of computation of arm's length price for an international transaction would be applicable to a specified domestic transaction also.

(iv) **Persons entering into a specified domestic transaction to maintain information and documents and furnish report of an accountant [Section 92D & 92E]:** With a view to create a legally enforceable obligation on assessees entering into a specified domestic transaction to maintain proper documentation and obtain and furnish report of a Chartered Accountant on or before the specified date, the provisions of section 92D and 92E have been made applicable to a specified domestic transaction as they apply to an international transaction.

(v) **Reference to Transfer Pricing Officer for computation of arm's length price of specified domestic transaction [Section 92CA]:** According to section 92CA, where any person has entered into an international or a specified domestic transaction in any previous year, the Assessing Officer can with the previous approval of the Principal Commissioner or Commissioner, if he considers necessary or expedient to do so, refer the computation of the arm's length price of such transaction to the Transfer Pricing Officer (TPO).

When such reference is made, TPO can call upon the assessee to produce evidence in support of the computation of arm's length price made by him in respect of such transaction.

The TPO has to pass an order determining the arm's length price in respect of the specified domestic transaction after considering the evidence, documents, etc. produced by the assessee and after considering the material gathered by him. He has to send a copy of his order to the Assessing Officer as well as the assessee.

However, the powers available to the TPO to determine the ALP of other international transactions identified subsequently in the course of proceedings before him, is not available in respect of other specified domestic transaction i.e., the TPO can determine the ALP in respect of other international transaction that came to his notice subsequently during the course of proceedings but such power is not available in respect of specified domestic transaction subsequently identified.

(vi) **Penalty provisions to apply to specified domestic transactions as they apply to an international transaction [Sections 271AA, 271BA & 271G]:** The penalty provisions under sections 271AA, 271BA and 271G shall apply to the specified domestic transaction as they apply to an international transaction defined under section 92B.

Failure to furnish the report under section 92E from an accountant would attract penalty of ₹ 1,00,000 under section 271BA.

In addition,

(i) in case of failure to keep and maintain information, document as required under section 92D(1) or 92D(2); or

(ii) failure to report such specified domestic transaction which is required to be reported; or

(iii) maintain or furnishes incorrect information or document

penalty under section 271AA at 2% of the value of each transaction would be attracted.

Penalty@2% of value of specified domestic transaction would be attracted under section 271G for failure to furnish the prescribed information or document as required under section 92D(3) within the period of ***10 days*** from the date of receipt of notice or the extended period not exceeding another 30 days, as the case may be.

(vii) Market value to be the arm's length price of goods or services in a specified domestic transaction [Section 80A & 80-IA(8)]: As per the provisions of section 80A(6), in a case where the goods or services held for the purpose of the undertaking or unit or enterprise or eligible business are transferred to any other business carried on by the assessee or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the undertaking or unit or enterprise or eligible business and the consideration for transfer as recorded in the accounts does not correspond to the market value of such goods or services as on the date of transfer, then, for the purpose of any deduction under Chapter VI-A, profits and gains of such undertaking or unit or enterprise or eligible business shall be determined at the market value of such goods or services as on the date of transfer.

Clause (iii) of *Explanation* to section 80A(6) clarifies that "market value" in relation to any goods or services sold, supplied or acquired, means the arm's length price as defined under section 92F of such goods or services, if it is a specified domestic transaction referred to in section 92BA i.e., the aggregate value of all such transaction specified in section 92BA exceeds **₹ 20 crore**.

Therefore, in case the transfer of goods and services between undertaking or unit or enterprise or eligible business and any other business of the assessee takes place at the arm's length price, such arm's length price shall be the market value for the purpose of section 80A(6), and no further adjustment would be required in respect of the same, if the transaction is a specified domestic transaction.

(viii) Similarly, for the purpose of section 80-IA(8), the market value, in relation to any goods or services transferred between the eligible business and any other business carried on by the assessee, shall mean -

(1) the price that such goods or services would ordinarily fetch in the open market; or

(2) the arm's length price as defined under section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

(ix) Profit from transactions between an assessee carrying on "eligible business" and other assessees to be determined as per arm's length price [Section 80-IA(10)]: Under section 80-IA(10), the Assessing Officer is empowered to make an adjustment while computing the profit and gains of the eligible business on the basis of the reasonable profit that can be derived from the transaction, in case the transaction between the assessee carrying on the eligible business under section 80-IA and any other person is so arranged that the transaction produces excessive profits to the eligible business.

It has been provided that if the aforesaid arrangement between the assessee carrying on the eligible business and any other person is a specified domestic transaction referred to in section 92BA, then, the amount of profit of such transaction shall be determined having regard to arm's length price as defined under section 92F and not as per the reasonable profit from such transaction.

(x) Transfer Pricing Rules made applicable to Specified Domestic Transactions

The transfer pricing provisions have been extended to Specified Domestic Transactions. Accordingly, the transfer pricing rules prescribed for international transactions have been suitably amended to make the same applicable for specified domestic transactions, as well.

Rule No.	Particulars	Amendment
10A	**Meaning of expressions used in computation of Arm's length price**	**Definition of "associated enterprise" and "enterprise" included** **"Associated Enterprise"** shall - (i) have the same meaning as assigned to it in section 92A; and (ii) in relation to a specified domestic transaction entered into by an assessee, include - (A) other units or undertakings or businesses of such assessee in respect of a transaction referred to in section 80A or section 80-IA(8);

		(B) any other person referred to in section 80-IA(10) in respect of a transaction referred to therein; (C) other units, undertakings, enterprises or business of such assessee, or other person referred to in section 80-IA(10) or in respect of a transaction referred to in section 10AA or the transactions referred to in Chapter VI-A to which the provisions of section 80-IA(8) or section 80-IA(10) are applicable; **"Enterprise"** shall have the same meaning as assigned to it in clause (iii) of section 92F and shall, for the purposes of a specified domestic transaction, include a unit, or an enterprise, or an undertaking or a business of a person who undertakes such transaction.
10AB	**Other methods of determination of ALP**	This Rule provides that for the purpose of section 92C(1)(f), the other method for determination of the arm's length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. This Rule has been made applicable to specified domestic transactions as well.
10B	**Determination of ALP under section 92C**	The methods for determination of arm's length price specified in this Rule for the purpose of section 92C(2) in relation to an international transaction shall also be made applicable in respect of specified domestic transactions.
10C	**Most appropriate method**	Sub-rule (1) provides that, for the purposes of section 92C(1), the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to an international transaction. Sub-rule (2) specifies the factors to be taken into account in selecting the most appropriate method. This Rule is made applicable in respect of a specified domestic transaction as well.

10D	**Information and documents to be kept and maintained under section 92D**	Sub-rule (1) requires every person who has entered into an international transaction or specified domestic transaction to maintain the requisite information and documents as detailed thereunder. As per sub-rule (2), maintenance of information and documents shall not apply where the aggregate value of international transactions does not exceed ₹ 1 crore. However, sub-rule (1) shall be applicable for every specified domestic transaction irrespective of its value.
10E	**Report from an accountant to be furnished under section 92E**	This rule provides for submission of audit report from a chartered accountant by every person who has entered into an international transaction. This provision would also apply to a person entered into a specified domestic transaction as well.

(xi) Safe Harbour Rules notified for Specified Domestic Transactions [Rule 10TH to Rule 10THD]

Section 92CB provides that determination of

- income referred to in section 9(1)(i); or
- arm's length price under section 92C or Section 92CA

shall be subject to Safe Harbour rules. Section 92CB(2) empowers the CBDT to prescribe safe harbour rules.

Safe Harbour means circumstances in which the income-tax authorities shall accept the transfer price or income, deemed to accrue or arise under section 9(1)(i), as the case may be, declared by the assessee.

Accordingly, the CBDT has, in exercise of the powers conferred by section 92CB and 92D, read with section 295, inserted Rules 10TH, 10THA, 10THB, 10THC & 10THD providing the safe harbour rules for specified domestic transactions.

Rule	Rule heading	Particulars
10TH	**Definitions:** **Appropriate Commission** →	Meaning assigned to it in section 2(4) of the Electricity Act, 2003. Appropriate Commission means the Central Regulatory Commission referred to in sub-section (1) of section 76 or the

		State Regulatory Commission referred to in section 82 or the Joint Commission referred to in section 83, as the case may be, of the Electricity Act, 2003.
	Government Company →	Meaning assigned to it in section 2(45) of the Companies Act, 2013. Government company means any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company. "Paid-up share capital" shall be construed as "total voting power", where shares with differential voting rights have been issued.
10THA	**Eligible assessee**	• A person who has exercised a valid option for application of safe harbour Rules in accordance with the provisions of Rule 10THC, **AND** • is a Government company engaged in the business of generation, supply, transmission or distribution of electricity; or • is a co-operative society engaged in the business of procuring and marketing milk and milk products.
10THB	**Eligible Specified Domestic Transaction**	A specified domestic transaction undertaken by an eligible assessee and which comprises of: (i) supply of electricity; or (ii) transmission of electricity; or (iii) wheeling of electricity; or (iv) purchase of milk or milk products by a co-operative society from its members.
10THC	**Safe harbour**	(1) Where an eligible assessee has entered into an eligible specified domestic transaction in any previous year relevant to an assessment year and the option exercised by the said assessee is treated to be validly exercised under Rule 10THD, the transfer price declared by the assessee in respect of such transaction for that assessment year shall be accepted by the income-tax authorities, if it is in accordance with the circumstances specified in Rule 10THC(2).

(2) The following are the circumstances in respect of the eligible specified domestic transaction.

S. No.	Eligible specified domestic Transaction	Circumstances
1	Supply of electricity, transmission of electricity, wheeling of electricity	The tariff in respect of supply of electricity, transmission of electricity, wheeling of electricity, as the case may be, is determined or the methodology for determination of the tariff is approved by the Appropriate Commission in accordance with the provisions of the Electricity Act, 2003.
2	Purchase of milk or milk products by a co-operative society from its members	The price of milk or milk products is determined at a rate which is fixed on the basis of the quality of milk, namely, fat content and Solid Not Fat (SNF) content of milk; and – (a) the said rate is irrespective of,- (i) the quantity of milk procured; (ii) the percentage of shares held by the members in the co-operative society; (iii) the voting power held by the members in the society; and (b) such prices are routinely declared by the co-operative society in a transparent manner and are available in public domain.

(3) No comparability adjustment and allowance under the second proviso to section 92C(2) shall be made to the transfer price declared by the eligible assessee and accepted by the income-tax authority.

(4) The provisions of sections 92D relating to maintenance and keeping of information and document and section

		92E for submission of report from an accountant in respect of a specified domestic transaction shall apply irrespective of the fact that the assessee exercises his option for safe harbour in respect of such transaction.
10THD	**Procedure**	**Furnishing of Form 3CEFB** The assessee has to furnish Form 3CEFB, complete in all respects, to the Assessing Officer on or before the due date for furnishing the return of income for the relevant assessment year specified in *Explanation* 2 to section 139(1), for exercising the option of safe harbour. The return of income should be furnished on or before the date of submitting the Form 3CEFB. **Verification by the Assessing Officer** Before treating the option for safe harbor by the assessee as validly exercised, the Assessing Officer has to verify whether the assessee exercising the option is an eligible assessee and the transaction in respect of which the option is exercised is an eligible specified domestic transaction. **Furnishing of documents or information required by the Assessing Officer** Assessing Officer may issue a notice to the assessee to furnish such information or documents or other evidence as he may consider necessary. The assessee has to furnish the same within the specified time in such notice. **Circumstances when option exercised can be declared Invalid** The Assessing Officer has to, by order in writing, declare the option exercised by the assessee as invalid and cause a copy of the order to be served on the assessee if – (i) the assessee does not furnish the information or documents or other evidence required by the Assessing Officer (ii) the Assessing Officer finds that the assessee is not an eligible assessee (iii) the Assessing Officer finds that the specified domestic transaction in respect of which option has been exercised is not an eligible specified domestic transaction (iv) the tariff is not in accordance with the circumstances specified in Rule 10THC. **Order by Assessing Officer** The Assessing Officer has to pass the order declaring the

		option exercised by the assessee as invalid within a period of 3 months from the end of the month in which Form 3CEFB is received by him. No order can be passed declaring the option exercised by the assessee invalid unless an opportunity of being heard is given to him. **Filling of objections against the order of Assessing Officer by the assessee** If the assessee objects to the order of the Assessing Officer declaring the option to be invalid, he may file his objections with the Principal Commissioner or the Commissioner or the Principal Director or the Director, as the case may be, to whom the Assessing Officer is subordinate, **within 15 days of receipt of the order of the Assessing Officer**. On receipt of objection, the Principal Commissioner or Commissioner or Principal Director or Director, as the case may be, shall, after providing an opportunity of being heard to the assessee, pass appropriate order, **within a period of 2 months from the end of the month** in which the objection filed by the assessee is received by him, in respect of the validity or otherwise of the option exercised by the assessee. A copy of the said order has to be served on the assessee and the Assessing Officer. If the Assessing Officer or the Principal Commissioner or the Commissioner or the Principal Director or the Director, as the case may be, does not pass an order within the specified time, then the option for safe harbour exercised by the assessee shall be treated as valid.

(xii) Information and documents to be kept and maintained under section 92D in case of an eligible assessee referred to in Rule 10THA in respect of eligible specified domestic transaction [Rule 10D(2A)]:

Section 92D(1)(i) provides that every person who has entered into an international transaction or specified domestic transaction shall keep and maintain prescribed information and document.

Rule 10D(1) provides for information and documents to be maintained under section 92D. Sub-rule (2A) in Rule 10D provides that nothing contained in Rule 10D(1) in so far as it relates to specified domestic transaction referred to in Rule 10THB, shall apply in the case of an eligible assessee referred to in Rule 10THA.

The information and documents to be maintained by an eligible assessee referred to in Rule 10THA relating to an eligible specified domestic transaction referred to in Rule 10THB are given in Rule 10D(2A) as follows:

Rule	Eligible Assessee	Information and documents to be kept and maintained
10THA(i)	**A government company engaged in the business of generation, supply, transmission or distribution of electricity**	(i) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises; (ii) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted; (iii) the nature and terms (including prices) of specified domestic transactions entered into with each associated enterprise and the quantum and value of each such transaction or class of such transaction; (iv) a record of proceedings, if any, before the regulatory commission and orders of such commission relating to the specified domestic transaction; (v) a record of the actual working carried out for determining the transfer price of the specified domestic transaction; (vi) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the transfer price; and (vii) any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the transfer price.
10THA(ii)	**A co-operative society engaged in the business of procuring and marketing milk and milk products**	(i) a description of the ownership structure of the assessee co-operative society with details of shares or other ownership interest held therein by the members; (ii) description of members including their addresses and period of membership; (iii) the nature and terms (including prices) of specified domestic transactions entered into with each member and the quantum and value of each such transaction or class of such transaction; (iv) a record of the actual working carried out for

		determining the transfer price of the specified domestic transaction; (v) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the transfer price; (vi) the documentation regarding price being routinely declared in transparent manner and being available in public domain; and (vii) any other information, data or document which may be relevant for determination of the transfer price.
The above information should be supported by authentic documents. Both the information and documents must be contemporaneous and should exist latest by the specified date [i.e., the date one month prior to the due date of filing return under section 139(1)] i.e., 31st October of the assessment year. Such information and documents have to be kept and maintained for a period of eight years from the end of the relevant assessment year.		

24.6 TRANSFER OF INCOME TO NON RESIDENTS [SECTION 93]

A resident and ordinarily resident is subject to tax in India in respect of his global income whereas in case of a non-resident, income accruing or arising outside India would not be taxable in his hands in India if it is not deemed to accrue or arise in India and is not received in India. Thus, in order to reduce his tax liability, a resident Indian may transfer the ownership in his foreign asset to a non-resident, while continuing to enjoy the benefits of income derived therefrom. Section 93 hits at such transactions which are effected with a view to avoiding income-tax liability. For the purpose of this section, the word “non-resident” also includes a person who is not-ordinarily resident.

In order to attract the provisions of this section, the following conditions must be satisfied:

(a) There should be a transfer of assets.

(b) The said transfer may be made either alone or in conjunction with associated operations.

(c) The transfer of assets is effected in such a manner that the income from transferred assets becomes payable to a non-resident.

(d) As a consequence of the transfer, the transferor, either alone or in conjunction with associated operations, has acquired any right, by virtue of which he gets the power to enjoy the income from transferred assets, whether immediately or in future.

(e) Such income of the non-resident transferee would have been chargeable to tax in India, had it been the income of the resident transferor.

(f) The Assessing Officer is satisfied that avoidance of liability to tax in India is the purpose of the transfer.

In such a case, the income from transferred asset would be deemed to be the income of the resident transferor and would, accordingly, be taxable in his hands. Therefore, where assets are transferred to a body corporate outside India, in consideration of shares allotted by it to the transferor, he (the transferor), will become assessable under this section in respect of the income of the company derived by it from those assets. This section will not, however, apply to cases where it is shown to the satisfaction of the Assessing Officer that (i) neither the transfer nor any associated operation had for its purpose or for one of its purposes the avoidance of liability to taxation or (ii) it is provided to the satisfaction of the Assessing Officer that the transfer was effected for *bona fide* commercial purpose and with no intent to avoid tax.

	Terms	Meaning
(i)	**Associated operation**	The expression 'associated operation," in relation to a transfer, means an operation of any kind effected by any person in relation to: (i) any of the assets transferred; (ii) any assets representing, whether directly or indirectly, any of the assets transferred; (iii) any income arising from such assets; (iv) any assets representing, whether directly or indirectly, the accumulation of income arising from such assets.
(ii)	**Assets**	It includes property or rights of any kind.
(iii)	**Transfer**	In relation to rights, includes creation of those rights
(iv)	**Benefit**	It includes a payment of any kind.

For purposes of this section, a person is deemed to have the power to enjoy the income of a non-resident if:

(i) the income, in fact, so dealt with by any person as to be calculated at some point of time to enure for the benefit of the transferor, whether in the form of the income or otherwise;

(ii) the receipt or accrual of the income operates to increase value of any assets held by the transferor or for his direct or indirect benefit;

(iii) the transferor receives or is entitled to receive at any time any benefit out of the income or out of any money available for the purpose by reason of the effect or successive effects of the associated operations on that income and the assets which represent that income;

(iv) the transferor is in a position to obtain for himself the beneficial enjoyment of the income by exercising any power of appointment or power of revocation or otherwise, whether with or without the consent of any other person, or

(v) the transferor is able to control, directly or indirectly, the application of the income in any manner whatsoever.

However, in determining whether a person has the power to enjoy the income, due regard shall be had to the substantial result and effect of the transfer and any associated operations; all benefits which may at any time accrue to such person as a result of the transfer and any associated operations must be taken into consideration irrespective of the nature or form of the benefits.

It may be noted that where an assessee has been charged to tax in respect of a sum deemed to be his income under this section, the subsequent receipt of that sum by the assessee, whether as income or in any other form, shall not be liable to tax in his hands at the time of receipt.

24.7 INTRODUCTION OF SPECIFIC ANTI AVOIDANCE MEASURES IN RESPECT OF TRANSACTIONS WITH PERSONS LOCATED IN NOTIFIED JURISDICTIONAL AREA [SECTION 94A]

The objective of anti-avoidance measures is to discourage assessees from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. The following are the anti-avoidance measures introduced -

(i) The Central Government is empowered to notify any country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.

> ***Clarification on removal of Cyprus from the list of notified jurisdictional area under section 94A of the Income-tax Act, 1961 – [Circular No. 15/2017, dated 21-04-2017]***
>
> Cyprus was specified as a "notified jurisdictional area" (NJA) under section 94A of the Income-tax Act, 1961 vide Notification No. 86/2013 dated 01.11.2013. The said Notification

No. 86/2013 was subsequently rescinded vide Notification No. 114 dated 14.12.2016 and Notification No. 119 dated 16.12.2016 with effect from the date of issue of the notification.

The CBDT has, vide this Circular, clarified that Notification No. 86/2013 has been rescinded with effect from the date of issue of the said notification, thereby, removing Cyprus as a notified jurisdictional area with retrospective effect from 01.11.2013.

(ii) A transaction where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction then all parties to the transaction to be deemed as associated enterprises, and accordingly, all the provisions of transfer pricing to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price based on the rate notified by the Central Government would not be available in respect of such transaction.

(iii) Such transaction may be in the nature of –

(1) purchase, sale or lease of tangible or intangible property or

(2) provision of service or

(3) lending or borrowing money or

(4) any other transaction having a bearing on the profits, income, losses or assets of the assessee. It may include a mutual agreement or arrangement for allocation or apportionment of, or contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided by or to the assessee.

(iv) Person located in a NJA shall include a person who is a resident of the NJA and a person, not being an individual, which is established in the NJA. It would also include a permanent establishment of any other person in the NJA.

(v) Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.

(vi) No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.

(vii) Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.

(viii) The rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –

(1) rates specified in the relevant provision of the Income-tax Act, 1961; or

(2) rate or rates in force; or

(3) 30%.

ILLUSTRATION 7

A Ltd., an Indian company, provides technical services to a company, XYZ Inc., located in a NJA for a consideration of ₹ 40 lakhs in October, 2023. It charges ₹ 42 lakhs for similar services rendered to PQR Inc., which is not located in a NJA. PQR Inc. is not an associated enterprise of A Ltd.

Discuss the tax implications under section 94A read with section 92C in respect of the above transaction of provision of technical services by A Ltd. to XYZ Inc.

SOLUTION

Since XYZ Inc. is located in a NJA, the transaction of provision of technical services by the Indian company, A Ltd., would be deemed to be an international transaction and XYZ Inc. and A Ltd. would be deemed to be associated enterprises. Therefore, the provisions of transfer pricing would be attracted in this case.

The price of ₹ 42 lakhs charged for similar services from PQR Inc, being an independent entity located in a non-NJA country, can be taken into consideration for determining the arm's length price (ALP) under Comparable Uncontrolled Price (CUP) Method.

Since the ALP is more than the transfer price, the ALP of ₹ 42 lakhs would be considered as the income arising from the international transaction between A Ltd. and XYZ Inc.

It may be noted that the benefit of permissible variation between the ALP and transfer price is not available in respect of a transaction entered into with an entity in NJA.

ILLUSTRATION 8

Mr. X, a non-resident individual, is due to receive interest of ₹ 5 lakhs during March 2024 from a notified infrastructure debt fund eligible for exemption under section 10(47). He incurred *expenditure amounting to ₹ 10,000 for earning such income. Assuming that Mr. X is a resident of a NJA, discuss the tax implications under section 94A, read with sections 115A and 194LB.*

SOLUTION

The interest income received by Mr. X, a non-resident, from a notified infrastructure debt fund would be subject to a concessional tax rate of 5% under section 115A on the gross amount of such interest income. Therefore, the tax liability of Mr. X in respect of such income would be ₹ 26,000 (being 5% of ₹ 5 lakhs *plus* health and education cess@4%).

Under section 194LB, tax is deductible @5% (*plus* health and education cess@4%) on interest paid by such fund to a non-resident. However, since X is a resident of a NJA, tax would be deductible@30% (*plus* health and education cess@4%) as per section 94A, and not @5% specified under section 194LB. This is on account of the provisions of section 94A(5), which provides that "**Notwithstanding anything contained in any other provision of this Act,** where a person located in a NJA is entitled to receive any sum or income or amount on which **tax is deductible under Chapter XVII-B,** the **tax shall be deducted at the highest of the following rates**, namely–

(a) at the rate or rates in force;

(b) at the rate specified in the relevant provision of the Act;

(c) at the rate of thirty per cent."

Mr. X can, however, claim refund of excess tax deducted along with interest.

24.8 LIMITATION OF INTEREST DEDUCTION IN CERTAIN CASES [SECTION 94B]

(1) Preference of debt over equity as a measure to finance businesses: Debt and equity are the instruments through which a company is generally financed or capitalized. The manner in which a company is capitalized has a major impact on the amount of taxable profit as the tax laws of countries generally provide for a deduction in respect of interest paid or payable while arriving at the taxable profit. However, the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus, the amount of interest it pays, the lower will be its taxable income. Due to this reason, debt is considered a more tax efficient method of finance than equity. Multinational groups are often able to structure their financing arrangements to maximize tax benefits through intra-group financing. In this manner, the MNEs are able to claim the excessive deduction of interest in the high tax jurisdiction and shift the profits to the low tax jurisdiction resulting in base erosion and profit shifting.

(2) **Tax Rules to prevent shifting of profits through excessive interest payments**: In order to address this issue, tax rules are in place in many countries to fix a ceiling limit on the amount of interest deductible in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, with the objective of protecting a country's tax base.

(3) **Relevant Action Plan of BEPS**: Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action Plan 4 and recommended certain measures in its final report.

(4) **Insertion of provision in the Income-tax Act, 1961 in line with BEPS Action Plan 4**: Section 94B has, accordingly, been inserted in the Income-tax Act, 1961, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest expenses claimed by an entity on loan borrowed from its associated enterprises shall not be deductible in computation of income under the "Profits and gains of business or profession" to the extent that it arises from excess interest.

Excess interest shall mean an amount of

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

whichever is less.

**"Total interest paid or payable" to be interpreted as interest paid or payable to non-resident associated enterprise as per the intent expressed in section 94B(1) and also the Explanatory Memorandum to the Finance Bill, 2017.*

(5) **Applicability**: The provision shall be applicable to an Indian company, or a permanent establishment of a foreign company in India, being the borrower who incurs expenditure by way of interest or similar nature in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower.

However, the provision of this section would be applicable only where the expenditure by way of interest or of similar nature exceeds **₹ 1 crore,** in respect of any form of debt issued by a non-resident, being an 'associated enterprise' of such borrower.

(6) **Meaning of debt**: Any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income chargeable under the head "Profits and gains of business or profession".

(7) **Provision of guarantee and deposit of matching amount deemed to be debt issued**: Where the debt is issued by a lender which is not associated but an associated enterprise either

- provides an implicit or explicit guarantee to such lender or
- deposits a corresponding and matching amount of funds with the lender,

such debt shall be deemed to have been issued by an associated enterprise.

(8) **Carry forward of excess interest**: The disallowed interest expense can be carried forward upto eight assessment years immediately succeeding the assessment year for which the disallowance was first made and claimed as deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

(9) **Businesses excluded from applicability of the provisions of section 94B**: The following has been excluded from the applicability of the provisions of this section -

- an Indian company or permanent establishment of a foreign company which is engaged in the business of banking and insurance or
- ***such class of non-banking financial companies as may be notified by the Central Government or***
- interest paid in respect of a debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.

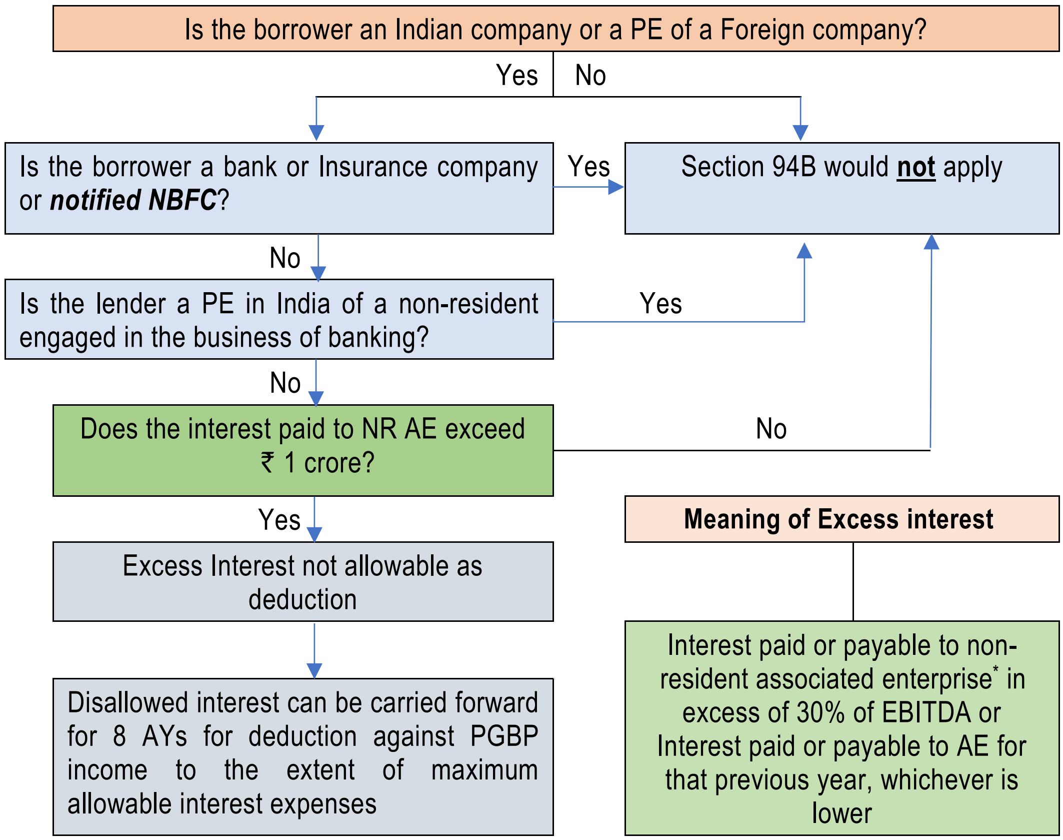
(10) ***Meaning of non-banking financial company****: A non-banking financial company" means -*

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as may be notified by the Bank with the previous approval of the Central Government.

Limitation of interest deduction (Section 94B): A Summary



**"Total interest paid or payable" may be interpreted as interest paid or payable to non-resident associated enterprise as per the intent expressed in section 94B(1) and also the Explanatory Memorandum to the Finance Bill, 2017.*

ILLUSTRATION 9

ND Ltd., an Indian Company, has borrowed ₹ 90 crores on 01-04-2023 from M/s. TM Inc, a company incorporated in London, at an interest rate of 10% p.a. The said loan is repayable over a period of 5 years. Further, this loan is guaranteed by M/s TY Inc. incorporated in UK. M/s. TD Inc, a non-resident, holds shares carrying 40% of voting power both in M/s ND Ltd. and M/s TY Inc.

Net profit of M/s. ND Ltd. for P.Y. 2023-24 was ₹ 11 crores after debiting the above interest, depreciation of ₹ 5 crores and income-tax of ₹ 4 crores.

Calculate the amount of interest to be allowed to be claimed under the head "Profits and gains of business or profession" in the computation of M/s ND Ltd. giving appropriate reasons. Also explain allowability of such disallowed interest, if any.

SOLUTION

If an Indian company, being the borrower, incurs any expenditure by way of interest in respect of any debt issued by its non-resident associated enterprise (AE) and such interest exceeds ₹ 1 crore, then, the interest paid or payable by such Indian company in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is lower, shall **not** be allowed as deduction as per section 94B.

Further, where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise and limitation of interest deduction would be applicable.

In the present case, since M/s TD Inc holds 40% of voting power i.e., more than 26% of voting power in both ND Ltd and M/s TY Inc, ND Ltd. and M/s TY Inc are deemed to be associated enterprises.

Since loan of ₹ 90 crores taken by ND Ltd., an Indian company from M/s TM Inc, is guaranteed by M/s TY Inc, an associated enterprise of ND Ltd., such debt shall be deemed to have been issued by an associated enterprise and interest payable to M/s TM Inc shall be considered for the purpose of limitation of interest deduction u/s 94B.

Computation of interest to be allowed as per section 94B in the computation of income under the head profits and gains of business or profession of ND Ltd.

Particulars		₹ (in crores)
Net profit		11.00
Add: Interest already debited (₹ 90 crores x 10%)		9.00
Depreciation		5.00
Income-tax		4.00
EBITDA		**29.00**
Interest paid or payable by ND Ltd.		**9.00**
Lower of the following would be disallowed		
- Total interest paid or payable in excess of 30% of EBITDA (₹ 9,00,00,000 – ₹ 8,70,00,000) = ₹ 30 lakhs	0.30	
- Interest paid or payable to non-resident AE	9.00	
Interest to be disallowed as deduction		**0.30**
Interest allowable as deduction under the head "Profits and gains from business or profession (₹ 9,00,00,000 – ₹ 30,00,000)		**8.70**

Disallowed interest of ₹ 30 lakhs can be carried forward to the subsequent assessment year and it would be allowed as deduction against profits and gains, to the extent of allowable interest expenditure u/s 94B.

TEST YOUR KNOWLEDGE

Questions

1. *Examine the consequences that would follow if the Assessing Officer makes adjustment to arm's length price in international transactions of the assessee resulting in increase in taxable income. What are the remedies available to the assessee to dispute such adjustment?*

2. *Mr. Hari holds 30% of voting power in ABC Inc, a company incorporated under the laws of Country A. For the purpose of expansion of business, the said company enters into an agreement with XYZ Ltd., a company incorporated under the Indian laws. As per one of the clauses of the agreement, ABC Inc has the power to appoint 6 directors of XYZ Ltd., which has 12 directors on the board. Further, total purchases by XYZ Ltd. for the F.Y. 2023-24 is estimated to be ₹ 500 crores, out of which, purchases of ₹ 48 crores has been sourced locally and the balance shall be supplied by ABC Inc. The price for entire purchase has been fixed in the agreement and the conditions for supply are determined by ABC Inc.*

   Advise Mr. Hari as to whether ABC Inc and XYZ Ltd are Associated Enterprises, on the basis of the provisions of the Income-tax Act, 1961.

3. *I. Limited, an Indian Company supplied billets to its holding company, U. Limited, UK during the previous year 2023-24. I. Limited also supplied the same product to another UK based company, V. Limited, an unrelated entity. The transactions with U. Limited are priced at Euro 500 per MT (FOB), whereas the transactions with V. Limited are priced at Euro 700 per MT (CIF). Insurance and Freight amounts to Euro 200 per MT. Compute the arm's length price for the transaction with U. Limited.*

4. *X Ltd., operating in India, is the dealer for the goods manufactured by Yen Ltd. of Japan. Yen Ltd. owns 55% shares of X Ltd. and out of 7 directors of the company, 4 were appointed by them. The Assessing Officer, after verification of international transactions of ₹ 300 lakhs of X Ltd. for the relevant year and by noticing that the company had failed to maintain the requisite records and had also not obtained the accountants report, adjusted its income by making an addition of ₹ 30,00,000 to the declared income and also issued a show cause notice to levy various penalties. X Ltd seeks your expert opinion.*

5. *Anush Motors Ltd., an Indian company declared income of ₹ 300 crores computed in accordance with Chapter IV-D but before making any adjustments in respect of the following transactions for the year ended on 31.3.2024:*

(i) 10,000 cars sold to Rida Ltd., US company, which holds 30% shares in Anush Motors Ltd. at a price which is less by $ 200 for each car than the price charged from Shingto Ltd.

(ii) Royalty of $ 1,20,00,000 was paid to Kyoto Ltd., a US company, for use of technical know-how in the manufacturing of car. However, Kyoto Ltd. had provided the same know-how to another Indian company for $ 90,00,000. Kyoto Ltd. is the sole owner of technology used by Anush Motors Ltd. in its manufacturing process and the manufacture of cars by Anush Motors Ltd is wholly dependent on the use of know-how owned by Kyoto Ltd.

(iii) Loan of Euro 1000 crores carrying interest @10% p.a. advanced by Dorf Ltd., a German company, was outstanding on 31.3.2024. The total book value of assets of Anush Motors Ltd. on the date was ₹ 90,000 crores. The said German company had also advanced a loan of similar amount to another Indian company @9% p.a. Total interest paid for the year was EURO 100 crores.

Explain in brief the provisions of the Act affecting all these transactions and compute the income of the company chargeable to tax for A.Y.2024-25 keeping in mind that the value of 1$ and of 1 EURO was ₹ 63 and ₹ 84, respectively, throughout the year.

6. *What is the legislative objective of bringing into existence the provisions relating to transfer pricing in relation to international transactions? Examine.*

7. *XE Ltd. is an Indian Company in which Zilla Inc., a US company, has 28% shareholding and voting power. Following transactions were effected between these two companies during the financial year 2023-24.*

(i) XE Ltd. sold 1,00,000 pieces of T-shirts at $ 2 per T-Shirt to Zilla Inc. The identical T-Shirts were sold to unrelated party namely Kennedy Inc., at $ 3 per T-Shirt.

(ii) XE Ltd. borrowed $ 2,00,000 from a foreign lender based on the guarantee of Zilla Inc. For this, XE Ltd. paid $ 10,000 as guarantee fee to Zilla Inc. To an unrelated party for the same amount of loan, Zilla Inc. collected $ 7000 as guarantee fee.

(iii) XE Ltd. paid $15,000 to Zilla Inc. for getting various potential customers details to improve its business. Zilla Inc. provided the same service to unrelated parties for $ 10,000.

Assume the rate of exchange as 1 $ = ₹ 64

XE Ltd. is located in a Special Economic (SEZ) and its income before transfer pricing adjustments for the year ended 31st March, 2024 was ₹ 1,200 lakhs.

Compute the adjustments to be made to the total income of XE Ltd. Assuming that such adjustments are made by the Assessing Officer, state whether it can claim deduction under section 10AA for the income enhanced by applying transfer pricing provisions.

8. *Examine with reasons whether the two enterprises referred to in the independent situations given below can be deemed to be associated enterprises under the Indian transfer pricing regulations:*

   (i) *PQR Inc, a US company having its place of effective management also in the USA, has advanced a loan equivalent to ₹ 170 crores to Mahanadi Ltd., an Indian company on 10-4-2023. The total book value of assets of Mahanadi Ltd. is ₹ 300 crores. The market value of the assets, however, is ₹ 320 crores. Mahanadi Ltd. repaid ₹ 30 crores before 31-3-2024.*

   (ii) *Queenland plc., a French company having its place of effective management also in the France, has the power to appoint 3 of the directors of Godavari Ltd, an Indian company, whose total number of directors in the Board is 8.*

   (iii) *Total value of raw materials and consumables of Saraswati Ltd., an Indian company, is ₹ 900 crores. Of this, supplies to the tune of ₹ 830 crores are by Zoel GmbH, a German company having its place of effective management in Germany, at prices and terms decided by the German company.*

9. *NP Ltd., an Indian Company, has borrowed ₹ 80 crores on 01-04-2023 from M/s. TL Inc, a company incorporated in London, at an interest rate of 10% p.a. The said loan is repayable over a period of 5 years. Further, loan is guaranteed by M/s ST Inc. incorporated in UK. M/s. Tweed Inc, a non-resident, holds shares carrying 40% of voting power both in M/s NP Ltd. and M/s ST Inc.*

   Net profit of M/s. NP Ltd. for P.Y. 2023-24 was ₹ 7 crores after debiting the above interest, depreciation of ₹ 6 crores and income-tax of ₹ 4 crores. Calculate the amount of interest to be disallowed under the head "Profits and gains of business or profession" in the computation of M/s NP Ltd., giving appropriate reasons.

10. *MNO Ltd., having its registered office in Mumbai, is engaged in multiple businesses. It has borrowed ₹ 200 crores from State Bank of India (SBI) for which 100% guarantee was given by the parent company, ABC Inc. of Country A. The total borrowings of MNO Ltd. is ₹ 1,000 crores.*

MNO Ltd. buys mobile phones from ABC Inc. The mobile phones are branded for which royalty at ₹ 100 per mobile phone sold is paid to ABC Inc. Similar mobile phones are also sold to other customers in India by ABC Inc. but no royalty is charged from them. The credit period offered to MNO Ltd. is 2 months, whereas for other customers, the credit period is 1 month. During the year, 10 lakh mobile phones were bought for an aggregate sum of ₹ 2,600 crores from ABC Inc. The purchase could be assumed as uniform throughout the financial year 2023-24. The cost of capital may be adopted as 10% per annum. ABC Inc. would have billed ₹ 2,400 crores (excluding interest component for the delay beyond 1 month) for supply of identical quantity of similar mobile phones to other customers. It may be assumed that the entire purchase has been sold out by 31st March, 2024.

Determine the arm's length price (ALP) of the transaction of purchase of mobile phones by MNO Ltd. from ABC Inc., Country A and its impact on the assessable income, if any, for the assessment year 2024-25.

11. *Beta Ltd., an Indian company, has two units in India, a manufacturing unit in Hyderabad and a trading unit in Surat. Beta Ltd. has entered into various international transactions with its associate enterprises from both the units. The assessment of Beta Ltd., an Indian company, for A.Y.2024-25 is pending before the Assessing Officer who referred the matter to Transfer Pricing Officer (TPO) for determination of arm's length price (ALP) in respect of its manufacturing unit at Hyderabad. The TPO, however, expanded the scope of his work by calling for details in respect of the trading unit of Beta Ltd. located at Surat.*

    Examine the procedure to be followed by the Assessing Officer before making reference to TPO. Can the TPO enlarge his scope of work by calling for details of trading activity at Surat, when the Assessing Officer has made reference only in respect of the manufacturing unit at Hyderabad? Examine.

12. *Allepey Ltd. is an Indian Company in which Andes Inc., a Country Z company holds 38% shareholding and voting power. During the previous year 2021-22, the Indian company supplied computers to the Country Z based company @CZD 1100 per piece. The price of computer supplied to other unrelated parties in Country Z is @CZD 1400 per piece. During the course of assessment proceedings relating to A.Y.2022-23, the Assessing Officer carried out primary adjustments and added a sum of ₹ 168 lakhs, being the difference between actual price of computer and arm's length price for 700 pieces and it was duly accepted by the assessee. The Assessing Officer passed the order, in which the primary adjustments were made, on 1.6.2023. On account of this adjustment, the excess money of ₹ 168 lakhs is available with Andes Inc, Country Z. In this context, Allepey Ltd. wants to*

know the effect of this transaction for the assessment year 2024-25 on the basis that it declared an income of ₹ 300 lakhs and the excess money is still lying with Andes Inc. till today. Assume the rate of exchange as 1 CZD = ₹ 80. [CZD stands for Country Z Dollars, which is the currency of Country Z]; six month LIBOR as on 30.9.2023 is 9.50%.

ANSWERS

1. In case the Assessing Officer makes adjustment to arm's length price in an international transaction which results in increase in taxable income of the assessee, the following consequences shall follow:-

(1) No deduction under section 10AA or Chapter VI-A shall be allowed from the income so increased.

(2) No corresponding adjustment would be made to the total income of the other associated enterprise (in respect of payment made by the assessee from which tax has been deducted or is deductible at source) on account of increase in the total income of the assessee on the basis of the arm's length price so recomputed.

The remedies available to the assessee to dispute such an adjustment are:-

(1) In case the assessee is an eligible assessee under section 144C, he can file his objections to the variation made in the income within 30 days of the receipt of draft order by him to the Dispute Resolution Panel and Assessing Officer. Appeal against the order of the Assessing Officer in pursuance of the directions of the Dispute Resolution Panel can be made to the Income-tax Appellate Tribunal.

(2) In any other case, he can file an appeal under section 246 to the Joint Commissioner (Appeals)/ under section 246A to the Commissioner (Appeals) against the order of the Assessing Officer within 30 days of the date of service of notice of demand.

(3) The assessee can opt to file an application for revision of order of the Assessing Officer under section 264 within one year from the date on which the order sought to be revised is communicated, provided the time limit for appeal to the Commissioner (Appeals) or the Income-tax Appellate Tribunal has expired or the assessee has waived the right of such an appeal. The eligibility conditions stipulated in section 264 should be fulfilled.

2. Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, more than half of the board of directors or members of the governing board, or one or more of the executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise.

In the present case, the power to appoint is only for half the number and not more than half. Hence, ABC Inc. and XYZ Ltd. are not associated enterprises under this criteria.

Two enterprises shall be deemed to be associated enterprises, if 90% or more of the raw materials and consumables required for the manufacture or processing of goods or article carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise.

In this case, ABC Inc. supplies more than 90% of the requirements of purchases of XYZ Ltd. Further, the price is controlled by the former by way of written agreement. Also, the conditions for supply are determined by ABC Inc. Hence, the two entities would be deemed to be associated enterprises under this criterion.

3. In this case, I. Limited, the Indian company, supplied billets to its foreign holding company, U. Limited. Since the foreign company, U. Limited, is the holding company of I. Limited, I. Limited and U. Limited are the associated enterprises within the meaning of section 92A.

As I. Limited supplies similar product to an unrelated entity, V. Limited, UK, the transactions between I. Limited and V. Limited can be considered as comparable uncontrolled transactions for the purpose of determining the arm's length price of the transactions between I. Limited and U. Limited Comparable Uncontrolled Price (CUP) method of determination of arm's length price (ALP) would be applicable in this case.

Transactions with U. Limited are on FOB basis, whereas transactions with V. Limited are on CIF basis. This difference has to be adjusted before comparing the prices.

	Amount (in Euro)
Price per MT of billets to V. Limited	700
Less: Cost of insurance and freight per M.T.	200
Adjusted Price per M.T.	500

Since the adjusted price for V. Limited, UK and the price fixed for U. Limited are the same, the arm's length price is Euro 500 per MT. Since the sale price to related party (i.e., U. Limited) and unrelated party (i.e., V. Limited) is the same, the transaction with related party U. Limited has also been carried out at arm's length price.

4. The facts of the case indicate that X Ltd. and Yen Ltd. of Japan are associated enterprises since Yen Ltd. holds 55% shares of X Ltd. and has appointed more than half of the board of directors of X Ltd. Since Yen Ltd. is a non-resident, any transaction between X Ltd. and Yen Ltd. would fall within the meaning of "international transaction" under section 92B. Therefore, the income arising from such transactions have to be computed having regard to the arm's length price.

The action of the Assessing Officer in making addition to the declared income and issuing show cause notice for levy of various penalties is correct since X Ltd. had committed defaults, as listed hereunder, in respect of which penalty, as briefed hereunder, is imposable -

(i) Failure to report any international transaction or any transaction, deemed to be an international transaction or any specified domestic transaction, to which the provisions of Chapter X applies, would attract penalty @ 200% of the amount of tax payable since it is a case of misreporting of income referred under section 270A(9) read with section 270A(8).

(ii) Failure to maintain the requisite records as required under section 92D in relation to international transaction makes it liable for penalty under section 271AA which will be 2% of the value of each international transaction.

(iii) Failure to furnish report from an accountant as required under section 92E makes it liable for penalty under section 271BA i.e., a fixed penalty of ₹ 1 lakh.

The Assessing Officer shall give an opportunity of hearing to the assessee with a notice as to why the arm's length price should not be determined on the basis of material or information or document in the possession of the Assessing Officer.

Note: *It is assumed that X Ltd. has not entered into an APA and has also not opted to be subject to Safe Harbour Rules.*

5. Any income arising from an international transaction, where two or more "associated enterprises" enter into a mutual agreement or arrangement, shall be computed having regard to arm's length price as per the provisions of Chapter X of the Act.

Section 92A defines an "associated enterprise" and sub-section (2) of this section speaks of the situations when the two enterprises shall be deemed to associated enterprises. Applying the provisions of section 92A(2)(a) to (m) to the given facts, it is clear that "Anush Motors Ltd." is associated with :-

(i) Rida Ltd. as per section 92A(2)(a), because this company holds shares carrying more than 26% of the voting power in Anush Motors Ltd.;

(ii) Kyoto Ltd. as per section 92A(2)(g), since this company is the sole owner of the technology used by Anush Motors Ltd. in its manufacturing process;

(iii) Dorf Ltd. as per section 92A(2)(c), since this company has financed an amount which is more than 51% of the book value of total assets of Anush Motors Ltd.

The transactions entered into by Anush Motors Ltd. with different companies are, therefore, to be adjusted accordingly to work out the income chargeable to tax for the A.Y. 2024-25.

Particulars		₹ (in crores)
Income of Anush Motors Ltd. as computed under Chapter IV-D, prior to adjustments as per Chapter X		300.00
Add:	Difference on account of adjustment in the value of international transactions:	
(i)	Difference in price of car @ $ 200 each for 10,000 cars ($ 200 x 10,000 x ₹ 63)	12.60
(ii)	Difference for excess payment of royalty of $ 30,00,000 ($ 30,00,000 x ₹ 63) [See Note below]	18.90
(iii)	Difference for excess interest paid on loan of EURO 1000 crores (₹ 84*1000*1/100)	840.00
Total Income		**1,171.50**

***Note**: It is presumed that Anush Motors Ltd. has not entered into an Advance Pricing Agreement or opted to be subject to Safe Harbour Rules.*

6. The presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions prompted the Government to set up an Expert Group to examine the issues relating to transfer pricing.

There is a possibility that two or more entities belonging to the same multinational group can fix up their prices for goods and services and allocate profits among the enterprises within the group in such a way that there may be either no profit or negligible profit in the jurisdiction which taxes such profits and substantial profit in the jurisdiction which is tax haven or where the tax liability is minimum. This may adversely affect a country's share of due revenue. The increasing participation of multinational groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, which may lead to erosion of tax revenue. Therefore, transfer pricing provisions have been brought in by the Finance Act, 2001 with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises.

7. XE Ltd, the Indian company and Zilla Inc., the US company are deemed to be associated enterprises as per section 92A(2)(a), since Zilla Inc. holds shares carrying not less than 26% of the voting power in XE Ltd.

As per *Explanation* to section 92B, the transactions entered into between these two companies for sale of product, lending or guarantee and provision of services relating to market research are included within the meaning of "international transaction".

Accordingly, transfer pricing provisions would be attracted and the income arising from such international transactions have to be computed having regard to the arm's length price. In this case, from the information given, the arm's length price has to be determined taking the comparable uncontrolled price method to be the most appropriate method.

Particulars	₹ in lakhs
Amount by which total income of XE Ltd. is enhanced on account of adjustment in the value of international transactions:	
(i) Difference in price of T-Shirt @ $ 1 each for 1,00,000 pieces sold to Zilla Inc. ($ 1 x 1,00,000 x ₹ 64)	64.00
(ii) Difference for excess payment of guarantee fee to Zilla Inc. for loan borrowed from foreign lender ($ 3,000 x ₹ 64)	1.92
(iii) Difference for excess payment for services to Zilla Inc. ($ 5,000 x ₹ 64)	3.20
	69.12
XE Ltd. cannot claim deduction under section 10AA in respect of ₹ 69.12 lakhs, being the amount of income by which the total income is enhanced by virtue of the first proviso to section 92C(4)	

8. **(i)** PQR Inc, a foreign company, has advanced loan of ₹ 170 crores to Mahanadi Ltd., an Indian company, which amounts to 56.67% of book value of assets of Mahanadi Ltd. Since the loan advanced by PQR Inc. is 51% or more of the book value of assets of Mahanadi Ltd., PQR Inc. and Mahanadi Ltd. are deemed to be associated enterprises under the Indian transfer pricing regulations.

The deeming provisions would be attracted even if there is a repayment of loan during the same previous year which brings down the said percentage below 51%.

(ii) Queenland plc, a foreign company has the power to appoint 37.50% (3 out of 8) of the directors of an Indian company, Godavari Ltd.

Two enterprises would be deemed to be associated enterprises **if more than half of the board of directors** of one enterprise **are appointed by the other enterprise.**

In this case, since Queenland plc has the power to appoint only 37.50% (which is less than half) of the directors of an Indian company, Godavari Ltd., Queenland plc and Godavari Ltd. are **not** deemed to be associated enterprises.

(iii) Since Zoel GmbH, a German company, supplies 92.22% of the raw materials and consumables required by Saraswati Ltd., an Indian company, which is more than the specified threshold of 90%; and the prices and terms of supply are decided by the German company, the two companies are deemed to be associated enterprises.

9. If an Indian company, being the borrower, incurs any expenditure by way of interest in respect of any debt issued by its non-resident associated enterprise (AE) and such interest exceeds ₹ 1 crore, then, the interest paid or payable by such Indian company in excess of 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is lower, shall not be allowed as deduction as per section 94B.

Further, where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise and limitation of interest deduction would be applicable.

In the present case, since M/s Tweed Inc holds 40% of voting power i.e., more than 26% of voting power in both NP Ltd and M/s ST Inc, NP Ltd. and M/s ST Inc are deemed to be associated enterprises.

Since loan of ₹ 80 crores taken by NP Ltd., an Indian company from M/s TL Inc, is guaranteed by M/s ST Inc, an associated enterprise of NP Ltd., such debt shall be deemed to have been issued by an associated enterprise and interest payable to M/s TL Inc shall be considered for the purpose of limitation of interest deduction under section 94B.

Computation of interest to be disallowed as per section 94B in the computation of income under the head profits and gains of business or profession of NP Ltd.

Particulars		₹
Net profit		7,00,00,000
Add: Interest already debited (₹ 80 crores x 10%)		8,00,00,000
Depreciation		6,00,00,000
Income tax		4,00,00,000
EBITDA		**25,00,00,000**
Interest paid or payable by NP Ltd.		8,00,00,000
Lower of the following would be disallowed		
- Total interest paid or payable in excess of 30% of EBITDA (₹ 8,00,00,000 – ₹ 7,50,00,000)	₹ 50,00,000	
- Interest paid or payable to non-resident AE	₹ 8,00,00,000	
Interest to be disallowed as deduction		**50,00,000**

10. MNO Ltd., an Indian company, and ABC Inc., a Country A based company, are associated enterprises as per section 92A, since ABC Inc. is a parent company of MNO Ltd. Thus, the transaction of purchase of mobile handsets by MNO Ltd. from ABC Inc. would be an international transaction. The value of international transaction is to be worked out on the basis of Arm's Length Price (ALP).

ABC Inc. is selling mobile phones to unrelated customers, which would be the comparable uncontrolled transaction in this case. The purchase price for unrelated customers has to be adjusted by taking into consideration the functional differences existing between the transactions of ABC Inc. with associated enterprise (MNO Ltd.) and other unrelated parties.

Accordingly, the arm's length price for purchase of mobile phones has to be computed for working out the impact on assessable value as per CUP method.

Computation of Arm's Length Price

Particulars	₹ in crores
Purchase price of mobile phones by unrelated parties from ABC Inc.	2,400
Adjustments for functional differences	
Add: Royalty payable by MNO Ltd. [₹ 100 per mobile phone x 10,00,000]	10

Cost of capital for 1 month credit which is not given to unrelated party [10% x ₹ 200 crore (monthly average sales i.e., ₹ 2,400 crore /12 months]	20
Arm's Length Price of 10,00,000 mobile phones (A)	**2430**
Purchase price of mobile phone by MNO Ltd. from ABC Inc., its parent company (associated enterprise) (B)	**2600**
Amount to be added to its total income (B) – (A)	**170**

***Note** – In case it is assumed that ₹ 10 crores is not included in the price of ₹ 2600 crores, the adjustment of royalty of ₹ 10 crores paid/payable is not required. The ALP in such a case would be ₹ 2,420 crores. The amount to be added to the total income would be ₹ 180 crores*

11. As per section 92CA(1), where the Assessing Officer considers it necessary or expedient so to do, he may refer the computation of the arm's length price in relation to the international transaction entered by any person, being an assessee, to the Transfer Pricing Officer (TPO).

However, the Assessing Officer has to take the prior approval of the Principal Commissioner of Income-tax (PCIT)/Commissioner of Income-tax (CIT) before making such a reference.

As per section 92CA(2A), the Transfer Pricing Officer (TPO) can also determine the ALP of other international transactions which have not been referred to him, but which have come to his notice subsequently in the course of proceedings before him.

The Assessing Officer has made reference for determination of ALP in respect of the manufacturing unit at Hyderabad which shall be taken as the proceedings before him (TPO).

The TPO can enlarge his scope of work during the course of proceedings before him of Hyderabad unit by calling for details of trading activity at Surat, and the same is within the powers conferred by section 92CA(2A).

12. In this case, Allepey Ltd., the Indian company, and Andes Inc., a Country Z company, are deemed to be associated enterprises as per section 92A(2) since Andes Inc. holds shares carrying not less than 26% voting power in Allepey Ltd.

On account of the primary adjustment of ₹ 168 lakhs made by the Assessing Officer, the total income of Allepey Ltd. for A.Y.2022-23 would increase by ₹ 168 lakhs.

I. If Allepey Ltd. opts not to pay additional income-tax on such excess money not repatriated

In this case, secondary adjustment has to be made under section 92CE, since –

(1) The company has accepted the primary adjustment made by the Assessing Officer;

(2) The primary adjustment is in respect of A.Y.2022-23; and

(3) The primary adjustment exceeds ₹ 100 lakhs.

Accordingly, the excess money (i.e., ₹ 168 lakhs) available with the associated enterprise (i.e., Andes Inc., Country Z) not repatriated to India within 90 days of the date of the order of the Assessing Officer would be deemed as an advance made by the Allepey Ltd. to its associated enterprise, Andes Inc. Interest would be calculated on such advance at 12.50% [i.e., the rate of six month LIBOR as on 30th September, 2023 (i.e., 9.50%)+ 3%], since the international transaction is denominated in foreign currency. Such interest computed from 1.6.2023 to 31.3.2024 amounting to 304/366 x 168 lakhs x 12.50% = ₹ 17,44,262 would be added to its total income for A.Y.2024-25.

II. If Allepey Ltd. opts to pay additional income-tax on such excess money not repatriated

In such a case, Allepey Ltd. has to pay additional income-tax @20.9664% (tax @18% *plus* surcharge @12% *plus* cess@4%) on ₹ 168 lakhs, which amounts to ₹ 35,22,355. Where additional income-tax is so paid by Allepey Ltd., it will not be required to make secondary adjustment and compute interest from the date of payment of such tax. The additional income-tax so paid by Allepey Ltd. would be treated as the final payment of tax in respect of excess money not repatriated and no further credit would be allowed to Allepey Ltd. or to any other person in respect of the amount of additional income-tax so paid.

NOTES

CHAPTER 25

FUNDAMENTALS OF BEPS

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **gain** a broad understanding of the concept of Base Erosion and Profit Shifting (BEPS);
- **appreciate** the significance of action plans of BEPS;
- **comprehend and appreciate** the provisions incorporated in the Indian tax laws in line with the different Action Plans of BEPS.

25.1 BACKGROUND

Impact of Globalisation

Globalisation has benefited our domestic economies, boosted trade and increased foreign direct investments in many countries. The unrestricted movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place. In this way, it accelerated growth, created jobs and fostered innovation. Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. It has a significant impact on a country's corporate income tax regimes.

Growth of Multi-national Enterprises and consequent tax abuse

Way back in 1920s, pursuant to the first world war, the League of Nations recognised that the interaction of domestic tax systems can lead to double taxation with adverse effects on growth and global prosperity. Globally, countries concur on the need to eliminate double taxation and the need to achieve this on the basis of accepted international laws that are clear and predictable, giving certainty to both governments and businesses. International tax law is, therefore, a pillar in facilitating the development of the global economy. With the economy, the enterprises also became more globally integrated. Multi-national enterprises (MNE) now represent a significant proportion of global GDP.

Also, the increasing significance of the service component of the economy, and of digital products which are deliverable over the Internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers. These developments have been accompanied by the increasing sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus, encouraging MNEs to minimise their tax burden by resorting to aggressive tax planning.

Adverse Effects of BEPS

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. This has become a critical issue since governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, BEPS undermines the integrity of the tax system, as reporting of low corporate taxes is considered to be unfair. In developing countries, the lack of tax revenue leads to significant under-funding of public investment that could help foster economic growth. Further, 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. Also, 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.

Need for international collaboration to protect tax sovereignty of its countries

Taxation is at the core of countries' sovereignty, but the interaction of domestic tax laws with the tax laws of other countries in certain cases leads to gaps and frictions. While developing their domestic tax laws, sovereign states may not adequately take into consideration the effect of other countries' laws. The interaction of separate sets of domestic laws enforced by sovereign countries causes frictions, including potential double taxation for corporations operating in many countries. It also causes gaps, in cases where corporate income is untaxed, both in the country of source and in the country of residence, or is taxed only at nominal rates. In the domestic context, coherence is generally achieved through a principle of matching – a payment that is deductible by the payer is usually taxable in the hands of the recipient, unless explicitly exempted. There is no similar principle of coherence at the international level, which leaves considerable scope for arbitrage by taxpayers, though sovereign states have united to ensure coherence in a narrow field, namely, to prevent double taxation. BEPS relates primarily to instances where the interaction of different tax rules & tax systems leads to double non-taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. International standards have tried to reduce these frictions in a manner that respects tax sovereignty; however, gaps still remain. Therefore, there is a need for countries to collaborate on tax matters so that they are able to get their due share of taxes.

25.2 OVERVIEW OF BEPS

In the background of the above repercussions and the global financial crisis in 2009, the G-20 countries shifted their focus to strengthen the international financial system. The G-20 mandated the OECD to address the issue of tax avoidance, in light of which during February 2013, the OECD published a report on "Addressing Base Erosion and Profit Shifting" iterating the need for analyzing the issue of tax base erosion and profit shifting by global corporations. The OECD followed it up with publishing draft Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan) in July 2013 which came to final fruition in October 2015. The BEPS action plan identifies fifteen actions to address BEPS in a comprehensive manner and sets a deadline to implement those actions.

The Action Plans were structured around three fundamental pillars viz.:

(i) Introducing **coherence** in the domestic rules that affect cross-border activities.

(ii) Reinforcing of **'substance'** requirements in existing international standards; Alignment of taxation with location of value creation and economic activity; and

(iii) Improving **transparency** and **tax certainty**.

A brief classification of the various action plans based on the fundamental pillars is as under:

BEPS Actions as per Objectives

Coherence
- **Action 2** Neutralise the effects of hybrid mismatch arrangements
- **Action 3** Strengthen CFC rules
- **Action 4** Limit interest deductibility

Substance
- **Action 5 - 1st component** Preferential tax regimes
- **Action 6** Prevent treaty abuse
- **Action 7** Prevent the artificial avoidance of PE status
- **Action 8-10** Aligning transfer pricing outcomes with value creation: Intangibles; Risk and capital; and Other high-risk transactions

Transparency
- **Action 5 - 2nd component** Exchange of information on tax rulings
- **Action 11** Data analysis
- **Action 12** Mandatory disclosure rules
- **Action 13** Re-examine transfer pricing documentation
- **Action 14** Dispute resolution

Horizontal
- **Action 1** Digital economy
- **Action 15** Multilateral instrument

Coherence

Domestic tax systems are coherent – tax deductible payments by one person results in income inclusions by the recipient.

International coherence in corporate income taxation - A pre-requisite to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation

Substance

Present tax laws must be modified: To align tax with substance.

Domestic and international tax laws should ideally relate to both income and the economic activity that generates it. - since at times,tax treaty and transfer pricing facilitate the separation of taxable profits from value-creating activities, such as through shell companies that have little or no economic substance.

Concerns in the area of transfer pricing should be addressed within the prevalent system : These areas include returns related to over-capital-isation, risk and intangible assets. Specific rules, either within or beyond the arm's length principle, may be required for this purpose.

Transparency

Greater transparency and improved data: Pre-requisites to evaluate the impact and magnitude of BEPS.

Taxpayers to report their aggressive tax planning arrangements and rules about transfer pricing documentation, breaking down the information on a country-by-country basis: Assist governments identify risk areas and focus their audit strategies.

Making dispute resolution mechanisms more effective: To provide businesses with greater certainty and predictability

The BEPS measures range from new minimum standards to a revision of pre-existing international standards, and to common approaches which will facilitate the convergence of national rules and guidance drawing on best practices.

An unprecedented amount of interest and participation has been witnessed by OECD with more than sixty countries, both OECD members and G-20 countries, being directly involved as a part of technical groups in the development of congruent international tax standards. The Inclusive Framework on BEPS works to ensure that the international tax framework for MNEs remains relevant for today and the future, thereby promoting economic efficiency and global welfare. It will also ensure that governments continue to efficiently raise revenues not only from traditional but also from digital businesses, both for direct tax and indirect tax purposes.

The summary explanatory statement indicates the level of political commitment by OECD, G20 and other States involved in the 2015 work to the various reports. The OECD has iterated the following terms to indicate the commitment by various participant countries:

New minimum standard - New minimum standard implies application of a new rule to be implemented by all states, since non-implementation may result in negative spill overs (including adverse impact of competitiveness) on other countries. Each of the four BEPS minimum standards [namely, Actions 5, 6, 13 and 14] is subject to peer review in order to ensure timely and accurate implementation and thus safeguard the level playing field. All members of the Inclusive Framework on BEPS commit to implementing the minimum standards and commit to participating in the peer review.

Revision of a standard which already exists – Existing standards have been updated and will be implemented but with the caveat that all BEPS participants have not endorsed the underlying standards on tax treaties or transfer pricing; and

Best practice – A best practice is not a standard but optional recommendation for states to follow. Guidance based on best practices will support those countries proposing to act in the areas of mandatory disclosure initiatives or controlled foreign company (CFC) legislation.

(1) ACTION PLAN 1 – ADDRESSING THE CHALLENGES OF THE DIGITAL ECONOMY

Digital economy: Dissolving link between income-producing activity and physical location

At present, in the digital domain, business may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location. Hence, business in digital domain doesn't actually occur in any physical location but instead takes place in "cyberspace." Persons carrying business in digital domain could be located anywhere in the world. Entrepreneurs across the world have been quick to evolve their business to take advantage of these changes. It has also made it possible for the businesses to conduct themselves in ways that did not exist earlier, and given rise to new business models that rely more on digital and telecommunication network, do not require physical presence, and derives substantial value from data collected and transmitted from such networks.

Given the rise of e-commerce, an entire digital economy has emerged in the last decade. Since there is a concept of 'intangibility' attached to the digital model of business, tax authorities often faced challenges rightly bringing to tax the profits earned from a digital business. To address the same, the first action plan 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. Before the same, 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. It was observed that servers were, therefore, placed in tax efficient jurisdictions, even though the main income generation and customers were from other jurisdictions.

Taxation issues in E-Commerce

These new business models under the industrial revolution 4.0 have created new tax challenges. Since the existing international tax system was designed during early 20th century, they remain archaic and are incompatible with the modern day business dynamics:

The typical taxation issues relating to digitalisation are:

(i) the difficulty in characterizing the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction,

(ii) the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes.

The digital business, thus, challenges physical presence-based permanent establishment rules. If permanent establishment (PE) principles are to remain effective in the new economy, the fundamental PE components developed for the old economy i.e., place of business, location, and permanency must be reconciled with the new digital reality.

OECD Recommendations under Action Plan 1 of the BEPS project

The OECD has recommended several options to tackle the direct tax challenges which include:

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.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

OECD - BEPS 2.0 – Consensus based solution for tax challenges arising out of digitalisation

The 2015 Action 1 report provided for options to safeguard against BEPS on account of digitalisation, however it did not provide for any recommendations and left it to the discretion of the countries to resort to these measures as part of their domestic law. The report also indicated that it was agreed between the members to continue to monitor developments in respect of the digital economy, with a further report to be delivered by October, 2021

After the delivery of the Interim Report in March 2018, the Inclusive Framework delivered a blueprint report in October 2020 including concrete proposals framed within two complementary pillars.

Pillar 1 - Re-allocation of profit and revised nexus rules: This pillar explores potential solutions for determining where tax should be paid for new business models and on what basis ("nexus"), as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located ("profit allocation").

Pillar 2 - Global anti-base erosion mechanism (Minimum Tax): This pillar explores the design of a system to ensure that multinational enterprises pay a minimum level of tax. This pillar is intended to address remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions which tax these profits at below the minimum rate.

The Pillar Two Model Rules have been designed to make sure they accommodate a diverse range of tax systems, including different tax consolidation rules, income allocation, entity classification rules etc., as well rules for specific business structures such as joint ventures and minority interests. As such, many of the specific provisions of the Pillar Two Model Rules will not apply to all jurisdictions or each individual inscope MNE. Taxpayers that either have no foreign presence or that have less than EUR 750 million in consolidated revenues are not in scope of the Model Rules. In addition, the Pillar Two Model Rules do not apply to government entities, international organisations and non-profit organisations (preserving domestic tax exemptions for sovereign, non-profit and charitable entities), nor do they apply to entities that meet the definition of a pension, investment or real estate fund (preserving the widely shared tax policy of not wishing to add an additional layer of taxation between the investment and the investor). These entities are excluded even if the MNE group they control remains subject to the rules. Taxpayers in scope of the rules calculate their effective tax rate for each jurisdiction where they operate, and pay top-up tax for the difference between their effective tax rate per jurisdiction and the 15% minimum rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the MNE. A de minimis exclusion applies where there is a relatively small amount of revenue and income in a jurisdiction. The Pillar Two Model Rules also contemplate the possibility that jurisdictions introduce their own domestic minimum top-up tax based on the GloBE mechanics, which eliminates (or is at least fully creditable against) any liability under GloBE, thereby preserving a jurisdiction's primary right of taxation over its own income.

Indian Taxation Regime

The concept of 'Significant Economic Presence' (SEP) which is similar to the virtual fixed place PE as recommended in the 2015 BEPS Action Plan 1 report has been introduced in the Income-tax Act, 1961 *vide Explanation 2A* to section 9(1)(i).

Significant economic presence of a non-resident in India shall also constitute business connection in India. Significant economic presence means-

	Nature of transaction	Condition
(a)	in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India	Aggregate of payments arising from such transaction or transactions during the previous year should exceed **₹ 2 crores.**
(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India	The number of users should be atleast **3 lakhs**.

Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;

(ii) the non-resident has a residence or place of business in India; or

(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

Insertion of Chapter VIII in the Finance Act, 2016 on Equalisation Levy to address this challenge

In order to address the challenges of the digital economy, 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. This is provided for in section 165 of the Finance Act, 2016.

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.

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

As per section 165A in the Finance Act, 2016, equalisation levy @ 2% would be chargeable on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it—

(i) to a person resident in India; or

(ii) to a non-resident in the following specified circumstances -

- (a) sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement though internet protocol address located in India; and
- (b) sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India; or

(iii) to a person who buys such goods or services or both using internet protocol address located in India.

However, equalisation levy would **not** be chargeable —

(i) where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment;

(ii) where the equalisation levy is leviable on specified services under section 165; or

(iii) sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than ₹ 2 crores during the previous year.

However, the consideration received or receivable for specified services and for e-commerce supply or services would not include the consideration, which are taxable as royalty or fees for technical services in India under the Income-tax Act, 1961 read with the DTAA notified by the Central Government under section 90 or section 90A.

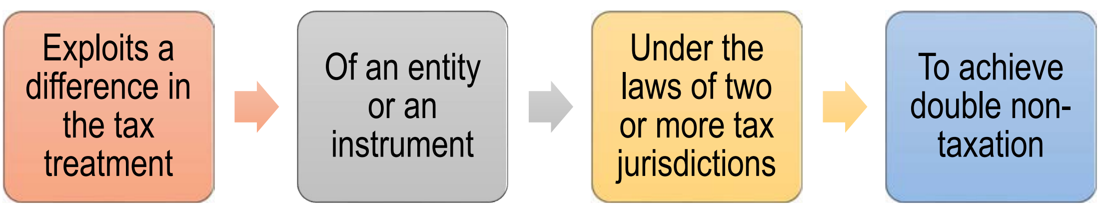
The applicability and mechanics of Equalisation Levy have been discussed at length in Chapter 11 Taxation of Digital Transactions.

(2) ACTION PLAN 2 - NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

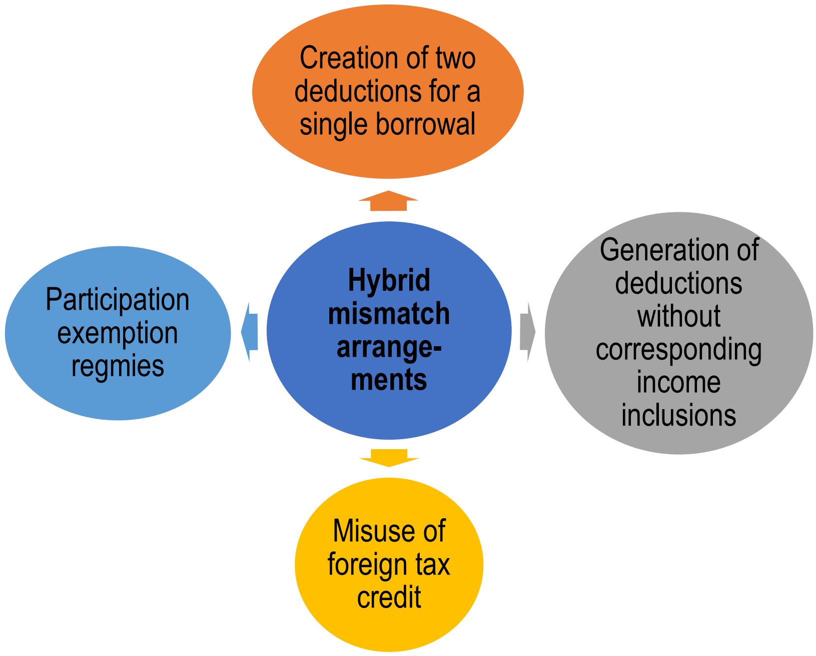
Before understanding what Action Plan 2 recommends, we must understand what a hybrid mismatch is.

Hybrid Mismatch Arrangement: Meaning

A hybrid mismatch is an arrangement that:



Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -



Specific country laws that allow taxpayers to opt for the tax treatment of certain domestic and foreign entities may aid hybrid mismatches. It may not be easy to find out which country has in fact lost tax revenue, since the laws of each country involved have been complied with; however, there is a reduction of the overall tax paid by all parties involved as a whole, which ultimately has an adverse effect on competition, economic efficiency, transparency and fairness.

Recommended general amendments are as follows:

- **A rule denying transparency to entities where the non-resident investors' resident country treats the entity as opaque;**

Example

Let us say, X Co., a parent company in country X indirectly holds Y Co., an operating company in country Y. Between X Co. and Y Co. is a hybrid entity that is treated as transparent or disregarded for country X tax purposes and as non-transparent for country Y tax purposes. X Co. holds all or almost all equity interest in the hybrid entity which in turn holds all or almost all equity interests in Y Co. The hybrid entity borrows money from a third party and the loan is used to invest equity into Y Co (or to buy the shares in Y Co from either another company of the same group or from an unrelated third party). The hybrid entity pays interest on the loan. Except for the interest, the hybrid entity does not claim any other significant deduction and does not have any significant income.

With respect to Country Y, for tax purposes, Hybrid Entity is subject to corporate income tax. Its interest expenses can be used to offset other country Y group companies' income under the country Y group tax relief regime. On the other hand, country X treats the hybrid entity as transparent or disregarded, with the result that its interest expenses are allocated to X Co, which deducts the interest expense to offset unrelated income. The net effect is that there are two deductions for the same contractual obligation in two different countries.

Therefore, by virtue of rule denying transparency to an entity which is treated as opaque in the subsidiary company's country, the double deduction can be avoided.

- **A rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer;**

Example

N Co, a company resident in country N is funded by M Co., a company resident in country M with an instrument that qualifies as equity in country M but as debt in country N. A payment made under the instrument would be deductible as interest expense for N Co under country N tax law. The corresponding receipts are treated as exempt dividends under the tax laws of country M. Consequently, deduction is available under the tax laws of country N without a corresponding income inclusion in country M.

Therefore, by virtue of rule denying an exemption or credit for foreign underlying tax for dividends that are deductible by the payer, exemption of such income in country M would not be possible.

- **A rule denying a foreign tax credit for withholding tax where that tax is also credited to some other entity**; **and**
- **Amendments to CFC and similar regimes attributing local shareholders the income of foreign entities that are treated as transparent under their local law.**

Treaty changes - Action Plan 2 recommends a new provision in the case of income earned by a transparent entity. As per the new provision, treaty benefits will only be afforded to so much of the income of the entity as the income of a resident of that State. A specific or general saving rule is proposed so that a State can tax a resident entity generally unrestricted by treaty.

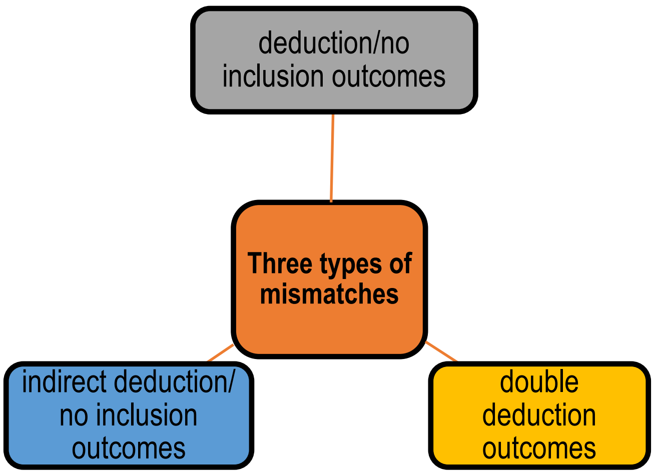
Anti-hybrid rules - The report further issued a series of dedicated domestic anti-hybrid rules which would work in two stages. The primary rules would deny deductions to payers in situations where either

(i) Those payments will not be included in the recipient's ordinary income, or

(ii) The same amount is being simultaneously deducted by another entity.

Treatment of Branch mismatches: 2017 Report

Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the branch and residence jurisdiction. Unlike hybrid mismatches, which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made by or to the branch. The 2017 report identifies five basic types of branch mismatch arrangements that give rise to one of three types of mismatches:



The 2017 report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

(3) ACTION PLAN 3 - STRENGTHEN CONTROLLED FOREIGN COMPANY (CFC) RULES

Shifting investment income and passive income to subsidiaries in low tax or no tax jurisdictions: Deferral of home country taxation

Under the tax laws of several countries, a shareholder of a corporation is not taxed on the corporation's income until the income is distributed as a dividend. Therefore, it was common for publicly traded companies to form foreign subsidiaries in tax havens and shift "portable" income to those subsidiaries. Generally, income shifted were mainly investment income (interest and dividends) and passive income (rents and royalties), as well as sales and services income involving related parties. Tax in parent country on this income was avoided until the tax haven country paid a dividend to the shareholding company. This dividend could be avoided indefinitely by loaning the earnings to the shareholder without actually declaring a dividend.

Many countries (where global multi-nationals are based) have high tax rates as compared to certain other countries, which used their low tax rates as a means of attracting inward investment. As a result, when dividends were repatriated from these lower tax countries, the recipient generally suffered additional tax on those profits. Therefore, many companies have a tendency to leave the profits from these low-taxed subsidiaries offshore, with the objective of deferring home country taxation.

Obviously, Governments were disturbed that multinationals based in their countries kept large amounts of profits offshore. In order to address this issue, governments in various countries have introduced legislation aimed at eliminating the benefits of deferral, by currently taxing income in the parent country even when the income has not been repatriated or remitted to that country. These rules are generally referred to as Controlled Foreign Corporation (CFC) rules.

CFC Rules: Addressing BEPS

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation.

The OECD Final Report does not propose a minimum standard for controlled foreign company (CFC) regimes. However, OECD regards CFC rules as being important in tackling BEPS and has made a series of **best practice recommendations** in relation to the 'building blocks' of an effective CFC regime. The major reason why the OECD was unable to provide more than best practice was fundamental disagreement over the policy of CFC regimes, in particular whether states should use the regime to protect other states' tax bases from earnings stripping.

(4) ACTION PLAN 4 – INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

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.

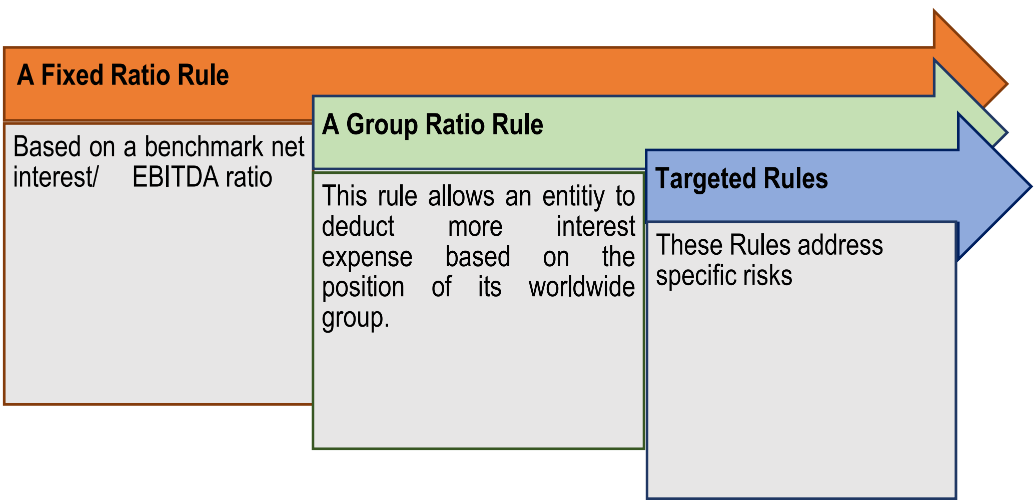
The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

In particular, the deductibility of interest expense can give rise to double non-taxation in both inbound and outbound investment scenarios. The interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed at comparatively low tax rates or not at all at the level of the recipient.

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.

Common Approach: Linking an entity's net interest deduction to its level of economic activity

The mobility and fungibility of money enables multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. The 2015 Report established a common approach which directly links an entity's net interest deductions to its level of economic activity, based on taxable earnings before interest income and expense, depreciation and amortisation (EBITDA). This approach includes three elements:



Indian Taxation Regime

Section 94B of the Income-tax Act, 1961: Addressing Thin Capitalization

Debt financing of cross-border transactions is often favorable than equity financing for taxpayer. In view of the above, in line with the recommendations of OECD BEPS Action Plan 4, section 94B of the Income-tax Act, 1961 provides 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.

Applicability

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.

Carry forward of disallowed interest expenditure

The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession” to the extent of maximum allowable interest expenditure.

Threshold limit

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹ 1 crore in respect of any debt issued by a non-resident associated enterprise exceeding which the provision would be applicable. Banks, Insurance business ***and such class of NBFCs notified by the Central Government*** are excluded from the ambit of the said provisions keeping in view of special nature of these businesses. Also, section 94B would not be attracted on interest paid in respect of debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.

(5) ACTION PLAN 5 – COUNTER HARMFUL TAX PRACTICES

The Action 5 Report is one of the four BEPS minimum standards. The minimum standard of the

Action 5 Report consists of two parts. One part relates to preferential tax regimes, where a peer review is undertaken to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. The second part includes a commitment to transparency through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns. Thirdly, the review of substantial activities requirements in no or only nominal tax jurisdictions to ensure a level playing field.

Indian Taxation Regime

In India, the Finance Act, 2016 has introduced vide Section 115BBF of the Income-tax Act, a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

Section 115BBF of the Income-tax Act, 1961: In line with nexus approach of BEPS Action 5

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, section 115BBF of the Income-tax Act, 1961 provides that where the total income of the eligible assessee includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, "developed" means atleast 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

(6) ACTION PLAN 6 – PREVENTING TREATY ABUSE

Protection against treaty shopping: Minimum Standard

Bilateral tax treaties concluded by jurisdictions in the world have served to prevent harmful double taxation and remove obstacles to cross-border trade in goods and services, and movements of capital, technology and persons. This extensive network of tax treaties has, however, also given rise to treaty abuse and "treaty-shopping" arrangements.

Treaty shopping typically involves the attempt by a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions. There are a wide number of arrangements through which a person who is not a resident of a jurisdiction that is a party to a tax agreement may attempt to obtain benefits that a tax agreement grants to a resident of that jurisdiction.

Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving jurisdictions of tax revenues.

Treaty abuse is one of the most important sources of BEPS concerns. It is undesirable for several reasons, including:

- Treaty benefits negotiated between the parties to a treaty are economically extended to residents of a third jurisdiction in a way the parties did not intend. The principle of reciprocity is therefore breached and the balance of concessions that the parties make is altered;
- Income may escape taxation altogether or be subject to inadequate taxation in a way the parties did not intend; and
- The jurisdiction of residence of the ultimate income beneficiary has less incentive to enter into a tax treaty with the jurisdiction of source, because residents of the jurisdiction of residence can indirectly receive treaty benefits from the jurisdiction of source without the need for the jurisdiction of residence to provide reciprocal benefits.

Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). That commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

Countries will implement this common intention by including in their treaties:

(i) the combined approach of Limitation of Benefits (LOB) and Principal Purpose Test (PPT) rule,

(ii) the PPT rule alone, or

(iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

Implementation of Action 6 Minimum Standard

The latest peer review on the implementation of the Action 6 minimum standard reveals that a large majority of Inclusive Framework members have modified, or are in the process of modifying, their treaty network to implement the minimum standard and other BEPS treaty-related measures.

As in previous editions, the latest peer review report continues to demonstrate the efficiency of the BEPS Multilateral Instrument (BEPS MLI) in implementing the minimum standard. It is by far the main tool of Inclusive Framework members for implementing the minimum standard. The majority of the jurisdictions that have signed the MLI have listed almost all their treaties under the MLI.

The provisions of the BEPS MLI have started to take effect with respect to treaties concluded by pairs of jurisdictions that have signed and ratified the BEPS MLI. For the treaties for which the MLI is effective, tax administrations can now use effective treaty provisions to put an end to treaty shopping.

Indian Tax Regime

LoB clause introduced in India-Mauritius Tax Treaty - On 10th May, 2016, India and Mauritius has signed a protocol amending the India-Mauritius tax treaty at Mauritius. In the said treaty, for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. The tax rate on such capital gains arising during the period from 1.4.2017-31.3.2019 should, however, not exceed 50% of the tax rate applicable on such capital gains in India. A Limitation of Benefit (LOB) Clause has been introduced which provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. Further, a shell or a conduit company claiming to be a resident of a Contracting State shall not be entitled to this benefit. A shell or conduit company has been defined as any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian rupee 15,00,000 or Indian ₹ 7,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

LoB clause in India-Singapore Tax Treaty - On similar lines, India and Singapore has signed a protocol amending the India-Singapore tax treaty. Capital gains on sale of shares of an Indian company by a resident of Singapore was taxable only in Singapore, if such shares were acquired before 1.4.2017. After amendment of the treaty, capital gains on alienation of shares would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty. In respect of shares acquired after 1.4.2017 and sold before 1.4.2019, the expenditure test needs to be met for the 12 month period immediately preceding the date of transfer.

(7) ACTION PLAN 7 – PREVENT THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS

Tax treaties generally provide that the business profits of a foreign enterprise are taxable in a jurisdiction only to the extent that the enterprise has in that jurisdiction a permanent establishment to which the profits are attributable. The definition of permanent establishment included in tax treaties is therefore crucial in determining whether a non-resident enterprise must pay income tax in another jurisdiction.

Strategies used to avoid having a taxable presence in a jurisdiction under tax treaties may cause cross-border income to go untaxed or be taxed at low rates. The BEPS Action Plan called for a review of that definition to prevent the use of certain common tax avoidance strategies used to circumvent the former Model permanent establishment definition, such as arrangements through which taxpayers replace subsidiaries that traditionally acted as distributors by commissionnaire arrangements, with a resulting shift of profits out of the jurisdiction where the sales took place without a substantive change in the functions performed in that jurisdiction.

These changes will ensure that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. The changes will also restrict the application of a number of exceptions to the definition of permanent establishment to activities that are preparatory or auxiliary nature and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations; they will also address situations where the exception applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises.

Thus, the following steps have been advocated:

- ***Reworking exceptions to PE definition*** – An anti-fragmentation rule to be adopted to aggregate all activities carried by an enterprise in a state, along with activities undertaken by its closely related entities undertaking business operation that create tax mismatch and are cohesive in nature. The above test can also be applied to understand whether the activities undertaken by an enterprise in a state are 'preparatory or auxiliary'.
- ***Analyzing arrangements entered through contractual agreements*** –A Commissionnaire arrangement may be broadly defined as an arrangement through which a person sells

products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in that State on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission). Commissionnaire arrangements have been a major cause of concern for tax administrations in many countries.

Progress in implementation of BEPS Action Plan 7

The changes to the PE definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the MLI (Articles 12 to 15). The Multilateral Instrument (MLI) is a flexible instrument that allows jurisdictions to adopt BEPS treaty-related measures to counter BEPS and strengthen their treaty network. The MLI was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes [For detailed understanding of MLI, refer to discussion under Action 15].

(8) ACTION PLAN 8-10 - TRANSFER PRICING OUTCOMES IN LINE WITH VALUE CREATION/INTANGIBLES/RISK AND CAPITAL AND OTHER HIGH-RISK TRANSACTIONS

Over the last decades and in step with the globalisation of the economy, worldwide intra-group trade has grown exponentially. Transfer pricing rules, which are used for tax purposes, are concerned with determining the conditions, including the price, for transactions within an MNE group resulting in the allocation of profits to companies within the group in different countries. In this regard, based on the arm's length principle, transactions between associated enterprises have to be priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances.

The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. The aforesaid Action plans represent the OECD's work on transfer pricing which has been a core focus of the BEPS Action Plans. The specific Actions focus on Intangibles, Risks and capital and other high-risk transactions. These are the hard areas of transfer pricing and are summarized together in the Final Report 'Aligning Transfer Pricing Outcomes with Value Creation'.

Clarification and Strengthening of existing standards on transfer pricing

Transfer pricing rules, which are set out in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the ALP the conditions, including the price, for transactions within an MNE group. The existing standards in this area have been clarified and strengthened, including the guidance on the arm's length principle and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm's length principle. The work has focused on three key areas.

Action Plan	Details
8	Addresses transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are generally difficult-to-value. Misallocation of the profits generated by valuable intangibles is a significant cause of BEPS.
9	Contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks. Moreover, Action 9 addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
10	This action focuses on other high-risk areas, which include: - the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational, - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and - the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.

Progress in Implementation

- Additional guidance on the attribution of profits to permanent establishments resulting from the changes in the Action 7 Final Report to Article 5 of the OECD Model Tax Convention was published in March 2018.

- Revised guidance on transactional profit split method (Action 10) was published in June 2018 and will be incorporated into the next edition of the OECD Transfer Pricing Guidelines.
- Additional guidance addressed to tax administrations on the application of the hard-to-value intangibles (HTVI) approach (Action 8) was finalised in June 2018 and it will be incorporated in the next edition of the OECD Transfer Pricing Guidelines.
- New transfer pricing guidance on financial transactions (Actions 4 and 8-10) was published in February 2020 and it will be incorporated in the next edition of the OECD Transfer Pricing Guidelines.

(9) ACTION PLAN 11 – MEASURING AND MONITORING BEPS

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some multinational enterprises (MNEs) take advantage of the mismatches and gaps in the international tax rules, separating taxable profits from the underlying value-creating activity, The Addressing Base Erosion and Profit Shifting report (OECD, 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain.

Although measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, the fiscal effects of BEPS are significant. BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment, and reducing the financing of needed public infrastructure.

Measuring the impact and scale of BEPS activities and the effect of the implementation of the BEPS measures are important components of the ongoing work of the OECD/G20 Inclusive Framework on BEPS. Such measurement and monitoring is necessary to inform both policymakers and taxpayers of the effectiveness of the BEPS measures and the extent to which BEPS issues continue to exist.

Indicators of BEPS activity

Six indicators of BEPS activity highlight BEPS behaviour using different sources of data, employing different metrics, and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS, and its continued increase in scale in recent years.

(i) **The profit rates of MNE affiliates located in lower-tax countries are higher than their group's average worldwide profit rate.** For example, the profit rates reported by MNE affiliates located in lower-tax countries are twice as high as their group's worldwide profit rate on average.

(ii) **The effective tax rates paid by large MNE entities are estimated to be lower than similar enterprises with only domestic operations** - This tilts the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.

(iii) **Foreign direct investment (FDI) is increasingly concentrated** - FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.

(iv) **The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly** - For example, the ratio of the value of royalties received to spending on research and development in a group of low-tax countries was six times higher than the average ratio for all other countries, and has increased three-fold between 2009 and 2012.

(v) **Royalties received by entities located in these low-tax countries accounted for 3% of total royalties** - This provides evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS.

(vi) **Debt from both related and third-parties is more concentrated in MNE affiliates in higher statutory tax-rate countries**. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

(10) ACTION PLAN 12 – DISCLOSURE OF AGGRESSIVE TAX PLANNING ARRANGEMENTS

A significant challenge faced by tax authorities worldwide is the lack of timely, comprehensive and relevant information on aggressive tax planning strategies. Timely access to such information would facilitate quick response to tax risks through informed risk assessment, audits, or changes to legislation or regulations. Action 12 contains recommendations regarding the design of mandatory disclosure rules for aggressive tax planning schemes, taking into consideration the administrative and compliance costs for tax administrations and business and drawing on experiences of countries that have implemented such rules. It recognises the advantages of tools designed to facilitate the information flow on tax risks to tax administrations and tax policy makers. The Report provides a modular framework for guidance drawn from best practices for use by countries without mandatory disclosure rules to design a regime that suits their requirement to get early information on potentially aggressive or abusive tax planning schemes and their users. The Action 12 report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations. The recommendations in this Report do not represent a minimum standard and countries can decide whether or not to introduce mandatory disclosure regimes. Where a country opts for mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and more timely information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and co-operation between tax administrations.

(11) ACTION PLAN 13 – RE-EXAMINE TRANSFER PRICING DOCUMENTATION

The lack of quality data on corporate taxation has been a major limitation to measuring the fiscal and economic effects of tax avoidance, making it difficult for authorities to carry out transfer pricing assessments on transactions between linked companies and even more difficult to carry out audits.

Under BEPS Action 13, all large multinational enterprises (MNEs) are required to prepare a country-by-country (CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. This CbC report is shared with tax administrations in these jurisdictions, for use in high level transfer pricing and BEPS risk assessments. This report contains revised standards for transfer pricing documentation incorporating a master file, local file, and a template for country-by-country reporting of revenues, profits, taxes paid and certain measures of economic activity. The revised standardised approach requires taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing and other BEPS risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. Country-by-country reports will be disseminated through an automatic government-to-government exchange mechanism. The implementation package included in this report sets out guidance to ensure that the reports are provided in a timely manner, that confidentiality is preserved and that the information is used appropriately, by incorporating model legislation and model Competent Authority Agreements forming the basis for government-to-government exchanges of the reports.

Requirements as per OECD report on Action 13 of BEPS Action Plan

The OECD report provides for:

(a) revised standards for transfer pricing documentation; and

(b) a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity.

Three-tier structure mandated by BEPS

The BEPS report recommends that countries adopt a standardised approach to transfer pricing documentation; it mandates the following three-tier structure:-

	Document	Information
(1)	Master File	Standardised information relevant for all multinational enterprises (MNE) group members. 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.
(2)	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 local tax administrations.
(3)	Country-by-country report	The BEPS Action 13 report provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by-Country (CbC) Report. To facilitate the implementation of the CbC Reporting standard, the BEPS Action 13 report includes a CbC Reporting Implementation Package which consists of (i) model legislation which could be used by countries to require the ultimate parent entity of an MNE group to file the CbC Report in its jurisdiction of residence including backup filing requirements and (ii) three model Competent Authority Agreements that could be used to facilitate implementation of the exchange of CbC Reports, respectively based on the: a) Multilateral Convention on Administrative Assistance in Tax Matters;

		b) Bilateral tax conventions; and c) Tax Information Exchange Agreements (TIEAs). **Following information are required in the CbC report**: Information relating to the global allocation of the MNE's income and taxes paid; and Indicators of the location of economic activity within the MNE group. 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.

Advantages of the three-tier structure [as per BEPS Report]:

(a) Taxpayers will be required to articulate consistent transfer pricing positions;

(b) Tax administrations would get useful information to assess transfer pricing risks;

(c) Tax administrations would be able to make determinations about where their resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries.

Indian Taxation Regime

Transfer Pricing provisions under the Income-tax Act, 1961

Chapter X of the Income-tax Act, 1961 comprising sections 92 to 92F contain provisions relating to transfer pricing regime.

Section 92D requires maintenance of prescribed information and document relating to the international transaction and specified domestic transaction by every person who has entered into an international transaction. Also, a constituent entity of an international group is required to keep and maintain the prescribed information and document in respect of the international group.

Implementation of international consensus in India

India is one of the active members of BEPS initiative and part of international consensus. For the purpose of implementing the international consensus, a specific reporting regime in respect of CbC reporting and also the master file has been incorporated in the Income-tax Act, 1961. The essential elements have been incorporated in the Income-tax Act, 1961 while the remaining aspects would be dealt with in detail in the Income-tax Rules, 1962.

***Note** – Refer to Chapter 24 Transfer Pricing, wherein the following have been discussed at length -*

(i) Elements relating to CbC reporting requirement and related matters which have been incorporated in section 286 of the Income-tax Act, 1961

(ii) Maintenance and furnishing of Master file: Consequent provisions incorporated in section 92D of the Income-tax Act, 1961.

Threshold limit of consolidated group revenue for applicability of CbC reporting requirement

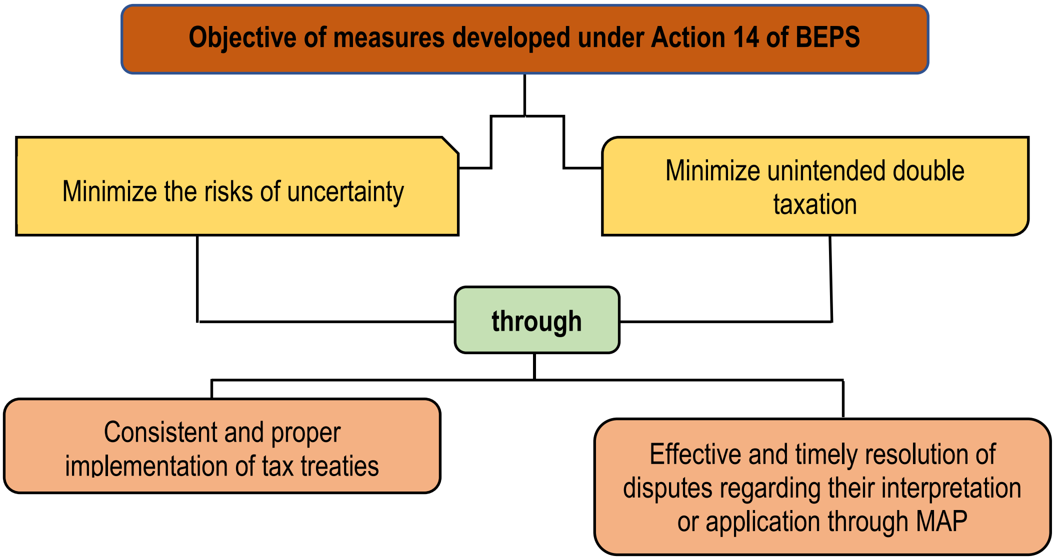
The CbC reporting requirement for a reporting year does not apply unless the consolidated revenues of the preceding accounting year of the group, based on consolidated financial statement, exceeds a threshold to be prescribed. This threshold for total consolidated group revenue of the international group prescribed under section 286 of the Income-tax Act, 1961 read with Rule 10DB of the Income-tax Rules, 1962 is ₹ 6,400 crores.

(12) ACTION PLAN 14 – MAKING DISPUTE RESOLUTION MORE EFFECTIVE

As novel challenges relating to international taxation surface, the necessity of having robust dispute resolution processes in place becomes increasingly apparent.

Recent statistics show that tax administrations are closing more cases than ever before. However, new MAP cases as from 2016 are increasing significantly, thus putting upward pressure on countries' MAP inventories. Therefore, the total inventory of MAP cases keeps increasing every year since the number of cases closed has not been able to keep up with the number of new cases.

The BEPS Action 14 Minimum Standard seeks to improve the resolution of tax-related disputes between jurisdictions. Inclusive Framework jurisdictions have committed to have their compliance with the minimum standard reviewed and monitored by its peers through a robust peer review process that seeks to increase efficiencies and improve the timeliness of the resolution of double taxation disputes.



Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are significant to developing an international tax system that facilitates economic growth and a buoyant global economy. Countries concur that the measures introduced to address BEPS pursuant to the BEPS Action Plans should not result in unnecessary uncertainty for compliant taxpayers and in unintended double taxation. Improving dispute resolution mechanisms is, therefore, a critical component of the work on BEPS issues.

The Action 14 Minimum Standard consists of elements and best practices, which assess a jurisdiction's legal and administrative framework in the following four key areas:

- preventing disputes;
- availability and access to MAP;
- resolution of MAP cases;
- implementation of MAP agreements.

Peer review implications for India

♦ The BEPS Action Plan 14 had suggested a peer review mechanism to ensure adequate implementation of the suggested minimum standard. As a result, the peer review undertaken for India in 2019 highlighted India's progress on MAP Programme and suggested recommendations for more effective functioning of the MAP. According to the peer review and BEPS Action Plan 14, the Indian tax authorities have taken significant steps to reform the MAP framework and make it effective.

- The significant reforms include:
  - The CBDT substituted Rule 44G and omitted Rule 44H of the Income-tax Rules, 1962 vide *CBDT Notification No. 23/2020 dated 6th May, 2020*. The new rule 44G extensively deals with the implementation and the procedural framework for the MAP process.
  - In line with the BEPS Action Plan 14 recommendation, India had released a detailed guidance note on MAP dated 7th August, 2020, available at https://www.incometaxindia.gov.in/news/map_guidance_7_8_2020.pdf. The MAP guidance addresses many of the open issues on procedural aspects of MAP and, more importantly, clarifies key practical nuances absent in the pre-BEPS era regime for the taxpayers to resort.

(13) ACTION PLAN 15 – DEVELOPING A MULTILATERAL INSTRUMENT

MLI's role in tackling BEPS

Abuse of tax treaties is an important source of BEPS. The MLI helps the fight against BEPS by implementing the tax treaty-related measures developed through the BEPS project in existing bilateral tax treaties in a synchronized and efficient manner. These measures will prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of permanent establishment status and neutralize the effects of hybrid mismatch arrangements.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

Formation of ad hoc Group to develop MLI

Based on this analysis, a mandate for the formation of an ad hoc Group to develop a multilateral instrument on tax treaty measures to tackle BEPS, was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015.

In line with Action 15 report, an ad-hoc group was formed with a pre-defined purpose of development of such Multilateral Instrument (MLI) and that adopted the text of the Convention and accompanying Explanatory Statement in November 2016. India was part of the Ad Hoc Group of more than 100 countries and jurisdictions from G20, OECD, BEPS associates and other interested countries, which worked on an equal footing on the finalization of the text of the Multilateral Convention, starting May 2015. The text of the Convention and the accompanying Explanatory Statement was adopted by the Ad hoc Group on 24th November 2016.

Features of MLI

The Multilateral Convention is, thus, an outcome of the OECD/ G20 Project to tackle Base Erosion and Profit Shifting (the "BEPS Project") i.e., tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.

The MLI modifies tax treaties that are "Covered Tax Agreements". A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.

The MLI is a flexible instrument which will modify tax treaties according to a jurisdiction's policy preferences with respect to the implementation of the tax treaty-related BEPS measures. The MLI provides for different types of flexibility:

(i) jurisdictions can choose amongst alternative provisions in certain MLI articles;

(ii) jurisdictions can choose to apply optional provisions (for instance, the provisions on mandatory binding arbitration);

(iii) jurisdictions may also choose to reserve the right not to apply MLI provisions (to opt out through a "reservation") with respect to all of their Covered Tax Agreements or with respect to a subset of their Covered Tax Agreements. Jurisdictions only have the possibility to opt out of provisions that do not reflect a BEPS minimum standard, with the possibility to withdraw their reservation (and opt in) later.

Coverage of the MLI

In the first signing ceremony of the MLI on 7th June, 2017, more than 65 countries have signed the MLI making it a historic moment in the international tax framework. India is an active participant in the BEPS programme and was one of the jurisdictions during the signing event. USA and Brazil have not signed the MLI and thereby not a party to this convention. The current status of signatories and parties to MLI is available at https://www.oecd.org/tax/beps/beps-mli-signatories-and-parties.pdf.

The MLI entered into for the avoidance of taxes is a new concept in International Taxation. The fundamentals of MLI can be decoded using the rhetoric 3W1H principles (Why, What, When and How).

Why the need for MLI under the BEPS? – The evolution from Bilateral to Multilateral

Before we embark into what is MLI, we must understand the need for an MLI under the international tax laws. The existing framework of international tax law is through tax treaties entered bilaterally between countries.

The MLI convention is synonymous to a treaty. Treaties are instruments which create international law, it is one of the most common and important sources of international law. They are agreements between sovereign states and are binding on every sovereign state signatory to such agreement. A treaty is defined by the Vienna Convention on the Law of Treaties (commonly referred to as 'VCLT') as 'an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation'. As much as treaties are instruments under international law, conventions, agreements, charters are all synonymously used along with treaty.

The tax treaty framework is through Countries which have entered into Double Tax Avoidance Agreements (generally referred to as 'DTAA') with several other countries on a bilateral basis i.e. agreement between two countries (e.g. Country A with Country B) to prevent double taxation of income. India has entered bilateral tax treaties with more than 90 countries. The bilateral tax treaties are, inter alia, entered with a view, majorly to prevent double taxation of income and give relief in respect of doubly taxed incomes.

The rapid growth of globalization led to the creation of Multinational Enterprises (MNEs) wherein the entities within a group were present all over the world and in many cases at jurisdictions which were set up with the main objective to obtain tax arbitrage using treaty shopping mechanism. Consequent to the 2008 global economic crisis, the international organizations and the fellow nations came up with the BEPS action plan to recognise and counter unfair tax planning strategies adopted by certain MNEs which had exploited the gaps in the global taxation system by artificially shifting profits to low or no-tax locations (where there is little or no economic activity which leads to little or no tax being paid). These tax planning strategies violated the 'Economic Allegiance' principle which means to compensate to a nation or a kingdom for the benefits that one derived from exploiting that nation or kingdom's resources. This resulted in the source taxation principle under the international tax principles.

As a result of the BEPS agenda, 15 Action Plans were brought out by the OECD under G20's mandate to tackle the unfair tax planning mechanisms adopted by MNEs. The action plan 15 can be considered as the machinery action, which is intended to put into play the anti-avoidance tax solutions proposed in the other BEPS action items. The need for such a machinery action item is because currently there are more than 3000 bilateral tax treaties that are active and to invoke the solutions proposed under the BEPS action plans, these bilateral tax treaties have to be amended. Amending the bilateral treaties and involves cumbersome legal process as each country have their own constitutional or other legal mechanisms to invoke international treaties into their domestic laws. Further, mere incorporation of these solutions in domestic law will not achieve the desired objective as the tax treaties will remain a tool for tax evaders. Therefore, to ensure the BEPS solutions are transposed into the tax treaty, action plan 15 objective was to bring all these amendments under one single umbrella and hence, the work on developing a multilateral agreement was undertaken.

Multilateral agreements are entered by three or more nations, thus, bringing many countries under one roof. Such agreements are considered effective and less time-consuming. The World Trade Organization (WTO) agreement, in which India is a party, is a classic example of multilateralism. Multilateral agreements, in the context of international taxation, is not new as there have been precedents from Scandinavian, Caribbean countries entering into such an agreement to avoid double taxation. India also has its experience through the SAARC Limited Multilateral Agreement for the avoidance of double taxation. But what distinguishes those agreements from the BEPS MLI is that the MLI is exclusively entered to ensure there are no double nontaxation and reduction of taxes, unlike the former whose objective was inter alia to avoid double taxation and to promote economic relations.

Therefore, the MLI modifies tax treaties not by directly amending the text of the tax treaty, but by being applied together with the relevant tax treaty. They do not make the existing DTAA otiose, they operate along with the existing DTAA and will modify the application of some clauses in the existing DTAA using the lex posterior (later in time) principle. Therefore, the BEPS MLI is an effective tool to implement the anti-avoidance measures in a synchronised manner without the need to bilaterally renegotiate each and every agreement. The BEPS MLI can act as a retaliatory tool for tax enforcers to use against the tax evaders, as it can disentitle a taxpayer from undertaking treaty shopping or availing unfair treaty benefits based on the anti-avoidance measures initiated under the BEPS action items. Having seen the need for an MLI on tax treaties, we will dwell further on the operational aspects of the same.

What is MLI? – Structure and key organs

The MLI under the BEPS action plan 15 is to implement the BEPS work into the existing treaty network. The MLI will enable to provide a standard language for modification of all the existing DTAAs. This enables elimination of disputes arising on account of different terms being used differently or distinctively in each of the DTAA between contracting states thereby acting as deterrence for tax abuse. It is reiterated that the BEPS MLI is an enabler to the existing tax treaties and does not replace the existing tax treaties. It operates along with the existing DTAA by modifying the application of a provision under the DTAA.

Structure of the MLI

Just as bilateral tax treaties are agreements, the MLI is also a similar instrument and its interpretation will be governed by the principles laid down by VCLT. There are 7 parts and 39 articles in the MLI. The coverage of MLI through its articles in light of the BEPS action plans is structured in the manner provided below. Articles 3 to 17 are recognised as substantive provisions under the MLI convention.

Part	Particulars	Article
Part I	Scope and Interpretation of terms	Article 1-Article 2
Part II	Hybrid Mismatches	Article 3-Article 5
Part III	Treaty Abuse	Article 6-Article 11
Part IV	Avoidance of PE Status	Article 12-Article 15
Part V	Improving Dispute Resolution	Article 16-Article 17
Part VI	Arbitration	Article 18-Article 26
Part VII	Final Provisions	Article 27- Article 39

Key Organs of the MLI

Each country before becoming a signatory is required to adopt certain ‘mandatory minimum standards’, make ‘notification’ of MLI provisions, ‘make a reservation’ to certain provisions of MLI and also provides for ‘compatibility clauses’ to ‘opt-in and opt-out’ of MLI provisions. Here, we will discuss the key organs of the MLI which acts as a fulcrum for the operation of the instrument.

Key organs
Covered Tax Agreement
Compatibility Clause
Reservation Clauses
Minimum Standard

Covered Tax Agreements (CTA)

The entire scope and starting point of the MLI revolve around CTA. Article 2 of MLI defines a CTA as: 'an agreement for avoidance of double taxation with respect to taxes on income that is in force between two or more parties and/or jurisdictions with respect to which each party has notified to the Depository as a listed agreement under the MLI'.

It is, therefore, extremely relevant that to make the MLI operational between two parties (or) jurisdictions/ states, each country must notify each other's bilateral tax treaty while becoming a signatory to the MLI. Each country has to notify the DTAA with other jurisdiction under the MLI, upon which the said DTAA will be the CTA for the purposes of MLI operation.

India has notified 93 jurisdictions under the MLI at the time of ratifying the MLI convention. Similarly, it is also important that the countries which have signed a bilateral treaty with India must also notify DTAA with India while depositing their instrument with OECD. Therefore, 'the matching principle' is a key attribute and only when the other country also notifies the DTAA with India, the DTAA between India and that country will be considered as a CTA.

Examples

Exhibit 1: Whether the India & Australia DTAA is a CTA under the MLI?

Steps	Considerations	Comments
Step 1	Whether India and Australia already have a DTAA in existence?	Yes, move to step 2
Step 2	Whether India and Australia are signatories to MLI?	Yes, both the parties are signatories to the MLI.
Step 3	Whether India has notified DTAA with Australia as a CTA in its MLI deposit note to the OECD?	Yes, India has notified DTAA with Australia as a CTA.
Step 4	Whether Australia has notified DTAA with India as a CTA in its MLI deposit note to the OECD?	Yes, Australia has notified DTAA with India as a CTA.
Step 5 - Conclusion	Article 2 – Scope provisions matched and hence India -Australia DTAA is a CTA.	MLI provisions will apply.

Exhibit 2: Whether the India & Mauritius DTAA is a CTA under the MLI?

Steps	Considerations	Comments
Step 1	Whether India and Mauritius already have a DTAA in existence?	Yes, move to step 2
Step 2	Whether India and Mauritius are signatories to MLI?	Yes, both the parties are signatories to the MLI.
Step 3	Whether India has notified DTAA with Mauritius as a CTA in its MLI deposit note to the OECD?	Yes, India has notified DTAA with Mauritius as a CTA.
Step 4	Whether Mauritius has notified DTAA with India as a CTA in its MLI deposit note to the OECD?	No, Mauritius has not notified DTAA with India as a CTA.
Step 5 Conclusion	India – Mauritius DTAA matching provisions not satisfied. Therefore, the said DTAA is not a CTA.	MLI provisions will **NOT** apply. Will be governed only by existing DTAA provisions
Note: India-Mauritius DTAA was amended in the year 2016, *inter alia*, to incorporate certain BEPS provisions. This may be the possible reason for Mauritius not notifying DTAA with India as a CTA. This shows the flexibility that is available under the MLI for countries to choose.		

Further, there are some countries like the USA and Brazil amongst others which have not signed the MLI Convention. Hence, in such a scenario, the India-USA DTAA or the India-Brazil DTAA will have no consideration towards the MLI and the existing DTAA provisions will only govern the tax treaty framework.

Therefore, once an existing tax treaty is recognised as a CTA in the MLI context, the tax treaty will have to take cognizance of the operational aspects of the MLI.

Compatibility Clauses – Bridge between the DTAA and the MLI

Once the existing DTAA becomes a CTA, we move to the next main organ of the MLI i.e. the compatibility clauses. One of the core objectives of the MLI is to ensure consistency amongst the nations to incorporate the BEPS solutions in their treaty network. Further, the objective of MLI is to only modify the application of certain provisions in the existing DTAA. Therefore, parties to the MLI are given the flexibility to choose the relevant provisions of the MLI that needs to be transposed to their existing DTAA. In a bilateral DTAA, two countries negotiate and have the flexibility to decide which provisions to be incorporated. Since tax policy of countries vary, flexibility is important to attract countries to sign the MLI. Therefore, the flexibility is provided in the form of compatibility clause and the reservation clause.

The compatibility clause is to ensure that there is no conflict between the two treaties i.e. the DTAA and the MLI. This is because of the uniqueness of the MLI, which is not a standalone treaty as it operates alongside the bilateral tax treaties. If there is a possible conflict that may arise between the two treaties i.e., the DTAA and the MLI, the compatibility clause would resolve this conflict. Further, the compatibility clause also gives options to parties to leave an existing provision of the DTAA undisturbed, if the existing provision serves the desired objective with which a particular provision of the MLI was placed to.

There are 4 different categories of compatibility clause(s) which are found under the MLI convention. They are depicted in the following table

Compatibility Clause	Meaning	Effect	Notification Criteria
"in place of"	Purpose of this clause is to replace an existing provision of the CTA, with that of mutually notified provisions of MLI between two countries.	The concerned provision of MLI shall replace the existing CTA provision.	Only when both the parties to the CTA notify, the CTA provision be replaced by the MLI provision.
"in the absence of"	Purpose of this clause is to enforce a new provision into the CTA, where such provision is absent in the CTA.	The concerned MLI provision is added to the existing CTA which does not contain such a provision.	Only when both the parties to the CTA notify, the MLI provision gets added in the CTA.
"applies to" or "modifies"	Purpose of this clause is that the relevant CTA provision will be modified by MLI provision without replacing the CTA provision.	This existence of this compatibility clause is that there should be a mutually notified CTA provision on which this condition is made effective. Thereafter, the relevant MLI provision shall be made applicable to an existing CTA provision without replacing the provisions of CTA.	Only when both the parties to the CTA notify, the MLI provision would be made applicable to the existing CTA provision.
"in place of or in the absence of"	Purpose of this clause is to replace an existing	**Use of "in place of":** Where existing	With regard to the notification, this is

	provision in CTA with the MLI provision. Further, where there is no such provision in the CTA, the MLI provision will be added to the existing CTA. This is the most commonly used clause in many of the substantive provisions of the MLI.	provisions of CTA are notified by two countries, then, the MLI provisions are replaced with CTA provisions. **Use of "in the absence of":** Where no such provisions exist in a CTA, then the MLI provisions includes them and gets added into the CTA.	different from the earlier clauses, wherein even if both the parties to the CTA does not notify this clause, the MLI provision shall apply and supersede the provisions of the CTA to the extent of incompatibility. The same holds good even if only one party notifies this clause.

Reservation Clauses – 'Opt-Out' Mechanism

The reserved provisions of MLI shall not apply to a CTA if either of the parties makes a reservation. A reservation is defined in the VCLT as a "unilateral statement made by a State, when signing, ratifying, accepting, approving or acceding to a multilateral instrument, whereby it purports to exclude or to modify the legal effect of certain provisions of the Convention"

Hence, reservations under treaties, introduce flexibility in treaty negotiations, so that States come forward to be a signatory to such multilateral conventions. The general rule of multilateral instrument is that its parties are bound by the entire instrument unless the parties make a reservation. The MLI enables states to opt-out of the provisions, either entirely or partially, by introducing a mechanism of reservations.

However, reservations concerning minimum standard provisions (discussed later) under the MLI can be made only on limited situations and subject to satisfying certain conditions.

Examples:

1) India has reserved its position on Article 3 of the MLI on transparent entities (BEPS Action 2), therefore Article 3 will not be added or modified in any of India's existing DTAA as India has opted-out.

2) France has reserved its position on Article 4 of the MLI on dual resident entities (BEPS Action 2), therefore when we apply India-France DTAA, Article 4 of the MLI will not affect the DTAA since France has opted-out/reserved its position on the said Article 4 of the MLI.

A party to the MLI may reserve the right for provisions of the MLI to not apply:

- to its covered tax treaties in their entirety; or
- a subset of its covered tax treaties

Further, the reservations made under the MLI by a party will apply symmetrically wherein it applies to the reserving party and other parties to the convention. In certain exceptional situation, the reservation provision also works asymmetrically, which is a unique feature of the MLI, unlike other multilateral agreements.

Mandatory Minimum Standards

The mandatory minimum standards form the genesis of MLI and without which the object of MLI may not be fulfilled. One of the core objectives of developing the MLI is to ensure consistency amongst the 3000 odd tax treaties that are currently in existence. As we have seen earlier, the MLI also gives flexibility to the parties through compatibility and reservation clause, however, to ensure there is some consistency, the parties have to adhere to incorporating mandatory minimum standard provisions in the MLI.

The objective of the minimum standard provisions is to ensure that these anti-abuse provisions will help eliminating the treaty shopping mechanism and consequentially the elimination of double non-taxation scenarios by tax-evaders. The minimum standards under the MLI, therefore, achieve certain consistency amongst the existing tax treaties. These minimum standard provisions, which have to be incorporated in the tax treaties, help in combating tax avoidance.

Out of the four minimum standards prescribed under the BEPS action plan i.e.

Action 5 - Countering Harmful Tax Practices

Action 6 - Treaty abuse prevention mechanism

Action 13 - Country by Country Reporting

Action 14 - Effective Dispute Resolution Mechanism

Action 6 and Action 14 solutions are specifically provided as a minimum standard provision under the BEPS MLI. With regards to Action 5 and Action 13, the solutions are to be incorporated under domestic laws.

However, in a case where the Contracting States together agree to reflect the minimum standard provisions specified under the MLI into their existing DTAA, then, such treaty partner may opt-out of the minimum standards under the MLI.

When – Entry into Force and Effective Date

The historic MLI was signed on 07 June 2017 by more than 65 countries at Paris, France during the initial signing ceremony. The Entry into Force and the Effective Date is specified under Articles 34-36 of the MLI. Since the MLI is a new instrument for the signatory countries, many countries which were not part of the initial signing ceremony have been signing the MLI on an ongoing basis. It is, therefore, important to understand when the MLI enters into force and the effective date.

The MLI will apply only to those countries which have:

- Signed the MLI;
- Ratified, accepted or approved the MLI under the domestic law and deposited such instrument of ratification with the OECD depositary.

Upon deposit of the instrument of ratification, the MLI enters into force on the first day of the month following the expiry of 3 calendar months beginning on the date of such subsequent deposit.

Effective date

Once the MLI is entered into force by both the Contracting States, the effective date of the MLI shall be:

For withholding taxes – 1st day of next calendar year that begins on or after the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the CTA.

For other taxes – Taxable period that begins on or after the expiration of a period of 6 calendar months from the latest of the dates on which this Convention enters into force for each of the Contracting Jurisdictions to the CTA.

India's journey and effective date on the applicability of the MLI

Date	Event
7th June, 2017	The signing of the MLI
25th June 2019	Deposit of ratification instrument with the OECD depository.
1st October 2019	Entry into Force of India's MLI

The provisions of the said Convention would have effect in India with respect to a Covered Tax Agreement in accordance with the provisions of Article 35 of the said Convention. Accordingly, in exercise of the powers conferred by section 90(1) of the Income-tax Act, 1961, the Central Government has, vide Notification No.57/2019 dated 9.8.2019 (available at https://www.incometaxindia.gov.in/communications/notification/notification57_2019.pdf), notified that the provisions of the said Convention shall be given effect to in the Union of India, in accordance with India's Position under the said Convention, as set out in the Annexure thereto.

If a country has signed and notified DTAA with India, however, the MLI has not entered into force, then in such a case, the MLI provisions will not be applicable. For e.g., Italy has notified DTAA with India as a CTA; however, Italy has not ratified its MLI under its domestic laws and hence the provisions of MLI cannot be applied until Italy's MLI is entered into force. Therefore, the MLI does not apply in respect for India-Italy DTAA.

ILLUSTRATION 1

An Indian company intends to withhold taxes on a payment to be made to an Italian Company on 10th April 2023. In this regard, the Indian company wants to understand whether the provisions of MLI are applicable to read it along with the India-Italy DTAA.

SOLUTION

With effect from 1st April 2020, India's MLI has entered into effect. However, Italy has not yet ratified the MLI as on 10th April 2023, therefore, the MLI provisions of Italy has not entered into force yet and therefore, the MLI provisions are not applicable. The Indian company will rely only on the existing India-Italy DTAA.

How does the MLI Operates - Mechanics

The MLI is only an addition to the existing DTAA and does not replace the DTAA. It only intends to modify/amend the existing DTAA subject to the discretion of the parties and hence has to be read along with the DTAA between the parties. Due to the unique feature of MLI not being a standalone agreement, the operation of the MLI is critical and needs proper application.

The mechanics for applying the MLI is on the satisfaction of the conditions as follows:

Both the Contracting States to the DTAA should be signatories to the MLI.

↓

Both the Contracting States should have duly notified their DTAA as a Covered Tax Agreement (CTA) and the MLI should have entered into force.

↓

The substantive provisions and choices of the Contracting States to be analysed through the compatibility clause and notification clause, regarding the provisions of the CTA that is to be modifed by the MLI.

↓

To identify, whether any reservation is made on the application of a provision of the MLI by either of the contracting parties.

ILLUSTRATION 2

Whether MLI provisions will apply in the following scenarios?

(a) Country A and Country B are signatories to the MLI. Both countries have ratified the MLI agreement as per their domestic legislative process. Country A has notified DTAA with Country B as a CTA, however, Country B has not notified DTAA with Country A.

(b) Country A - Country B DTAA is a CTA under Article 2 of the MLI as both the countries have notified the concerned DTAA. Country A has ratified the MLI under their domestic laws and has deposited the ratification instrument. Country B has not ratified the MLI owing to political instability in their country. In this regard, Country A wishes to invoke the MLI provisions while accessing the Country A – Country B DTAA. Is the action of Country A valid?

SOLUTION

(a) Since Country B has not notified DTAA with Country A as CTA, the MLI provisions will not apply with regard to the Country A - Country B DTAA, as per Article 2 of the MLI.

(b) Under Article 34 - Entry into Force of the MLI, only when a Country deposits its instrument of ratification, the MLI will enter into force according to the timelines stipulated in the mentioned Article. In the given scenario, since Country B has not ratified the MLI, consequently, the MLI with regards to Country B has not entered into force yet. Hence, Country A - Country B CTA under MLI is not in force yet and, therefore, provisions of the MLI are not applicable. The action of Country A is, therefore, invalid.

Resources: The discussion on BEPS Action Plans contained in this chapter is essentially based on the Action Plans developed in the context of the OECD/G20 BEPS Project and available at the website http://www.oecd.org/tax/beps/beps-actions.htm

SUMMARY

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<tr><th colspan="2">OECD Recommendation</th><th>Provision incorporated in Indian Tax Laws</th></tr>
<tr><td>i</td><td>Modifying existing Permanent Establishment (PE) rule to provide whether an enterprise engaged in fully de-materialized digital activities would constitute a PE if it maintained significant digital presence in another country's economy</td><td rowspan="2">Equalisation Levy
Equalisation levy@6% is attracted on the amount of consideration for specified services received or receivable by a non-resident not having PE in India or providing services not effectively connected with PE in India, from:
• a resident in India who carries on business or profession or
• from a non-resident having PE in India.
The resident or non-resident having PE in India has to deduct equalisation Levy@6% from consideration for specified services paid to non-resident and remit the same to the Central Government within the prescribed time.
Equalisation levy@2% would be chargeable on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it—
(i) to a person resident in India; or
(ii) to a non-resident in the following specified circumstances -
(a) sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement though internet protocol address located in India; and
(b) sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India; or
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<tr><td>ii</td><td>A virtual fixed place of business PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction & carries on business through that website.</td></tr>
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<tr><td>iii</td><td>Imposition of a final withholding tax on certain payments for digital goods or services provided by a foreign e-commerce provider.</td><td>Further, section 194-O provides that where sale of goods or provision of services of an e-commerce participant is facilitated by an e-commerce operator through its digital or electronic facility or platform, such e-commerce operator is liable to deduct tax at source @1% of the gross amount of such sales or services or both.</td></tr>
<tr><td>iv</td><td>Imposition of an Equalisation Levy on consideration for certain digital transactions received by a Non-resident from a resident or Non-resident having PE in the other contracting state.</td><td>Significant economic presence
Significant economic presence of a non-resident in India shall also constitute business connection in India. Significant economic presence means-
<table><tr><th></th><th>Nature of transaction</th><th>Condition</th></tr><tr><td>(a)</td><td>in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India</td><td>Aggregate of payments arising from such transaction or transactions during the previous year should exceed ₹ 2 crores.</td></tr><tr><td>(b)</td><td>systematic and continuous soliciting of business activities or engaging in interaction with users in India</td><td>The number of users should be atleast 3 lakhs.</td></tr></table></td></tr>
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BEPS Action Plan 6: Preventing treaty abuse	
OECD Minimum Standard	**LoB clause incorporated in Indian Tax Treaties**
Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping by including in their treaties: (i) the combined approach of **Limitation of Benefits (LOB)** and **Principal Purpose Test (PPT)** rule, (ii) the **PPT rule** alone, or (iii) the **LOB rule** supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.	**LoB clause in India-Mauritius Tax Treaty** • On 10.5.2016, the India-Mauritius tax treaty was amended and for the first time, it has been provided that gains from the alienation of shares acquired on or after 1.4.2017 in a company which is a resident of India may be taxed in India. • The tax rate on such capital gains arising from 1.4.2017-31.3.2019 should, however, not exceed 50% of the applicable tax rate on capital gains in India. • LOB Clause provides that a resident of a Contracting State shall not be entitled to the benefits of 50% of the tax rate applicable in transition period if its affairs are arranged with the primary purpose of taking advantage of concessional rate of tax. • A shell or a conduit Co. claiming to be a resident of a Contracting State shall not be entitled to this benefit. • A shell or conduit Co. is any legal entity falling within the meaning of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. **LoB clause in India-Singapore Tax Treaty** • Capital gains on sale of shares of an Indian company by a resident of Singapore was taxable only in Singapore, if such shares were acquired before 1.4.2017. • The India-Singapore tax treaty has been amended to provide that capital gains on alienation of shares acquired on or after 1.4.2017 would be taxable in a similar manner as laid out in India-Mauritius tax treaty, subject to LoB clause. • The transition period benefit is also similar to that contained in India-Mauritius Tax Treaty.

BEPS Action Plan 7: Prevent the Artificial Avoidance of PE Status

OECD Recommendation

Review of definition of PE

To prevent tax avoidance

- By way of **Commissionaire Arrangements**
  - Modification of Article 5(5) to **include a person who habitually plays a principal role leading to conclusion of contracts** in the definition of agent
- By way of **Fragmentation of business activities**
  - Introduction of anti-fragmentation Rule **to prevent fragmentation of functions** which are otherwise a whole activity to avail benefit of exemption

Provision incorporated in the Income-tax Act, 1961

Expanding the scope of business connection (BC) u/s 9(1)(i) of Income-tax Act, 1961

Upto A.Y.2018-19	From A.Y.2019-20
BC is established, *inter alia,* where a person acting on behalf of NR has and habitually exercises the authority to conclude contracts on behalf of the NR.	BC also includes any business activity carried through a person who, acting on behalf of the NR, habitually concludes contracts or **habitually plays the principal role leading to conclusion of contracts** by the NR. Such contracts should be- (i) in the name of the NR; or (ii) for transfer of ownership of, or for the granting of right to use, property owned by that NR or that the NR has the right to use; or (iii) for provision of services by that NR

BEPS Action Plan 13 Re-examine transfer pricing (TP) documentation

OECD Minimum Standard

Standardised approach to TP documentation

- **Master File** – Standardised information relevant for all MNE group members regarding **global business operations & TP policies**
- **Local File** – Transactional info specific to each country in detail covering **related party transactions**
- **CBC Report** – Information relating to **global allocation of MNE's income & taxes paid**; & indicators of the location of the eco. activity within the MNE group

Master File and Local File: To be delivered by MNEs directly to **local tax administrations**

CBC Report: To be filed in the tax residence jurisdiction of ultimate parent entity

Provisions incorporated in the Income-tax Act, 1961

Provisions in the IT, Act, 1961

- **Section 92D** – Maintenance & Furnishing of **Master File** – Maintenance of prescribed information and documents
- **Section 286** – **CBC Reporting** requirement and related matters – Requires aggregate information w.r.t. amount of revenue, P&L before income-tax, amount of income-tax paid and accrued, stated capital, no. of employees, nature and details of main business activity of each constituent entity etc.

BEPS Action Plan 15 Developing a Multilateral Instrument (MLI)	
BEPS Report	**Entry into Force of MLI**
The MLI helps fight against BEPS by implementing tax treaty-related measures developed through the BEPS Project in existing bilateral treaties in a synchronized and efficient manner to – • **prevent treaty abuse,** • **improve dispute resolution** • **prevent the artificial avoidance of PE status** • **neutralize the effects of hybrid mismatch arrangements**. The MLI is flexible instrument which modifies tax treaties that are "**Covered Tax Agreements**". A Covered Tax Agreement is an agreement for the avoidance of double taxation that is in force between Parties to the MLI and for which both Parties have made a notification that they wish to modify the agreement using the MLI.	➢ The Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS) was signed by India at Paris, France on 7th June, 2017. ➢ India had ratified the said Convention and had deposited the instrument of ratification along-with the list of Covered Tax Agreements, reservations and notifications (India's Position under the said Convention) to the Depositary on 25th June, 2019. ➢ The date of entry into force of the said Convention for India is 1st October, 2019, being the first day of the month following the expiry of a period of three calendar months beginning on 25th June, 2019, being the date of deposit by India of the instrument of ratification. ➢ The earliest date when the provisions of this Convention can take effect in India is 1st April, 2020 (six months from 1st October, 2019, the date of entry into force for India)

TEST YOUR KNOWLEDGE

Questions

1. *What do you understand by base erosion and profit shifting? Describe briefly its adverse effects.*

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

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

4. *Describe the three tier structure for transfer pricing documentation mandated by BEPS Action Plan 13.*

5. *Explain the nexus approach recommended by OECD in BEPS Action Plan 5 which has been adopted in the Income-tax Act, 1961.*

6. *What are the ways in which hybrid mismatch arrangements are used to achieve unintended double non-taxation or long-term tax deferral?*

Answers

1. 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.

2. The OECD has recommended 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.

Taking into consideration the potential of new digital economy and the rapidly evolving nature of business operations, it becomes necessary to address the challenges in terms of taxation of such digital transactions.

The concept of 'Significant Economic Presence' (SEP) which is similar to the virtual fixed place PE as recommended in the 2015 BEPS Action Plan 1 report has been introduced in the Income-tax Act, 1961 *vide Explanation 2A* to section 9(1)(i).

Significant economic presence of a non-resident in India shall also constitute business connection in India. Significant economic presence means-

	Nature of transaction	Condition
(a)	in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India	Aggregate of payments arising from such transaction or transactions during the previous year should exceed **₹ 2 crores.**
(b)	systematic and continuous soliciting of business activities or engaging in interaction with users in India	The number of users should be atleast **3 lakhs**.

Further, the above transactions or activities shall constitute significant economic presence in India, whether or not,—

(i) the agreement for such transactions or activities is entered in India;

(ii) the non-resident has a residence or place of business in India; or

(iii) the non-resident renders services in India:

However, where a business connection is established by reason of significant economic presence in India, only so much of income as is attributable to the transactions or activities referred to in (a) or (b) above shall be deemed to accrue or arise in India.

In order to address the challenges of the digital economy, 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. This is provided for in section 165 of the Finance Act, 2016.

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;

Specified Service also includes any other service as may be notified by the Central Government.

Further, in order to reduce burden of small players in the digital domain, it is also provided that no such levy shall be made if the aggregate amount of consideration for specified services received or receivable by a non-resident from a person resident in India or from a non-resident having a permanent establishment in India does not exceed ₹ 1 lakh in any previous year.

The Finance Act, 2020 has expanded the scope of equalisation levy by inserting new section 165A in the Finance Act, 2016 to include within the ambit of Chapter VIII thereto, consideration received or receivable for e-commerce supply or services made or provided or facilitated on or after 1.4.2020. Accordingly, on and from 1st April, 2020, equalisation levy @ 2% would be chargeable on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it—

(i) to a person resident in India; or

(ii) to a non-resident in the following specified circumstances -

(a) sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement though internet protocol address located in India; and

(b) sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India; or

(iii) to a person who buys such goods or services or both using internet protocol address located in India.

However, equalisation levy would **not** be chargeable —

(i) where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment;

(ii) where the equalisation levy is leviable on specified services under section 165; or

(iii) sales, turnover or gross receipts, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated is less than ₹ 2 crores during the previous year.

However, the consideration received or receivable for specified services and for e-commerce supply or services would not include the consideration, which are taxable as royalty or fees for technical services in India under the Income-tax Act, 1961 read with the DTAA notified by the Central Government under section 90 or section 90A.

3. In line with the recommendations of OECD BEPS Action Plan 4, section 94B has been inserted in the Income-tax Act, 1961 by the Finance Act, 2017 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.

The provision is applicable to an Indian company, or a permanent establishment of a foreign company, being the borrower, who pays interest in respect of any form of debt issued by a non-resident who is an 'associated enterprise' of the borrower. Further, the debt is deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender, being a non-associated enterprise, or deposits a corresponding and matching amount of funds with such lender.

The provision allows for carry forward of disallowed interest expense for 8 assessment years immediately succeeding the assessment year for which the disallowance is first made and deduction against the income computed under the head "Profits and gains of business or profession" to the extent of maximum allowable interest expenditure.

In order to target only large interest payments, it provides for a threshold of interest expenditure of ₹ 1 crore in respect of any debt issued by a non-resident associated enterprise exceeding which the provision would be applicable. Banks, Insurance business and class of NBFCs notified by the Government are excluded from the ambit of the said provisions keeping in view of special nature of these businesses. Also, section 94B would not be attracted on interest paid in respect of debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.

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

(a) **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.

(b) **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 local tax administrations.

(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.

5. In India, the Finance Act, 2016 has introduced a concessional taxation regime for royalty income from patents for the purpose of promoting indigenous research and development and making India a global hub for research and development. The purpose of the concessional taxation regime is to encourage entities to retain and commercialise existing patents and for developing new innovative patented products. Further, this beneficial taxation regime will incentivise entities to locate the high-value jobs associated with the development, manufacture and exploitation of patents in India.

The nexus approach has been recommended by the OECD under BEPS Action Plan 5. This approach requires attribution and taxation of income arising from exploitation of Intellectual property (IP) in the jurisdiction where substantial research and development (R & D) activities are undertaken instead of the jurisdiction of legal ownership. Accordingly, section 115BBF has been inserted in the Income-tax Act, 1961 to provide that where the total income of the eligible assessee (being a person resident in India who is the true and first inventor of the invention and whose name is entered in the patent register as the patentee in accordance with the Patents Act, 1970 and includes every such person, being the true and the first inventor of the invention, where more than one person is registered as patentee under Patents Act, 1970 in respect of that patent.) includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10% (plus applicable surcharge and cess). For this purpose, developed means atleast 75% of the expenditure should be incurred in India by the eligible assessee for any invention in respect of which patent is granted under the Patents Act, 1970.

6. Hybrid mismatch arrangements are sometimes used to achieve unintended double non-taxation or long-term tax deferral in one or more of the following ways -

(1) Creation of two deductions for a single borrowal;

(2) Generation of deductions without corresponding income inclusions;

(3) Misuse of foreign tax credit; and

(4) Participation exemption regimes.

NOTES

CHAPTER 26

APPLICATION AND INTERPRETATION OF TAX TREATIES

LEARNING OUTCOMES

After studying this chapter, you would be able to

- ❑ **identify** the connecting factors of double taxation;
- ❑ **appreciate** the meaning of, and need for, tax treaties;
- ❑ **appreciate** the basic principles of interpretation of tax treaties;
- ❑ **identify** the extrinsic aids to interpretation of a tax treaty;
- ❑ **appreciate** the importance of commentaries in interpretation of tax treaties;
- ❑ **appreciate** the role of Vienna Convention in application and interpretation of tax treaties.

26.1 INTRODUCTION

Article 38(1) of the International Court of Justice (ICJ)[1] provides that the court shall apply the following in deciding on a particular matter –

International Convention(s) [general or particular]

- establishing rules expressly recognised by the contesting states

International Customs

- serving as evidence of general practice accepted as law

General principles

- recognised by civilised nations

Judicial decisions and teachings of highly qualified publicists of various nations

- serving as subsidiary means for determination of rules of law

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret any law or agreement, one needs to understand the philosophy of law which has been kept in mind at the time of passing such law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

The interpretation of DTAAs require a different approach than the interpretation of domestic tax laws as the latter is based on interpretative principles set out by the national courts, whereas, the DTAAs are an international agreement between the government of two countries. The treaties are interpreted in light of the customary principles set out under the Vienna Convention of the Law of treaties.

Source(s) of International Tax Law

S. No.	Source	Particulars relating to the source/origin
(i)	Double Taxation Avoidance Agreement (DTAA)	DTAAs may be comprehensive or limited. It is to be noted that along with the DTAA, it is the protocols, memorandum of understanding, and exchange of

[1] https://www.icj-cij.org/en/statute#CHAPTER_II. The International Court of Justice acts as a world court. The Court's jurisdiction is twofold: it decides, in accordance with international law, disputes of a legal nature that are submitted to it by States (jurisdiction in contentious cases); and it gives advisory opinions on legal questions at the request of the organs of the United Nations or specialized agencies.

		information, etc. forming part of the DTAA which enables interpretation of a DTAA.
(ii)	Customary international law and general principles of law	Customary international law is the aspect of international law that derives from customs and conventions. Along with general principles of law and treaties, custom is also considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of the world's governments accept, in principle, the existence of customary international law, although there are many differing opinions as to what rules are contained therein.
(iii)	Vienna Convention on Law of Treaties (VCLT)	VCLT is a multilateral treaty signed and ratified by several countries, which codifies the customary international law for interpretation of tax treaties.

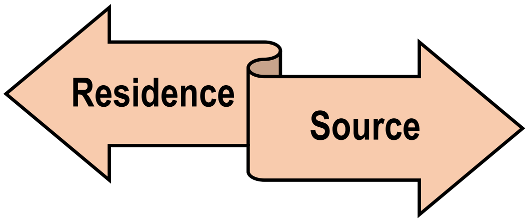
26.2 DOUBLE TAXATION AND CONNECTING FACTORS

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.

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 as the company would be heavily engaged in doing business in the territory of other country, for example, through its branch in that country.

However, if a company is doing business **with** another country (i.e., host/source country), then, it would generally be subject to tax in its home country alone, based on its residence link, since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods to another country). In this regard, it may, however, be noted that significant economic presence in another country may result in tax liability in the other country. For example, as per the Income-tax Act, 1961, transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India if aggregate of payments arising from such transaction or transactions during the previous year exceeds ₹ 2 crores, would be deemed as significant economic presence of such non-resident in

India. Significant economic presence of a non-resident in India would constitute business connection in India and consequently, income would be deemed to accrue or arise in India and hence, be taxable in India (the Source country).



- **Juridical double taxation**

  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 "juridical double taxation".

  In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or Double Taxation Convention–DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91, providing unilateral relief in the event of double taxation.

Example 1

Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.

If, instead of UK, ICO has a branch in a state with which India does not have tax treaty, then it can claim unilateral relief under section 91 of the Income-tax Act, 1961 in respect of taxes paid by its branch in that state.

- **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 persons (because of lack of subject identity)

Example 2

When one State attributes an income/capital to its legal owner whereas the tax law of other State attributes it in the hands of the person in possession or having economic control over the income, it leads to economic double taxation. For example, if one State (say, Country X) levies dividend distribution tax on the company resident in that State (say, ABC Ltd.) and the other State (say, Country Y) levies tax on dividend received by the shareholder who is resident of Country Y, receiving dividend income from shares held in ABC Ltd., the company resident in Country X, then, economic double taxation arises.

26.3 TAX TREATIES: AN OVERVIEW

(1) Definition of "Treaty"

Treaty is a generic term embracing all instruments binding under international law, regardless of their formal designation, concluded between two or more international juridical persons.

The application of the term treaty signifies that the parties intend to create rights and obligations enforceable under international law.

Article 2 of Vienna Convention on Law of Treaties, 1969 defines a "treaty" as an international **agreement** concluded between States **in written form** and **governed by international law**, whether embodied in a **single instrument or in two or more related instruments** and whatever its particular designation.

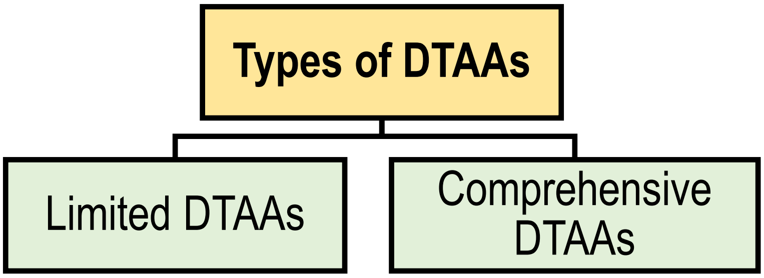
(2) Role of Tax Treaties

"Treaty" represents various compromises agreed upon by the respective Contracting States depending upon the economic expediency of a particular country.

Tax, in the country of source is considered as a cost, whereas the same is an obligation in the country of residence. Therefore, there is need to achieve tax efficiency. Double Tax Avoidance Agreements come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned States on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

(3) Types of DTAAs



Limited DTAAs are those which are limited to certain types of incomes only. e.g., DTAA between India and Pakistan is limited to income from international air transport only.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

(4) Directive Principles set out in the Indian Constitution

In the Indian context, Article 51 of the Indian Constitution has, *inter alia*, set out some directive principles which must be followed by the State in the context of International agreements and relationships. It has been provided that-

"The State shall endeavor to -

(a) Promote international peace and security;

(b) Maintain just and honourable relations amongst nations;

(c) Foster respect for international law and treaty obligations in the dealings of organised people with one another; and

(d) Encourage settlement of international disputes by arbitration.

Article 253 of the Indian Constitution provides that Parliament has power to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body.

It is pertinent to note that entries 10 and 14 of List I of the Seventh Schedule to the Constitution of India confer the power on Parliament to legislate treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide sections 90 and 90A of the Income-tax Act, 1961.

(5) Need for tax treaties

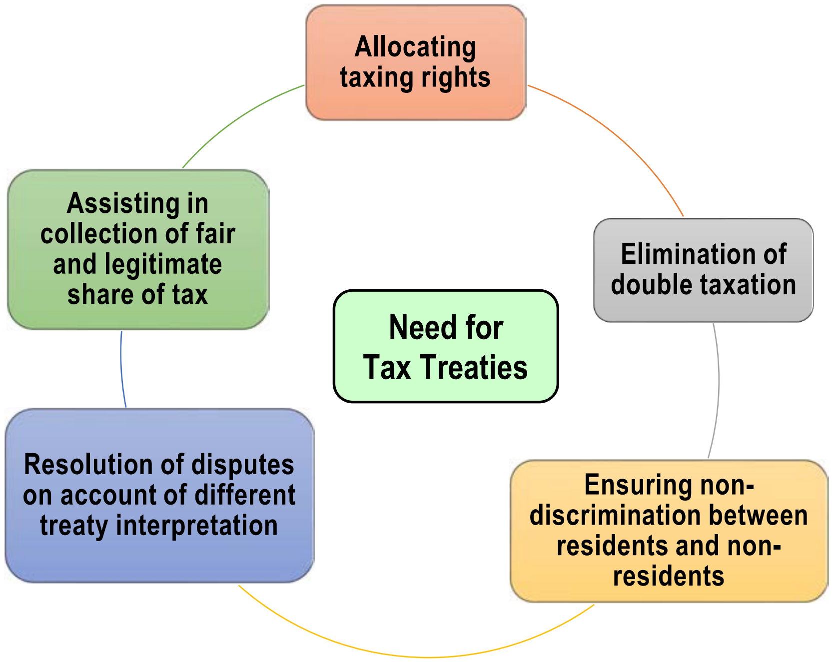
The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force. Generally, the residence state has the primary right to tax the global income of its residents unless it exempts that income under its domestic tax law. The right of the source state gets curtailed under the DTAA as it is always a secondary state and has limited connection with the taxpayer. The rights of the source state are sometimes limited (e.g. in case of royalties, interest) or are unconditional or are conditional (e.g. business profits only taxable if PE exists). Even in some cases, no rights are granted to the source state and the entire income is taxable in the residence state. The allocation or distribution of the taxing rights depends upon the negotiation or bargaining power between the two countries and flow of investment and trade between them.

Tax treaties only distribute or assign taxing jurisdiction. It does not impose tax. Having assigned the jurisdiction of tax between the State of Residence and State of Source, the domestic tax laws of the respective State determine taxing rules. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

English lawyers called it "Classification and Assignment Rule", whereas German jurists called it the **"Distributive Rule".** According to this principle, "to the extent that an exemption is agreed to, its effect is, in principle, independent of whether the Contracting States imposes a tax, in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax". The point here is that having agreed to give the right of tax to the other state, that state may or may not levy tax and if the state in whose favour right to tax is devolved, chooses not to tax such income, then, it may result in double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, this rule ensures that double taxation does not arise in future also, if the source state decides to levy tax.

In addition to allocating the taxing rights and eliminating double taxation, there are various other important considerations as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.



Section 90 also provides that the Central Government may enter into an agreement with the Government of any country outside India for

(a) granting of relief in respect of Income-tax; or

(b) avoidance of double taxation without creating any opportunities for double non-taxation or reduced taxation through tax evasion or avoidance (including treaty shopping arrangements); or

(c) exchange of information for the prevention of evasion or avoidance of income-tax or for investigation of cases of such evasion or avoidance; or

(d) recovery of income-tax.

Further, in addition to above, there are some other principles which must be considered by countries in tax treaties –

(i) Equity and fairness: Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) Neutrality and efficiency: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) **Promotion of mutual economic relation, trade and investment:** In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country's overall economic growth and development.'

26.4 INTERPRETATION OF TAX TREATIES

(1) Introduction

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the Vienna Convention on Law of Treaties (VCLT). These rules of interpretation are not restricted to tax treaties but also apply to any treaty between two countries. Therefore, any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD/UN Model Conventions has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation.

In India, even before insertion of Section 90(2) by the Finance (No.2) Act, 1991, with retrospective effect from 1-4-1972, CBDT had clarified *vide Circular No. 333 dated 2-4-1982* that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income.

Section 90(2) of 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.

Interpretation of any statute, more so international tax treaties, requires that we follow some rules of interpretation. In subsequent paragraphs, we shall deal with rules of interpretation of tax treaties.

(2) Role of Vienna Convention in Application and Interpretation of Tax Treaties

The International Law Commission initiated the work on the Vienna Convention on Law of Treaties in the year 1949 which was completed in the year 1969. It came into force in the year 1980. As of 2.8.2023, it was ratified by 116 Countries. It is an open treaty whereby any country can become signatory of the Convention at any time.

Since tax treaty is a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty). It represents the customary international law. The VCLT codifies the principles of interpretation laid down by usage, custom and courts over centuries.

The principles engraved in Vienna Convention on Law of Treaties have been acknowledged and embraced by the Indian courts of law while pronouncing their ruling. Para 60 of the Supreme Court ruling in *Ram Jethmalani & Ors. v. Union of India & Ors* Writ Petition (Civil) No. 176/2009 reads as follows –

"Article 31, "General Rule of Interpretation", of the Vienna Convention of the Law of Treaties, 1969 provides that a "treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." While India is not a party to the Vienna Convention, it contains many principles of customary international law, and the principle of interpretation, of Article 31 of the Vienna Convention, provides a broad guideline as to what could be an appropriate manner of interpreting a treaty in the Indian context also".

The Delhi High Court ruling in *AWAS Ireland v. Directorate General of Civil Aviation (W.P.(C) 671/2005 delivered on 19th March 2015*, applied the principles enshrined in the Vienna Convention of Law of Treaties, 1969. The said ruling invited reference to Article 51(c) of the Constitution of India which enjoins that the State shall endeavour to "foster respect for international law". The Court observed that the provisions of Article 51(c) of the Constitution of India when read with Articles 26, 27 and 31 of the Vienna Convention of Law of Treaties clearly cast an obligation on the Contracting States to not only remain bound by the terms of a treaty entered into by it but also obliges the State not to cite internal law as a justification for failure to perform its obligations under a treaty. An international convention, i.e., a treaty, is required to be interpreted in good faith, in accordance with the ordinary meaning given to the terms of the treaty, in their context and in light of its stated object and purpose.

Therefore, it would be worthy to understand some of the Articles of the Vienna Convention of Law of Treaties which would help appreciate the manner of application and interpretation of tax treaties.

Principles enunciated in the Vienna Convention on Law of Treaties[2]

Article No.	Article Heading	Principle enunciated
26	***Pacta Sunt Servanda (in good faith)***	Every treaty in force is binding upon the parties and must be followed by them in good faith.
27	**Internal law and observance of treaties**	A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. For instance, the parties to the treaty should not dishonour their international commitments with each other by retrospectively amending their domestic tax laws or by not abiding by the treaty terms.
28	**Non-retroactivity of treaties**	Unless a different intention appears from the treaty or is otherwise established, treaty provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party. In other words, unless otherwise provided, treaties cannot have retrospective application
29	**Territorial Scope of Treaties**	Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.
31	**General Rule of Interpretation**	• A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose. This is a basic principle. It states that treaties should be interpreted by first giving the ordinary meaning to the language. It is only if the ordinary meaning is ambiguous, or leads to illogical results, that the purpose may be considered. • The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

[2] https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf

		(b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto. • The following shall be taken into account, together with the context in that: (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) Any relevant rules of international law applicable to relation between the parties. • A special meaning shall be given to a term if it is established that the parties so intended.
32	**Supplementary means of interpretation**	Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.
33	**Interpretation of Treaties Authenticated in two or more languages**	• When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail. • A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree. • The terms of the treaty are presumed to have the same meaning in each authentic text. • Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts,

		having regard to the object and purpose of the treaty, shall be adopted.
34	**General Rule regarding third states**	A treaty does not create either obligations or rights for a third State without its consent.
42	**Validity and Continuance in force of treaties**	• The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention. • The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty
60	**Termination or Suspension of the operation of a treaty as a consequence of its breach**	• A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part. • A material breach of a multilateral treaty by one of the parties entitles: (a) the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations amongst themselves and the defaulting State, or (ii) as between all the parties; (b) a party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State; (c) any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty. • A material breach of a treaty, for the purposes of this Article, consists in: (a) a repudiation of the treaty not sanctioned by the Convention; or

		(b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty. • The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
61	**Supervening impossibility of performance**	• A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it, if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation. • Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party thereto.
62	**Fundamental change of circumstances**	• A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless – (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. • A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty – (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. • If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a

		ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation.
64	**Emergence of new peremptory norm of general international law**	If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated.

(3) Basic Principles of Interpretation of law for interpreting a Treaty

Principles or rules of interpretation of a tax treaty would be relevant only where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible. If words are clear or unambiguous, then there is no need to resort to different rules for interpretation.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Just as each country's legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law.

Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) **Golden Rule – Objective Interpretation:** Ideally, any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. The term has to be interpreted contextually.

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the intention of the parties, it should not be adopted[3].

(ii) **Subjective Interpretation:** Under this approach, the terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

In *Abdul Razak A. Meman's case [2005] 276 ITR 306,* the Authority for Advance Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

[3] Prof. J. G. Starke in Introduction to International Law 10th Edition

(iii) **Purposive Interpretation:** In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the 'objects and purpose' method. For identifying the intention of the parties entering into treaty, reference can be made to the preamble of the treaty, its protocol and the technical memorandum.

In case of *Union of India v. Azadi Bachao Andolan 263 ITR 706,* the Supreme Court of India observed that "the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases."

The Supreme Court also made the reference to the preamble of the treaty to ascertain the purpose of India-Mauritius Treaty. The Apex Court agreed with the contention of the Appellant that "the preamble to the Indo-Mauritius DTAA recites that it is for 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty".

(iv) **The Principle of Effectiveness:** According to this principle, a treaty should be interpreted in a manner as to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which 'on the whole' will render the treaty 'most effective and useful', in other words, which will enable the provisions of the treaty to work and to have their appropriate effects[4].

(v) **Principle of *Contemporanea Expositio:*** A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

In *Abdul Razak A. Meman's* case *[2005] 276 ITR 306*, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material *contemporanea expositio,* which means that a statute is best explained by following the construction put upon it by judges at the time it was made, or soon after. This proposition is embodied in Article 32 of the Vienna Convention, and is also referred to in the decision of the Hon'ble Supreme Court in *K. P. Varghese v. ITO [1981] 131 ITR 597*."

(vi) **Liberal Construction:** It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

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[4] Prof. J. G. Starke in Introduction to International Law 10th Edition

In *John N. Gladden v. Her Majesty the Queen*[5], the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed that "contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item under consideration is concerned."

The Court further recognised that "we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms."

(vii) **Treaty as a Whole – Integrated Approach:** A treaty should be construed as a whole and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

(viii) **Reasonableness and consistency**[6] **:** Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.

An important aspect to be noted regarding the rules of interpretation is that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act.

(4) Extrinsic Aids to Interpretation of a Tax Treaty

A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

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[5] 85 D.T.C. 5188 at 5190, Source: UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)

[6] Prof. J. G. Starke in Introduction to International Law 10th Edition

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y? Though the interpretation or explanations in treaty X would not be binding while interpreting the treaty Y, however, if the language is similar between the two treaties, one can make a reference to treaty X for understanding the intention of the Contracting parties.

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

International Articles/Essays/Reports

Like in the direct tax cases, Courts many a times refer to the Commentaries of Kanga Palkhiwala and Sampath Iyengar for interpretation as they are considered authoritative source. Also under the International taxation, various authors like Phillip Baker and Klaus Vogel's commentary are considered as classic sources of interpretation for understanding the tax treaties. International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained "useful material" through international articles.

Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation(MFN) Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

MFN clause is usually found in Protocols and Exchange of Notes to DTCs. Under this clause a country agrees to extend the benefits to the residents of the other country, which it had (first country) promised to the residents of third country. It tries to avoid discrimination between residents of different countries.

Normally, the benefit under this clause is restricted to a specific group like OECD countries or developing countries. The nature of benefits under MFN clause could either be application of lower *rate of tax or narrowing the scope of the income liable to tax or allowing higher deduction in respect of executive and general administrative expenses of head office.*

CLARIFICATION REGARDING THE MOST-FAVOURED-NATION (MFN) CLAUSE IN THE PROTOCOL TO INDIA'S DTAAS WITH CERTAIN COUNTRIES [CIRCULAR NO.3/2022 DATED 3.2.2022]

The Protocol to India's DTAAs with some of the countries, especially European States and OECD members (The Netherlands, France, the Swiss Confederation, Sweden, Spain and Hungary) contains a provision, referred to as the Most-Favoured-Nation (MFN) clause. Though each MFN clause in these DTAAs has a different formulation, the general underlying provision is that if after the signature/ entry into force (depending upon the language of the MFN clause) of the DTAA with the first State, India enters into a DTAA with another OECD Member State, wherein India limits its source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, Fees for Technical Services, etc.) to a rate lower or a scope more restricted than the scope provided for those items of income in the DTAA with the first State, such beneficial treatment should also be extended to the first State.

Through this circular, the CBDT clarifies that the applicability of the MFN clause and benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, Fees for Technical Services, etc.) provided in India's DTAAs with the third States will be available to the first (OECD) State only when all the following conditions are met:

(i) The second treaty (with the third State) is entered into after the signature/ Entry into Force (depending upon the language of the MFN clause) of the treaty between India and the first State;

(ii) The second treaty is entered into between India and a State which is a member of the OECD at the time of signing the treaty with it;

(iii) India limits its taxing rights in the second treaty in relation to rate or scope of taxation in respect of the relevant items of income; and

(iv) A separate notification has been issued by India, importing the benefits of the second treaty into the treaty with the first State, as required by the provisions of section 90(1) of the Income-tax Act, 1961.

If all the conditions enumerated in (i) to (iv) are satisfied, then, the lower rate or restricted scope in the treaty with the third State is imported into the treaty with an OECD State having MFN clause from the date as per the provisions of the MFN clause in the DTAA, after following the due procedure under the Indian tax law.

However, notwithstanding the clarification given above, where in the case of a taxpayer there is any decision by any court on this issue favourable to such taxpayer, this Circular will not affect the implementation of the court order in such case.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. As mentioned above, in case of *Azadi Bachao Andolan*, the Apex Court observed that 'the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty'. These observations are very significant whereby the Apex Court has upheld 'economic considerations' as one of the objectives of a Tax Treaty. Further, now after the BEPS Action Plan 6 recommendation and Multi-lateral Instrument (MLI), the new text has been added to the Preamble to reflect that the treaties are not intended for creating opportunities for double-non taxation and treaty shopping arrangements. This will play a key-role in interpreting the treaties post MLI.

Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also serve as precedence in case of subsequent applications.

Basic Principles of Interpretation of a Treaty

- **Golden Rule - Objective Interpretation**: Any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind.
- **Subjective Interpretation**: Terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.
- **Teleological or Purposive Interpretation**: Treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as 'objects and purpose' method.
- **The Principle of Effectiveness**: A treaty should be interpreted in a manner to have effect rather than make it void.
- **Principle of *Contemporanea Exposition***: A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.
- **Liberal Construction**: It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.
- **Integrated Approach**: Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.
- **Reasonableness and consistency**: Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument.

Extrinsic Aids to Interpretation of a Tax Treaty

- Provisions in Parallel Tax Treaties
- International Articles/Essays/Reports
- Protocol
- Preamble
- Mutual Agreement Procedure [MAP]

(5) Commentaries on OECD/UN Models and their importance

There are two model conventions – OECD Model Convention and the UN Model Convention. The OECD Model was framed by the members from the developed countries. It gives importance to residence based taxation. UN Model Convention represents a compromise between the developing and developed countries. UN Model focusses on source based taxation. The OECD or UN Model Convention provides template to the tax administrations for negotiating the tax treaties. There are commentaries annexed to the Model Convention which helps in interpreting the model conventions. The OECD Model Commentaries represent the views of the Members of OECD from different countries. The UN Model Commentaries represent the views of the Group of Experts from different countries who represent in their individual capacity. Therefore, commentaries are one of the important rules of interpretation of tax treaties.

Views expressed in the commentaries carry great authority. However, the same are not binding on the countries even where the countries are signatories to the Model Convention. This is due to the fact that the actual treaties may be different from the model convention. Where Contracting States adopt the text of the Article as per OECD Model convention or UN Model Convention without any change, reliance can be placed on the Model Commentaries for interpreting the tax treaties. In the *Azadi Bachao Andolan* case, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

(6) Foreign Courts' Decisions

Tax treaties may be interpreted differently by the different countries. A treaty signed between country A and B, may be interpreted by courts of Country A and B differently. Therefore, there may be no harmonization in the interpretation of tax treaties. A same income may be classified as royalty by one country and business income by another country. Therefore, reliance on foreign court rulings may result in harmonious interpretation.

In many of the rulings Indian courts have referred to the foreign court cases for interpretation of treaty provisions. In *CIT v. Vishakhapatnam Port Trust's* case *[1983] 144 ITR 146*, the Andhra Pradesh High Court observed that, "in view of the standard OECD Models which are being used in various countries, a new area of genuine 'international tax law' is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant."

In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

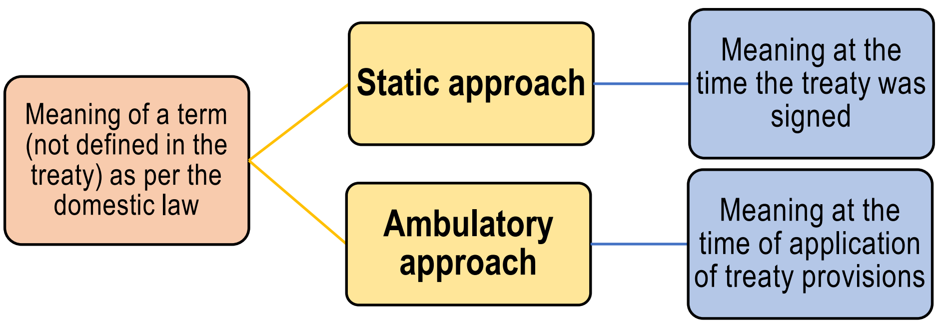
Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

CIT v. Vishakhapatnam Port Trust [1983] 144 ITR 146

Abdul Razak A. Meman's case [2005] 276 ITR 306(AAR)

(7) Ambulatory v. Static Approach

International tax law gets updated from time to time to keep up with the developments in the society and the technology. Over the years, the OECD and UN have come up with different version of commentaries. Similarly, even the domestic tax laws also amended from time to time. The tax treaties make a reference to the domestic tax laws for the terms not defined under the treaty. Therefore, whenever a reference is made in a treaty to the provisions of domestic tax laws or to the Model Commentary 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.



All Model Commentaries including the Technical Explanation on US Model Tax Convention favors 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. Therefore, the current position under the domestic law or the latest version of the commentary should be resorted to if that interpretation provides a suitable meaning of the term and clarifies the term in a better way. This is due to the fact that such an interpretation has been introduced under the Model Commentary because of lack of clarity at the earlier point in time. Therefore, even if the treaty would be based on OECD Model 1977, still the meaning under the 2017 can be resorted to if that meaning provides a better clarity and the amendment is of clarificatory nature. However, if the meaning of the term changes altogether, then the meaning at the time when the treaty was signed should be resorted to.

TEST YOUR KNOWLEDGE

Questions

1. *What do you mean by double taxation? Discuss the connecting factors which lead to double taxation.*

2. *"In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into tax treaty". Elucidate.*

3. *What is the General Rule of Interpretation under Vienna Convention of Law of Treaties?*

4. *What are the Extrinsic Aids to interpretation of a tax treaty?*

5. *Matrix Inc. incorporated in Country X, holds 26% controlling interest in Pilu Ltd., an Indian Company. Pilu Ltd. declared dividend of ₹ 50,00,000 during the P.Y. 2023-24. The DTAA between India and Country X, which came into force on 1.1.2018, provides for taxation of dividend @15%. Thereafter, India entered into a DTAA with Country Y, which came into force from 15.5.2018. The India-Country Y DTAA, inter alia, provides for concessional tax rate of 10% in respect of dividend. Country X is an OECD member since 2015 and Country Y is also an OECD member since 2017.*

   Mr. Jack, CFO of Matrix Inc. seeks your opinion on whether the concessional tax rate provided in the DTAA between India and Country Y can be availed by a resident of Country X and if so, are there any further conditions to be satisfied in this regard. You may assume that the protocol annexed to India's DTAAs with all OECD member countries contain the relevant tax parity clause.

   Would your answer change, if Country Y had become an OECD member only in the year 2020?

Answers

1. 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. 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 as the company would be heavily engaged in doing business in the territory of other country, for example, through its branch in that country.

However, if a company is doing business with another country (i.e., host/source country), then, it would generally be subject to tax in its home country alone, based on its residence link, since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods to another country). In this regard, it may, however, be noted that significant economic presence in another country may result in tax liability in the other country. For example, as per the Income-tax Act, 1961, transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India if aggregate of payments arising from such transaction or transactions during the previous year exceeds ₹ 2 crores, would be deemed as significant economic presence of such non-resident in India. Significant economic presence of a non-resident in India would constitute business connection in India and consequently, income would be deemed to accrue or arise in India and hence, be taxable in India (the Source country).

- **Juridical double taxation:** 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 "juridical double taxation".

  In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or Double Taxation Convention–DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91, 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 persons (because of lack of subject identity)

2. In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into a tax treaty, as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness:** Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) **Neutrality and efficiency:** Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) **Promotion of mutual economic relation, trade and investment:** In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country's overall economic growth and development.

3. Article 31 of Vienna Convention of Law of Treaties contains the General Rule of Interpretation. It lays down that following general rule of interpretation:

- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose.
- The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure

  (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

  (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto.
- The following shall be taken into account, together with the context in that:

  (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) Any relevant rules of international law applicable to relation between the parties.

- A special meaning shall be given to a term if it is established that the parties so intended.

4. A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y? Though the interpretation or explanations in treaty X would not be binding while interpreting the treaty Y, however, if the language is similar between the two treaties, one can make a reference to treaty X for understanding the intention of the Contracting parties.

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

International Articles/Essays/Reports

Like in the direct tax cases, Courts many a times refer to the Commentaries of Kanga Palkhiwala and Sampath Iyengar for interpretation as they are considered authoritative source. Also under the International taxation, various authors like Phillip Baker and Klaus Vogel's commentary are considered as classic sources of interpretation for understanding the tax treaties. International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained "useful material" through international articles..

Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation (MFN) Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. As mentioned above, in case of *Azadi Bachao Andolan*, the Apex Court observed that 'the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty'. These observations are very significant whereby the Apex Court has upheld 'economic considerations' as one of the objectives of a Tax Treaty. Further, now after the BEPS Action Plan 6 recommendation and Multi-lateral Instrument (MLI), the new text has been added to the Preamble to reflect that the treaties are not intended for creating opportunities for double-non taxation and treaty shopping arrangements. This will play a key-role in interpreting the treaties post MLI.

Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also serve as precedence in case of subsequent applications.

5. The CBDT has, vide Circular No. 3/2022 dated 3.2.2022, clarified that the applicability of the Most Favoured Nation (MFN) clause and benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income including dividends provided in India's DTAAs with the third State (Country Y, in this case) will be available to the first (OECD) State (Country X, in this case) **only when all the following conditions are met:**

Condition		Satisfaction of condition in the case on hand
(i)	The second treaty (with the third State) is entered into after the signature/ Entry into Force of the treaty between India and the first state	This condition is satisfied as India has entered into a DTAA with Country Y on 15.5.2018, after it has entered into a DTAA with Country X on 1.1.2018.
(ii)	The second treaty is entered into between India and a State which is a member of the OECD at the time of signing the treaty with it;	This condition is satisfied as India has entered into a DTAA on 15.5.2018 with Country Y, which is a member of OECD since 2017. Hence, on 15.5.2018, Country Y was an OECD member.
(iii)	India limits its taxing rights in the second treaty in relation to rate or scope of taxation in respect of relevant items of income	This condition is satisfied since in DTAA between India and Country Y, dividend is taxable@10%.
(iv)	A separate notification has been issued by India, importing the benefits of the second treaty into the treaty with the first State as required by the provisions of section 90(1) of the Income-tax Act, 1961.	In this case, conditions (i), (ii) and (iii) mentioned above have been satisfied. The concessional rate of 10% can be applied for taxing the dividend received by Matrix Inc. from Pilu Ltd., an Indian company, only if India has issued a separate notification importing the benefits of India-Country Y tax treaty into India-Country X tax treaty, as required by the provisions of sections 90(1). If such notification has been issued, then, the concessional rate of 10% can be applied for taxing the dividend received by Matrix Inc. from Pilu Ltd., an Indian company; otherwise it cannot be applied, even if other conditions are satisfied.

In case if Country Y became an OECD member only in the year 2020, then, the concessional rate of 10% cannot be applied for taxing dividend received by Matrix Inc. from Pilu Ltd., since Country Y was not an OECD member on 15.5.2018, at the time when India signed the DTAA with it. Consequently, condition (ii) mentioned above would not be satisfied in such a case. Hence, dividend received by Matrix Inc. from Pilu Ltd. would be subject to tax@15%.

NOTES

CHAPTER 27

OVERVIEW OF MODEL TAX CONVENTIONS

LEARNING OUTCOMES

After studying this chapter, you would be able to:

- **appreciate** the need for Model Tax Convention;
- **appreciate** the key features of the OECD and UN Model Tax Conventions;
- **identify** the subject of the various articles of the OECD and UN Model Tax Conventions;
- **appreciate** the broad similarities and differences between the principles enshrined in certain articles of the OECD Model Tax Convention *vis-à-vis* the corresponding articles of the UN Model Tax Convention.

27.1 INTRODUCTION

In order to enable various countries to enter into treaties, which are standardized to some extent, Organization for Economic Cooperation and Development (OECD) and the United Nations (UN) have developed certain Model Tax Treaties. These treaties can be used by various countries as a starting point in their negotiations with other countries. While these Models are not legally binding, they have been extensively used by various countries as a reference point while entering into Tax Treaties. In some cases, they have been incorporated verbatim or with minor changes. However, in other cases, countries have made suitable changes in the draft model according to their economic environment and commercial and tax considerations.

The significant model conventions have been briefly discussed hereunder:

OECD Model - The emergence of present form of OECD Model Convention can be traced back to 1927, when the Fiscal Committee of the League of Nations prepared the first draft of Model Form applicable to all countries. In 1946 the model convention was published in Geneva by the Fiscal Committee of U.N. Social & Economic Council and later by the Organisation for European Economic Co-operation (OEEC) in 1963. However, in 1961, the Organisation for Economic Co-operation and Development (OECD) was established, with developed countries as its members, to succeed the OEEC, and OECD approved the draft presented to the OEEC. In 1977, the final draft was prepared in the present form which has been revised several times; the latest being in the year 2017.

OECD Model Convention (OECD MC) is essentially a model treaty **between two developed nations.** This model advocates residence based taxation, i.e., it lays emphasis on the right of state of residence to tax the income.

UN Model – In 1968, the United Nations set up an Adhoc Group of Experts from various developed and developing countries to prepare a **draft model convention between developed and developing countries**. In 1980, this Group finalised the UN Model Convention (UN MC) in its present form. Since its first publication in 1980, the Model has been updated previously in 2001, 2011 and 2017. The latest updation was in the year 2021.

The UN MC is a compromise between the source principle and the residence principle. However, it gives more weight to the source principle as against the residence principle of the OECD MC. UN MC is designed to encourage flow of investments from the developed countries to developing countries. It takes into account sharing of tax-revenue with the country providing capital.

The United Nations MC seeks to be balanced in its approach. As a corollary to the principle of taxation at source, the Articles of the Convention are based on a recognition by the source country that

(a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis,

(b) taxation should not be so high as to discourage investment and

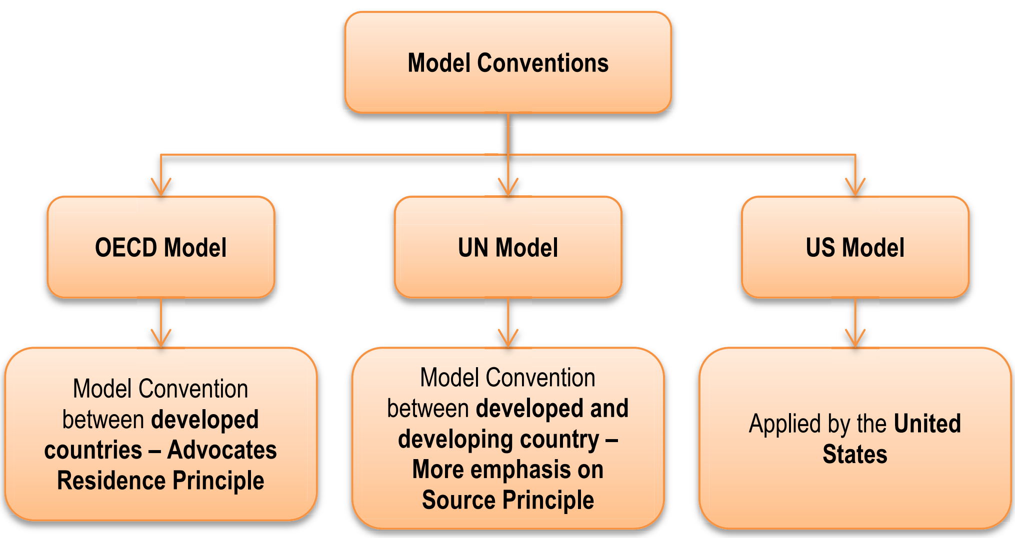
(c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital.

In addition, the United Nations MC embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either a foreign tax credit or an exemption, as is also the case with the OECD Model Convention.

US Model – This Model Convention is used by the United States while entering into tax treaties with various countries. The US Model Convention was last revised in 2016.

These Models have a significant influence on international treaty practice, and have important common provisions. The similarities between these Models highlight the areas of consistency. The areas of divergence indicate some critical differences in approach or emphasis which need special focus. These differences are mainly in relation to the taxing rights which would be available to a country under domestic law and the extent to which any country should forego, under a bilateral tax treaty, in order to avoid double taxation and encourage investment.

The above model conventions have been illustrated in the following diagram:



OECD Model contains VII chapters comprising of 32 articles and UN Model also contains VII chapters but comprising of 31 articles. List of articles of OECD MC and UN MC is given below:

Article	OECD Model, 2017	UN Model, 2021
	Chapter I : Scope of the Convention	
1	Persons covered	Persons covered
2	Taxes covered	Taxes covered
	Chapter II : Definitions	
3	General definitions	General definitions
4	Resident	Resident
5	Permanent establishment	Permanent establishment
	Chapter III : Taxation of Income	
6	Income from immovable property	Income from immovable property
7	Business profits	Business profits
8	International shipping and air transport	International shipping and air transport (Alternatives A & B)
9	Associated enterprises	Associated enterprises
10	Dividends	Dividends
11	Interest	Interest
12	Royalties	Royalties
12A		Fees for technical services
12B		Income from automated digital services
13	Capital gains	Capital gains
14		Independent personal services
15	Income from employment	Dependent personal services
16	Directors' fees	Directors' fees and remuneration of top-level managerial officials
17	Entertainers and sportspersons	Artistes and sportspersons
18	Pensions	Pensions and social security payments (Alternatives A & B)
19	Government service	Government service
20	Students	Students
21	Other income	Other income

	Chapter IV : Taxation of Capital	
22	Capital	Capital
	Chapter V : Methods for the Elimination of Double Taxation	
23A	Exemption method	Exemption method
23B	Credit method	Credit method
	Chapter VI : Special Provisions	
24	Non-discrimination	Non-discrimination
25	Mutual agreement procedure	Mutual agreement procedure (Alternatives A & B)
26	Exchange of information	Exchange of information
27	Assistance in the collection of taxes	Assistance in the collection of taxes
28	Members of diplomatic missions and consular posts	Members of diplomatic missions and consular posts
29	Entitlement to benefits	Entitlement to benefits
30	Territorial extension	
	Chapter VII : Final Provisions	
31/30	Entry into force	Entry into force
32/31	Termination	Termination

Now, let us discuss the comparative analysis of some of the significant Articles in the Model Tax conventions

27.2 COMPARATIVE ANALYSIS OF SOME OF THE SIGNIFICANT ARTICLES OF OECD AND UN MODEL CONVENTIONS

Title and Preamble to the Model Conventions

The title of the UN Model Convention reads as follows:

"Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and capital and the prevention of tax avoidance and evasion"

There is a specific reference to "the prevention of tax avoidance and evasion" in the title to emphasize its significance in the Model Convention.

The Preamble to the UN Model Convention reads as follows:

"(State A) and (State B),

Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)"

The Title and Preamble to the OECD Model Convention is almost identical to that of the UN Model Convention. The only minor difference is the reference to "tax evasion and avoidance" in the place of "tax avoidance and evasion" in the Title and Preamble.

The Preamble clearly indicates that the UN and OECD Model Conventions do not intend to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion including through treaty shopping arrangements.

This language of the Preamble would help ensuring that the provisions of the Conventions are interpreted and applied to prevent abusive treaty shopping arrangements.

Significant Articles in the Model Conventions

Over the years, both Model Conventions have seen a lot of convergence and the language is identical in quite a few Articles. However, there are key differences in approach and language in some Articles which will be the focus of our discussion, in the section below.

The jurisdiction or country of residence of the taxpayer is referred to as the Residence State and the jurisdiction or country where the source of income is located is referred to as the Source State.

Article 1: Persons Covered

The OECD and UN Model Convention would apply to persons who are residents of one or both of the Contracting States.

For the purposes of these Conventions, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State. However, the same would be treated as income only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

Example

State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company, and taxes that entity on interest that it *receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership, and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.*

***Note** – The above example forms part of the Commentary to the UN Model Tax Convention.*

With the exception of benefits granted under certain Articles of these conventions, these Conventions would not affect the taxation, by a Contracting State, of its resident.

Article 1 of UN Model Convention covers provision dealing with the application of the Convention to "Collective investment vehicles". Funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established are referred to as "collective investment vehicles" (CIVs) like REITs.

These funds adopt different legal structures and may be set up, for instance, as companies, partnerships, trusts or contractual arrangements that create a joint ownership. It is to ensure that investing through a domestic CIV should result in a tax burden that is equal to the one that applies in the case of a direct investment, i.e. an investment where the CIV would not exist and where the investor in the CIV would have acquired directly its share of the assets held by the CIV.

Article 2: Taxes Covered

The OECD and UN Conventions would apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

Taxes on income and on capital cover all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

The existing taxes to which the Conventions would apply in case of each Contracting State are specifically to be mentioned.

The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.

Article 4: Residence

A taxpayer has to demonstrate that he is a resident of one or both Contracting States to be able to gain access to a tax treaty and avail the benefits thereunder.

The concept of 'resident of a Contracting State' has various functions and assumes significance in the following three scenarios:

- In determining a convention's scope of application;
- In solving cases where double taxation arises as a consequence of double residence;
- In solving cases where double taxation arises as a consequence of taxation in the state of residence and also in the state of source of income.

As per paragraph 1 of the UN Model Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of ***that person's*** domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof ***as well as a recognized pension fund of that State.*** This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

Paragraph 1 of the OECD Model Convention is worded on similar lines. However, it does not contain reference to place of incorporation ***and does not include recognized pension fund***.

Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then, his status shall be determined as follows:

(a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

As per paragraph 3 of this Article, where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement, the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention. They shall do so having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such mutual agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

The situation of dual residence may arise in case of companies in case where one Contracting State attaches importance to the place of incorporation and the other State to the place of effective management. The tie-breaker rule traditionally has been 'place of effective management'. Even India has used place of effective management in some of its treaties. In the latest update by OECD and UN, this has changed to a case by case approach considering the number of tax avoidance cases involving dual resident companies. Determination under the case by case approach will be requested by the concerned taxpayer through Article 25 (Mutual Agreement Procedure). Competent authorities will then rely on a range of factors to resolve the question of dual residency.

The last sentence of paragraph 3 of this Article provides that in the absence of determination by the competent authorities, the dual resident person would not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person.

Article 5: Permanent Establishment

The concept of "Permanent Establishment" (PE), defined in Article 5, has considerable importance as business profits (Article 7) of an enterprise cannot be taxed by a Source State unless it proves the existence of a PE.

The comparable term to PE under the Indian tax law is "business connection" [Section 9(1)(i)]. Generally speaking, the concept of "business connection" is wider than PE and hence, a business connection may exist even without a PE, but the absence of a "business connection" may indicate absence of a PE.

As the PE concept gives the Source State the right to tax, it is an important Article for developing countries. Hence, the UN Model Convention varies from the OECD Model Convention in the following respects:

- As per Article 5(3)(a) of the OECD Model Convention, a building site or construction or installation project constitutes a PE if it lasts more than twelve months. The UN Model Convention is wider as it covers "assembly or installation project" or "supervisory" activities in connection thereto and requires the activity in question to continue only for six months for constituting a PE.

- Article 5(3)(b) of the UN Model makes a specific reference to Service PE which is absent in the OECD Model. Article 5(3)(b) of the UN Model reads as follows –

  "The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the fiscal year concerned".

  In the absence of a Service PE reference in OECD Model, the presence has to be ascertained through general principles under Article 5(1).

- Article 5(1) states the "basic rule" for a PE and expresses the primary meaning of PE. The definition of PE in Article 5 does not use the qualifying words "unless the context otherwise requires". As such, the definition needs to be followed in all cases unless specifically excluded.

  Paraphrasing Article 5(1), a PE exists if the following conditions are satisfied cumulatively:

  - There is an "enterprise".
  - Such enterprise is carrying on a "business";
  - There is a "place of business";
  - Such place of business is at the disposal of the enterprise (may be owned/rented but must be one which the enterprise has the effective power to use);
  - The place of business is "fixed", that is, it must be established at a distinct place with a certain degree of permanence

The business of the enterprise is carried on wholly or partially through this fixed place of business.

A PE does not exist unless all the aforesaid conditions are satisfied.

- As per Article 5(2), the term "permanent establishment" includes especially:

  a) a place of management;

  b) a branch;

  c) an office;

  d) a factory;

  e) a workshop, and

  f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

- Agency PE under OECD and UN Models targets activities done by a dependent agent of the enterprise in the Source State. The definition of dependent agent PE includes instances when an agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts routinely concluded without material modification by the enterprise.

  In UN Model Convention, PE is constituted even if the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State, a stock of goods or merchandise from which that person regularly deliver goods or merchandise on behalf of that enterprise.

- The UN Model Convention has an additional Article 5(6) relating to insurance which is absent in OECD Model.

  As per this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person.

  In the absence of similar Article in the OECD Model, a PE of an insurance enterprise has to be determined in accordance with provisions of Article 5(1) or 5(2) of the OECD model.

Article 7: Business Profits

Business profits of an enterprise can only be taxed by the Residence State. Right of Source State to tax business profits of an enterprise only exists if a PE exists in its jurisdiction.

As per the approach under the OECD Model Convention, once a PE is proven, the Source State can tax only such profits as are attributable to the PE. The UN Model Convention amplifies this attribution principle by a **limited** Force of Attraction rule (FOA).

The FOA rule implies that when a foreign enterprise sets up a PE in State of Source, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that profits that the enterprise derives from State of Source, whether through the PE or not, can be taxed by it (State of Source).

As per Article 7 of the UN Model Convention, if the enterprise carries on business in the other Contracting State through a PE, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:

(a) that PE;

(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE; or

(c) other business activities carried on in that other State of the same or similar kind as those effected through that PE.

Article 11: Interest

Paragraph 1 of this Article provides the right to Residence State to tax interest. Paragraph 2, however, also confers right to the Source State to tax interest. Generally, the interest is taxed in the Source State at a given rate on gross basis. However, if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged cannot exceed a specified percentage of the gross amount of the interest. The OECD Model specifies the percentage as 10%, but the UN Model leaves this percentage to be established through bilateral negotiations.

It may be noted that the definition of interest in both the models viz. OECD and UN Model is similar in that it essentially means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment are not regarded as interest for the purpose of this Article.

Article 12: Royalties

This Article provides the right of Contracting States to tax income from royalty.

Key differences between the two Models are as follows:

- As per the OECD Model, royalties arising in the Source State and beneficially owned by a resident of the Residence State are taxable only in the Residence State. However, the UN Model provides that royalties may be taxed in the Residence State. Hence, the UN Model departs from the principle of exclusive right to tax provided to Residence State in the OECD Model. Thus, under the UN Model, the Source State may also tax royalties. However, if the beneficial owner is a resident of the Residence State, the tax charged by the Source State cannot exceed the specified percentage of the gross amount of royalties. This specified percentage is to be established through bilateral negotiations.
- The term "royalties" as per UN Model Convention 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, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.
- The definition of 'royalties' under the OECD Model does not include the following: (a) rentals for films or tapes used for radio or television broadcasting and (b) equipment rentals like rentals for industrial, commercial or scientific equipment.

Article 12A: Fees for Technical Services

India is the pioneer of the FTS concept which was added to the Income-tax Act, 1961 since 1976. Some of our tax treaties do contain a specific provision for FTS.

The UN Model has a specific article pertaining to Fees for Technical Services (FTS). There is no specific reference to FTS in the OECD Model.

Paragraph 1 of Article 12A provides that the FTS may be taxed in the Residence State but does not provide that the FTS is exclusively taxable in the Residence State.

Paragraph 2 establishes the right of the country in which FTS arises to tax in accordance with its domestic law, subject to the limitation on the maximum rate of tax on gross amount of the fees, if the beneficial owner is a resident of the other Contracting State. The maximum rate of tax is to be established through bilateral negotiations.

FTS is defined as payments for managerial, technical or consultancy services but excludes payment to an employee, payment for teaching in an educational institution or for teaching by an educational institution, payments by an individual for services for personal use. Management involves application of knowledge, skill or expertise in the control or administration of the conduct of a commercial enterprise or organization. Payments made to a consultant for advice related to the management of an enterprise (or of the business of an enterprise) would be FTS. Technical involves the application of specialized knowledge, skill or expertise with respect to a particular art, science, profession or occupation. Fees received for services provided by regulated professions such as law, accounting, architecture, medicine, engineering would constitute FTS. Services performed by other professionals, such as pharmacists, and scientists, etc. may constitute technical services if those services involve provision of specialized knowledge, skill and expertise. The ordinary meaning of "consultancy" involves the provision of advice or services of a specialized nature.

An example of FTS can be seen from the following facts: R Company is a financial institution resident in State R. R Company provides a wide variety of financial services to its customers, including acceptance of deposits, extension of credit, guarantees, foreign exchange, negotiable instruments. R Company's business is conducted primarily in State R, but it also has clients in other countries, including State S. State R and State S have a tax treaty which contains an article akin to Article 12A. Payments received for services provided by a financial institution would constitute FTS if the services involve use of knowledge, skill and expertise to provide research, analysis or advice to a specific client related to particular circumstances. This has to be distinguished from provision of non-specialized services such as payment and transmission services, debit and credit card services, etc., which do not involve the application of any specialized knowledge, skill and expertise on behalf of a particular client.

Article 12B: Income from Automated Digital Services

With the advent of modern means of telecommunications and the spread of digitalization, enterprises have the ability to effectively engage in substantial business activities in the market country (source jurisdiction) without a fixed place of business there, or to conclude contracts remotely through technological means with no involvement of individual employees or dependent agents.

Article 12B was added to the United Nations Model Tax Convention in its 2021 update to preserve the domestic law taxing rights for States from which payments for automated digital services are made. There is no article in the OECD Model corresponding to Article 12B.

Paragraph 1 of Article 12B provides that the income from automated digital services arising in a Contracting State, underlying payments for which made to a resident of other Contracting State, may be taxed in the Residence State. It does not, however, provide that the income from automated digital services is exclusively taxable in the Residence State.

Paragraph 2 establishes the right of the country in which income from automated digital services arises to tax in accordance with its domestic law. However, if the beneficial owner of the income is a resident of the Residence State, the tax charged by the Source State cannot exceed the specified percentage of the gross amount of payments underlying the income from automated digital services. This specified percentage is to be established through bilateral negotiations.

"Automated digital services" is defined in paragraph 5 to mean any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.

An important indicator of the concept of automated services is whether there is ability to scale up and provide the same type of services to new users with minimal human involvement. Once the service offering an automated digital service business is developed (such as a music catalogue or a social media platform), then, the business can provide that service to one user, or many more, on an automated basis with the same basic business processes. On the other hand, a non-automated digital service business would see a proportionate increase in the costs per unit in connection with providing the services to new customers.

Paragraph 6 lists examples of services that may constitute automated digital services. However, the provision is not self-standing; the requirements of paragraph 5 must also be met. Paragraph 6 simply provides an indication that an activity may constitute an automated digital service; it does not provide that an activity listed therein necessarily is an automated digital service. The following services are expressly mentioned in paragraph 6:

(a) online advertising services;

(b) supply of user data;

(c) online search engines;

(d) online intermediation platform services;

(e) social media platforms;

(f) digital content services;

(g) online gaming;

(h) cloud computing services; and

(i) standardized online teaching services.

The categories are not mutually exclusive; for example, a digital content service could be funded in whole or in part by online advertising.

Paragraph 7 provides that the provisions of Article 12B shall not apply if the payments underlying the income from automated digital services qualify as "royalty" or "fees for technical services" under Article 12 or Article 12A.

Article 13: Capital Gains

This is the most commonly used Article and it provides for the taxation of income arising from transfer of a capital asset, including transfer of shares. The right to tax income from capital gains may be exclusively with the Residence State, or shared between the Residence and Source States.

The Article does not specify what is a capital gain and how is to be computed, this being left to the applicable domestic law. The Article contains rules for taxation of gains made from alienation of different assets such as immovable property, immovable property forming part of a PE, ships and aircrafts, etc.

In respect of shares, both Models are identical. Rights are conferred to the Source State if more than 50 percent of the value of shares during the preceding 365 days is derived directly or indirectly from immovable property in such Source State. Otherwise, the Residence State would have the exclusive right to tax.

UN Model Convention allows a State to tax gains from the alienation of rights granted under the law of that State as long as these rights allow the use of resources that are naturally present in that State and that are under the jurisdiction of that State. This would cover, for example, the alienation of rights such as fishing quotas granted by the State; the right to fell timber in a forest; the right to extract water; the right to explore part of a territory of the State for oil, gas or minerals; the right to install wind or tidal stream turbines in part of the territory of the State as well as the right to use all or part of the radiofrequency spectrum in the State, including for cell phone purposes.

This provision does not cover rights granted contractually between private parties even if these rights are protected under the law of the State. Thus, the alienation of exclusive right to use know how in a given State would not be covered by the provision as that right granted by the owner of the know-how is not granted under the law of the State.

Both UN and OECD Model convention gives exclusive right to Residence State in case of gains from the alienation of any property other than covered in the other paragraphs of this Article.

Article 14: Independent Personal Services

Article 14 is only present in the UN Model. It was deleted from the OECD Model on 29-4-2000 on the basis of OECD Report (2000) on "Issues Related to Article 14 of the OECD Model Tax Convention". The Effect of deletion of Article 14 is that income derived from Professional Services etc., is now dealt with as 'Business Profits' (Article 7) under the OECD MC.

This Article deals with the taxation of income derived by a person for professional or specified services which are offered in the Source State through some presence. This article on Independent personal services in the UN Model reads as under:

(1) Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

 (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

 (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

(2) The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Thus, the Article covers independent activities involving professional skills rendered by individuals on a principal to principal basis. The meaning of the term "professional services" is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. It excludes industrial and commercial activities that are covered under the Article on Business Profits. Likewise, it also excludes professional services while in employment which are covered under the Article on Dependent Personal Services, e.g. a physician serving as a medical officer in a factory. Income of Artists, Athletes and Sportsmen, etc. is not covered by this Article. Also, income from Fees from Technical Services is also not covered.

Article 21: Other Income

This Article deals with taxation of items of income which are not specifically taxable under any other specific Article. Key differences are as under:

- OECD approach envisages that the exclusive right to tax is with the Residence State. UN Model contains an additional paragraph, Article 21(3), which provides that Source State may also tax other income.
- Article 21(2) of both OECD and UN Model provides that for income effectively connected with a PE maintained in a Contracting State by a resident of the other Contracting State, taxation is governed by the provisions of Article 7 (Business Profits). Additionally, UN Model provides that if the aforesaid income is effectively connected with a fixed base situated in a Contracting State by a resident of the other Contracting State, taxation would be governed by the provisions of Article 14 (Independent personal services).

Articles 23A & 23B : Elimination of Double Taxation

In many cases, the application of tax treaty may result into double taxation for tax payers. In such a case, in order to provide relief to such tax payers, Articles 23A and 23B which contains provisions relating to elimination of double taxation have to be applied. Articles 23A and 23B provide for the mechanism through which tax credit/exemption may be available in the Residence State for taxes deducted in the Source State.

The OECD and UN Model Conventions specify two approaches - Exemption method (Article 23A) and Credit method (Article 23B). Under the exemption method, tax exemption may be available in the Residence State. Under the credit method, tax credit may be available in the Residence State for taxes deducted in the Source State. These methods are not mutually exclusive and there may be cases where a treaty may adopt exemption method for certain types of income and credit method for other incomes.

The double taxation referred to here, is juridical double taxation, meaning the same income or capital is taxable in the hands of the same person by more than one State. It does not thus, encompass situations of economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

Article 25: Mutual Agreement Procedure

There may be a situation wherein a tax payer may believe that the treatment accorded by either or both Contracting States is not in accordance with the provisions of the tax treaty. In such a case, there is a need for dispute resolution which is addressed by this Article. This Article requires competent authorities of both countries to endeavor to resolve the conflict by engaging in bilateral negotiations.

The UN Model Convention provides two alternatives - Alternative A and Alternative B, for the article on Mutual Agreement Procedure which were introduced in 2011. Under OECD Model the taxpayer may make a request to either Contracting State while UN Model (Alternative A) contemplates taxpayer going to Residence State or the country of his nationality. Alternative B of UN Model Article 25 contemplates reference to an arbitration process as part of the Mutual Agreement Procedure. The decision arrived at, through the process is binding unless a person directly affected does not accept it.

Key differences between the OECD Model Convention (Article 25) and UN Model Convention (Article 25B - Alternative B) are as follows:

- Article 25B(5) of the UN Model provides that an arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case. However, Article 25(5) of the OECD Model provides a time limit of two years from the date when all the information required by the competent authorities in order to address the case need to be provided to both competent authorities.
- Article 25B(5) of the UN Model provides that arbitration must be requested by the competent authority of one of the Contracting States. Once such a request is made, the taxpayer will be notified. However, as per Article 25(5) of the OECD Model, arbitration must be requested in writing by the person who initiated the case.
- Article 25B(5) of the UN Model allows the competent authorities to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them.

Article 26: Exchange of Information

In order to complete tax cases, a country may require certain information which may be available with the treaty partner. Article 26 provides for the information which may be exchanged and the manner in which such a request has to be made. The purpose of Article 26 is to facilitate effective exchange of information between Contracting States. From the perspective of many developing countries, Article 26 is particularly important not only for curtailing cross-border tax evasion and avoidance, but also to curtail the capital flight that is often accomplished through such evasion and avoidance.

The OECD and UN Model Conventions are similar with respect to this Article. A Contracting State cannot be expected to provide confidential financial information to another Contracting State unless it has confidence that the information will not be disclosed to unauthorized persons. A Contracting State can avoid the exchange of information obligations by showing that the information pertains to communication between an attorney and his client which is protected from disclosure under domestic law. However, lack of interest or use in such information cannot form the basis for a Contracting State to not co-operate with the exchange of information obligations.

Resources: The discussion on Model Tax Conventions in the above chapter is essentially based on the text and commentaries of the OECD Model Tax Convention, 2017 and UN Model Tax Convention, 2021 available at the websites http://www.oecd.org/tax/treaties/ and http://www.un.org, respectively.

SUMMARY

<table>
<tr><th colspan="2">Article</th><th>OECD MC vis-à-vis UN MC
Common paras & Significant differences</th></tr>
<tr><td colspan="3">Chapter I : Scope of the Convention</td></tr>
<tr><td>1</td><td>Persons covered</td><td>Resident of CS - For application of treaty, a person has to be a resident of one or both of the Contracting States (CSs).
Fiscally transparent entity - Income derived by or through a fiscally transparent entity under the tax law of either CS to be considered to be income of a resident of a CS, to the extent such income is treated, for purposes of taxation by that State, as the income of a resident of that State.
Collective investment vehicles - Provision dealing with the application of the UN Model Convention to “Collective investment vehicles.</td></tr>
<tr><td>2</td><td>Taxes covered</td><td>Taxes on income and capital - The MCs apply to taxes on income and on capital imposed on behalf of a CS or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
Coverage of taxes - Taxes on income and on capital covers:
<table>
<tr><th>Taxes imposed</th><th>Taxes included</th></tr>
<tr><td rowspan="3">On total income
on total capital
on elements of income or of capital</td><td>taxes on gains from alienation of movable or immovable property</td></tr>
<tr><td>taxes on total amounts of wages or salaries paid by enterprises</td></tr>
<tr><td>taxes on capital appreciation</td></tr>
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<tr><th colspan="3">Chapter II : Definitions</th></tr>
<tr>
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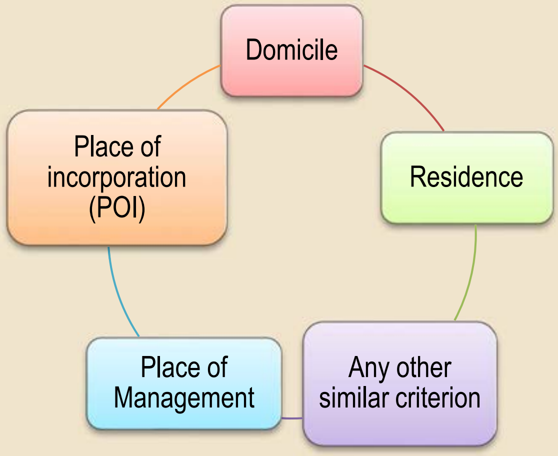
<td>Resident</td>
<td>

Resident of either CS - A taxpayer has to demonstrate that he is a resident of one or both CSs to be able to gain access to a tax treaty and avail benefits thereunder.
Meaning of “Resident of a Contracting State”- Any person who, under the laws of that State, is liable to tax therein by reason of that person’s:



This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
Note - OECD MC does not contain reference to place of incorporation

Tie-breaker Rule

<u>In case of individuals</u>
Where an individual is a resident of both CSs as per domestic tax laws of that CS, then, his residential status shall be determined by applying the tie-breaker rule in the following sequence:
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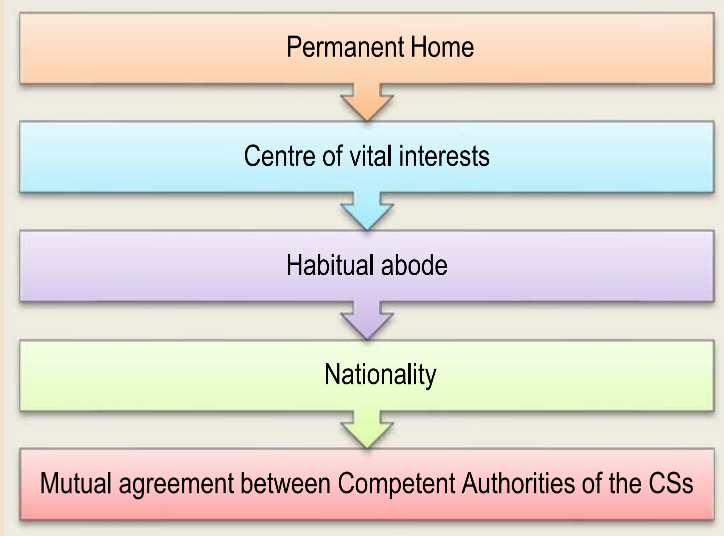
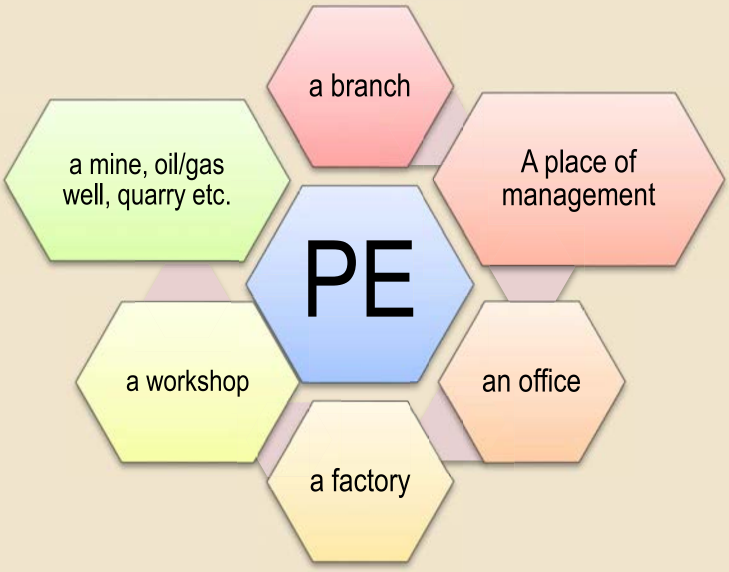
		 **<u>In case of companies</u>** • Dual residence arises where one CS attaches importance to POI and the other CS to the POEM. • The tie-breaker test involves a case by case approach considering the no. of tax avoidance cases involving dual resident Cos. • Request has to be made by the tax payer through Article 25 (MAP). • Competent Authorities will rely on range of factors to resolve the question of dual residency.
5	**Permanent establish-ment (PE)**	**Meaning of PE [Article 5(1)]** • There should be an "**enterprise**" (Entr). • Such Entr should be carrying on a "**business**"; • There should be a "**place of business** (POB)"; • Such place of business (POB) should be at the **disposal of the Entr** (may be owned / rented but must be one which the Entr has the effective power to use); • The POB should be "fixed", i.e., it must be established at a distinct place with a certain **degree of permanence** • The business of the enterprise is carried on wholly or partially through this fixed POB. A PE does not exist unless all the aforesaid conditions are satisfied.

Specific inclusions in the meaning of PE [Article 5(2)]



Expansion of scope of Agency PE

- Agency PE targets activities done by a dependent agent (DA) of the Entr in the Source State (SS).
- DAPE now includes instances when an agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts routinely concluded without material modification by the enterprise.
- In UN Model Convention, PE is constituted even if the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State, a stock of goods or merchandise from which that person regularly deliver goods or merchandise on behalf of that enterprise.

PE of an Insurance Enterprise

UN MC	OECD MC
UN MC has an additional Article 5(6) relating to insurance. An insurance Entr of a CS is deemed to have a PE in the other CS if it collects premiums in the territory of that other CS or insures risks situated therein through a person.	In the absence of similar Article in the OECD MC, a PE of an insurance Entr is to be determined in accord with Article 5(1) or 5(2).

<table>
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Right of CS to tax business profits (BPs)
<table>
<tr><th>OECD MC</th><th>UN MC</th></tr>
<tr><td colspan="2">BPs of an Entr can only be taxed by the Residence State (RS). Right of Source State (SS) to tax BPs of an enterprise only exists if a PE exists in its jurisdiction.</td></tr>
<tr><td rowspan="2">Once a PE is proven, the SS can tax only such profits as are attributable to the PE</td><td>

The attribution principle is amplified by a <u>limited</u> Force of Attraction rule (FOA).
The FOA rule implies that when a foreign enterprise sets up a PE in SS, it brings itself within the fiscal jurisdiction of that State to such a degree that profits that the Entr derives therefrom, whether through the PE or not, can be taxed by it (i.e., the SS).

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Accordingly, if the Entr carries on business in the other CS through a PE, the profits of the Entr may be taxed in the other CS but only so much of them as is attributable to:
(a) that PE;
(b) sales in that other CS of goods or merchandise of the same or similar kind as those sold through that PE; or
(c) other business activities carried on in that other State of the same or similar kind as those effected through that PE.

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Right of CSs to tax interest
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<tr><td>2</td><td>Confers right to the SS to tax interest.
Generally, interest is taxed in the SS at a given rate on gross basis.
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The specified % as per OECD MC is 10%, but the UN MC leaves this % to be established through bilateral negotiations.</td></tr>
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Definition of interest in OECD & UN MCs - Interest means income from debt claims of every kind,
whether or not secured by mortgage and
whether or not carrying a right to participate in the debtor’s profits.
Specific inclusions in the definition of interest as per OECD & UN MCs
income from govt securities
income from bonds or debentures
premiums and prizes attaching to such securities, bonds or debentures.
Note - Interest does not include penalty charges for late payment.
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<tr><td>12</td><td>Royalties
(Roy)</td><td>
<table>
<tr><th></th><th>OECD MC</th><th>UN MC</th></tr>
<tr><td>Right of CS to tax Roy. income</td><td>Roy. arising in SS and beneficially owned by resident of the RS is taxable only in RS. Thus, RS has exclusive right to tax royalty income.</td><td>Roy may also be taxed in the SS. However, if the beneficial owner is a resident of the RS, the tax charged by SS ≤ the specified %, (to be established through bilateral negotiations) of gross royalty.</td></tr>
<tr><td>Definition of Roy</td><td>Definition of Royalty does not include:
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(b) rentals for industrial, commercial or scientific equipment.</td><td>Royalty includes:
(a) rentals for films or tapes used for radio or TV broadcasting and
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<tr><td>12A</td><td>FTS</td><td>
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Right of CS to tax FTS [UN Model]
<table>
<tr><th>Para of Article</th><th>Right of CS to tax FTS</th></tr>
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<tr><td>2</td><td>Establishes the right of the SS to tax FTS in accordance with its domestic law, subject to limitation on the max. rate of tax on gross amount of fees, to be established through bilateral negotiations, if the beneficial owner is a resident of the other CS.</td></tr>
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Meaning of FTS [UN Model]
<table>
<tr><td colspan="2">FTS means payments for managerial, technical or consultancy services</td></tr>
<tr><td colspan="2"><u>Exclusions from the meaning of FTS</u>:</td></tr>
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</td></tr>
<tr><td>12B</td><td>Income from Automated Digital Services</td><td>
Article 12B was added to the United Nations Model Tax Convention in its 2021 update to preserve the domestic law taxing rights for States from which payments for automated digital services are made. There is no article in the OECD MC corresponding to Article 12B.
Right of CS to tax income from automated digital [UN Model]
<table>
<tr><th>Para of Article</th><th>Right of CS to tax income from automated digital services</th></tr>
<tr><td>1</td><td>Confers right to the RS to tax income from automated digital services arising in a CS. However, does not state that FTS is exclusively taxable in the RS.</td></tr>
<tr><td>2</td><td>Establishes the right of the SS to tax income from automated digital services in accordance with its domestic law, subject to the specified percentage of the gross amount of payments underlying the income from automated digital services, to be established through bilateral negotiations, if the beneficial owner is a resident of the other CS.</td></tr>
</table>
Meaning of Automated digital services [UN Model]
<table>
<tr><td colspan="2">Automated digital services any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.</td></tr>
<tr><td colspan="2"><u>Specific inclusions</u>:</td></tr>
<tr><td>i</td><td>online advertising services</td></tr>
<tr><td>ii</td><td>supply of user data</td></tr>
</table>
</td></tr>
</table>

		iii online search engines iv online intermediation platform services v social media platforms vi digital content services vii online gaming viii cloud computing services ix standardized online teaching services
13	**Capital gains**	This Article provides for the taxation of income arising from transfer of a capital asset, including transfer of shares. **Right of CS to tax income from Capital Gains** • The right to tax capital gains may be exclusively with the RS, or shared between the RS and SS. • The Article does not specify what is a capital gain and how is to be computed, this being left to the applicable domestic law. • The Article contains rules for taxation of gains from alienation of different assets such as immovable property, immovable property forming part of a PE, ships & aircrafts, etc. • In respect of shares, OECD and UN MCs are identical. Rights are conferred to the SS if more than 50% of the value of shares during the preceding 365 days is derived directly or indirectly from immovable property in such SS. Otherwise, the Residence State would have the exclusive right to tax. • UN MC allows a State to tax gains from the alienation of rights granted under the law of that State as long as these rights allow the use of resources that are naturally present in that State and that are under the jurisdiction of that State. • Both UN and OECD Model convention gives exclusive right to Residence State in case of gains from the alienation of any property other than covered in the other paragraphs of this Article.
14	**Indepen-dent personal services**	This Article present only in the UN MC deals with the taxation of income derived by a person for professional or specified services which are offered in the SS through some presence. **Right of CS to tax income from professional services (IPS) [UN MC]** **Right of RS**: **Income derived by a resident of a CS in respect of professional services or other activities of an independent character is taxable only in the RS.** **Right of SS**: In the following circumstances, however, IPS may also be taxed in the other CS (i.e., the SS):

<table>
<tr>
<td></td>
<td></td>
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<table>
<tr><th></th><th>Circumstance</th><th>Extent of income taxable in SS</th></tr>
<tr><td></td><td>If he has a fixed base regularly available to him in the SS for the purpose of performing his activities</td><td>Only so much of the income as is attributable to that fixed base may be taxed in the SS.</td></tr>
<tr><td></td><td>If his stay in the SS is for a period > 183 days in any 12 month period commencing or ending in the fiscal year concerned</td><td>Only so much of the income as is derived from his activities performed in the SS may be taxed in that State</td></tr>
</table>
Definition of “Professional Services” [UN MC]
The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.
Note – OECD MC does not contain a separate article on IPS. The same is dealt with as “Business Profits (Article 7)” under the OECD MC.
</td>
</tr>
<tr>
<td>21</td>
<td>Other income (OI)</td>
<td>
This Article deals with taxation of items of income which are not specifically taxable under any other specific Article [i.e., upto Article 20].
<table>
<tr><th></th><th>OECD MC</th><th>UN MC</th></tr>
<tr><td>Right to tax OI</td><td>Exclusive right to tax is with the RS.</td><td>Contains an additional para, Article 21(3), which provides that SS may also tax other income.</td></tr>
<tr><td rowspan="2">Right to tax income [other than income from immovable property] effectively connected with PE</td><td colspan="2">Article 21(2) of both OECD and UN MC provides that for income effectively connected with a PE maintained in a CS by a resident of the other CS, taxation is governed by the provisions of Article 7 (Business Profits).</td></tr>
<tr><td></td><td>Additionally, UN Model provides that if the aforesaid income is effectively connected with a fixed base situated in a CS by a resident of the other CS, taxation would be governed by the provisions of Article 14 (IPS).</td></tr>
</table>
</td>
</tr>
<tr>
<td colspan="3">Chapter V : Methods for the Elimination of Double Taxation</td>
</tr>
<tr>
<td>23A/ 23B</td>
<td>Exemption method/</td>
<td>In many cases, the application of tax treaty may result into double taxation (DT) for tax payers. In such a case, Articles 23A and 23B provide for the</td>
</tr>
</table>

	Credit Method	mechanism through which tax credit/exemption may be available in the RS for taxes deducted in the SS.

Two approaches for elimination of DT under MCs:

Exemption method (Article 23A)	Credit method (Article 23B)
Tax exemption may be available in the RS for taxes deducted in the SS.	Tax credit may be available in the RS for taxes deducted in the SS.

These methods are not mutually exclusive and there may be cases where a treaty may adopt exemption method for certain types of income and credit method for other incomes.

Juridical DT and Economic DT:

	Juridical DT	Economic DT
Meaning	The same income or capital is taxable in the hands of the same person by more than one State	Two different persons are taxable in respect of the same income or capital
Example	FTS may be taxable in the hands of the recipient both in the RS as well as in SS, based on the domestic laws of the CSs.	In respect of dividend distributed by a Co., DDT may be payable by the Co. in SS, whereas the dividend may be taxable in the hands of the shareholder of the other CS, on the basis of his residence.
Type of DT addressed by Article 23A & 23B	Articles 23A & 23B address Juridical DT.	The Articles do not address Economic DT. If two States wish to solve problems of economic DT, they must do so in bilateral negotiations.

Chapter VI : Special Provisions

25	**Mutual agreement procedure (MAP)**	Where a tax payer believes that the treatment accorded by either or both CSs is not in accordance with the provisions of the tax treaty, this Article provides for dispute resolution through bilateral negotiations between competent authorities (CAS) of both CSs.

	OECD MC	UN MC
Request for MAP	The taxpayer may make a request to either CS	**Alternative A** - Taxpayer has to approach RS or the country of his nationality **Alternative B** - Reference to an arbitration process as part of MAP. The decision arrived at

<table>
<tr><td rowspan="4"></td><td rowspan="4"></td><td></td><td></td><td>through the process is binding unless a person directly affected does not accept it.</td></tr>
<tr><td>Time limit</td><td>Stipulates a time limit of 2 years from the date when all the information required by the CAS in order to address the case need to be provided to both CAS.</td><td>An arbitration may be initiated if the competent authorities (CAS) are unable to reach an agreement on a case within 3 years from presentation of that case [Alternative B]</td></tr>
<tr><td>Who can request for Arbitration?</td><td>Arbitration must be requested in writing by the person who initiated the case</td><td>Arbitration must be requested by the CAS of one of the CS. Once such a request is made, the taxpayer will be notified [Alternative B]</td></tr>
<tr><td>Departure from arbitration by CAS</td><td>No specific provision for departure from arbitration.</td><td>The CAS may depart from the arbitration decision if they agree to do so within 6 months after the decision has been communicated to them [Alternative B]</td></tr>
<tr><td>26</td><td>Exchange of information (EOI)</td><td colspan="3">
Purpose of Article 26
In order to complete tax cases, a country may require certain info which may be available with the treaty partner.
Article 26 provides for:
• the info which may be exchanged
• the manner in which such a request has to be made.
Importance of Article 26:
• facilitates effective exchange of information between CSs.
• curtails cross-border tax evasion and avoidance,
• curtails the capital flight that is often accomplished through tax evasion & avoidance. This is particularly relevant in the perspective of developing countries.
Similar provisions contained in OECD and UN MCs
• A CS cannot be expected to provide confidential financial info to another CS unless it has confidence that the info will not be disclosed to unauthorized persons.
• A CS can avoid the EOI obligations by showing that the info pertains to communication between an attorney and his client which is protected from disclosure under domestic law.
• Lack of interest or use in such info cannot, however, form the basis for a CS to not co-operate with the EOI obligations.
</td></tr>
</table>

TEST YOUR KNOWLEDGE

Questions

1. *Explain briefly the significant difference between the UN and OECD Model Tax Convention.*

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

3. *Explain the meaning of "interest" and "fees for technical services" under the UN Model Convention.*

4. *What is the meaning of Automated Digital Services? Elucidate.*

5. *What are the payments covered within the scope of "Royalties" under the UN Model Convention and OECD Model Convention. Elucidate.*

Answers

1. OECD Model is essentially a model treaty between two developed nations whereas UN Model is a model convention between a developed country and a developing country.

Further, OECD Model advocates the residence principle, 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 principle and residence principle, giving more weight to the source principle as against the residence principle.

2. 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, relief should be sought from Article 4 of the Tax Treaty. A series of tie-breaker rules are provided in Paragraph 2 Article 4 of 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**. 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.

(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, in other words, the place where lies **his 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) Paragraph (ii) establishes a secondary criterion for two quite distinct and different situations:

- The case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
- The case where the individual has a permanent home available to him in neither Contracting State.

In the aforesaid scenarios, 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.

3. As per Article 11 of the UN Model Convention, "Interest" essentially means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment are not regarded as interest for the purpose of this Article.

As per Article 12A of the UN Model Convention, "Fees for technical services" is defined as payments for managerial, technical or consultancy services but excludes payment to an employee, payment for teaching in an educational institution or for teaching by an educational institution, payments by an individual for services for personal use.

4. As per Article 12B of UN Model Convention, "Automated digital services" means any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.

The term "Automated digital services" includes specially:

(a) online advertising services;

(b) supply of user data;

(c) online search engines;

(d) online intermediation platform services;

(e) social media platforms;

(f) digital content services;

(g) online gaming;

(h) cloud computing services; and

(i) standardized online teaching services.

5. The term "royalties" as per UN Model Convention 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, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

The definition of 'royalties' under the OECD Model Convention does not include the following: (a) rentals for films or tapes used for radio or television broadcasting and (b) equipment rentals like rentals for industrial, commercial or scientific equipment.

NOTES

CHAPTER 28

LATEST DEVELOPMENTS IN INTERNATIONAL TAXATION

LEARNING OUTCOMES

After studying this chapter, you would be aware of the -

- latest developments in OECD/G20 BEPS Project
- two Pillar approach to address tax challenges out of digitalization
- key highlights of Pillar One and Pillar Two of BEPS 2.0

28.1 BRIEF BACKGROUND OF BEPS

What is BEPS?

Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax. Developing countries' higher reliance on corporate income tax means they suffer from BEPS disproportionately.

The report Addressing Base Erosion and Profit Shifting (OECD[1], 2013) concluded that no single tax rule on its own enables BEPS, it is rather the interplay among different issues that makes it possible. Domestic laws and rules that are not coordinated across borders, international tax standards that have not always kept pace with the changing global business environment and a pervasive lack of relevant information at the level of tax administrations and policymakers combine to provide opportunities for taxpayers to undertake BEPS strategies. The availability of harmful tax practices was also identified as a key pressure area.

Out of a shared desire to address BEPS concerns, there is agreement on a comprehensive package of measures which are designed to be implemented domestically and through treaty provisions in a coordinated manner, supported by targeted monitoring and strengthened transparency. The goal is to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms.

Thus, in 2015, under the OECD/G20 BEPS Project, 15 Actions Plans were delivered to tackle tax avoidance, improve the coherence of international tax rules, and ensure a more transparent tax environment (BEPS package).

ACTION-1 Addressing the tax challenges of the digital economy	**ACTION-2** Neutralise the effects of hybrid mismatch arrangements	**ACTION-3** Strengthen CFC Rules	**ACTION-4** Interest deductions and other financial payments	**ACTION-5** Counter harmful tax practices
ACTION-6 Preventing treaty abuse	**ACTION-7** Prevent the artificial avoidance of PE status	**ACTION-8** Transfer pricing	**ACTION-9** Transfer pricing	**ACTION-10** Transfer pricing
ACTION-11 Measuring and monitoring BEPS	**ACTION-12** Disclosure of aggressive tax planning arrangements	**ACTION-13** Re-examine transfer pricing documentation	**ACTION-14** Making dispute resolution more effective	**ACTION-15** Developing a multilateral instrument

[1] Organisation for Economic Co-operation and Development (OECD)

Recognising all the progress made, including establishing a new OECD-G20 framework for more inclusive deliberations, it appears necessary to further deepen cooperation and focus on monitoring the implementation and effectiveness of the measures adopted in the context of the BEPS Project as well as the impact on both compliance by taxpayers and proper implementation by tax administrations.

OECD and G20 countries agree to keep working on an equal footing to monitor the implementation of the BEPS measures. The monitoring will consist of an assessment of compliance in particular with the minimum standards in the form of reports on what countries have done to implement the BEPS recommendations.

28.2 ESTABLISHMENT OF INCLUSIVE FRAMEWORK (IF)

Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries. The strong interest expressed by developing countries through their participation in the BEPS Project should be sustained by the establishment of an even more inclusive framework, which will continue to include other international organisations and regional tax organisations.

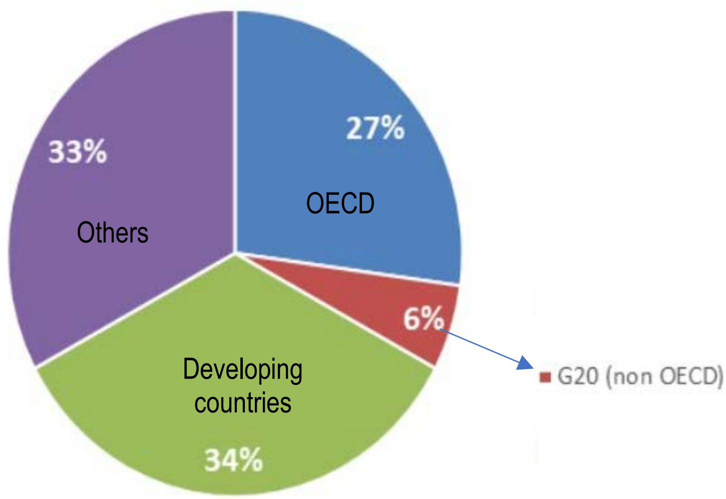
Drawing on the successful experience of the Global Forum on Transparency and Exchange of Information for Tax Purposes, in early 2016 OECD and G20 countries decided to work together to design and propose a more inclusive framework to support and monitor the implementation of the BEPS package, with countries and jurisdictions participating on an equal footing.

The idea was to include consideration of the manner in which non-OECD non-G20 countries and jurisdictions can commit to the agreed standards and their implementation. Thus, it was proposed to call on the OECD to prepare a framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions, particularly developing economies, on an equal footing.

Resultantly, in June 2016, at the request of the G20, **the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework)** was established in Kyoto, Japan with an initial membership of 89 countries and jurisdictions.

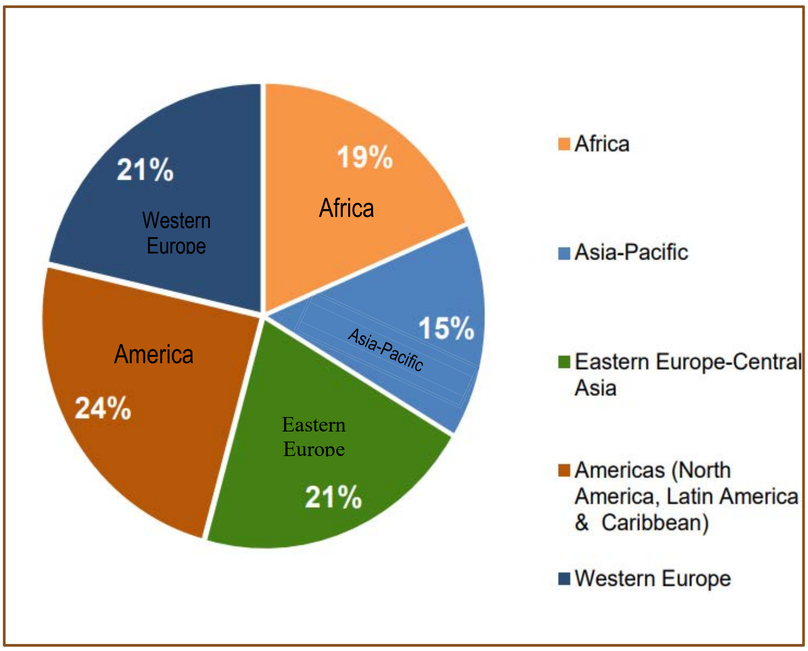
As of 9th June 2023, the Inclusive Framework includes 143 members, who, on an equal footing, monitor the implementation and contribute to the development of measures to combat BEPS, while reviewing and monitoring the implementation of the OECD/G20 BEPS Project.

143 Members of the Inclusive Framework



Source: OECD, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf

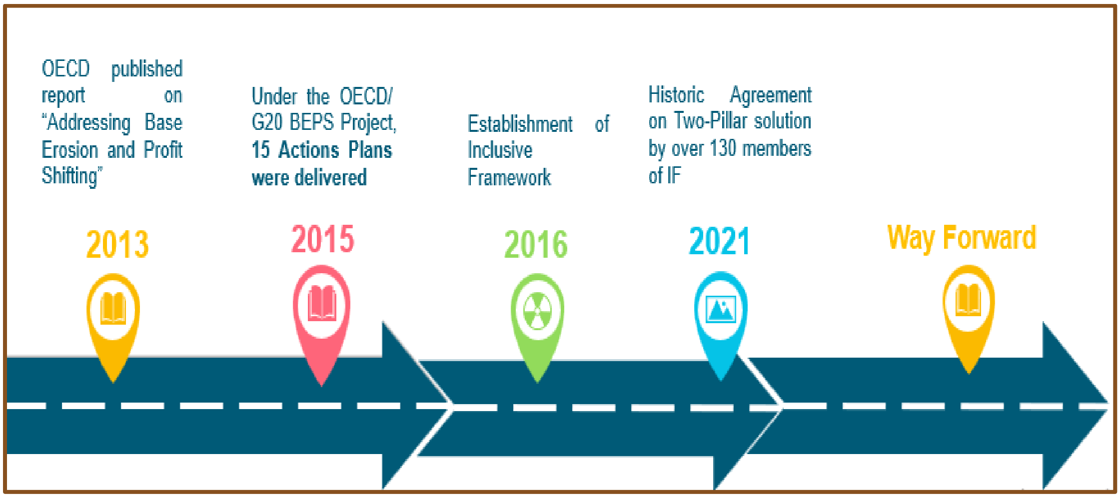
The Inclusive Framework also reflects a strong regional balance, with members from all geographic regions of the world.



Source: OECD, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pd

28.3 INTRODUCTION OF TWO-PILLAR SOLUTION (BEPS 2.0)

In July 2021, 134 members of the Inclusive Framework, representing more than 90% of worldwide GDP, reached a historic agreement on a two-pillar solution to address the tax challenges of digitalisation and introduce a global minimum tax on the profits of large multinational enterprises (MNEs).



The agreement provides for fundamental tax reforms updating key elements of the century-old international tax system and will help countries protect their tax bases.

137 countries and jurisdictions have joined the landmark agreement reached on the 8th of October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (Two-Pillar Solution or 2021 October Statement).

It represented a major step forward in the reform of the international tax system and the outcome of intensive work carried out under BEPS Action 1 "Addressing the tax challenges arising from the digital economy," which has been the top priority of the OECD/G20 Inclusive Framework.

Since the agreement on the 2021 October Statement, the OECD/G20 Inclusive Framework has moved to its implementation, with significant progress achieved. On Pillar Two, the Global Anti-Base Erosion (GloBE) Model Rules for the minimum tax were released in December 2021, followed by the related Commentary in March 2022. The release of the Model Rules and related Commentary enables Inclusive Framework members to begin implementing the rules.

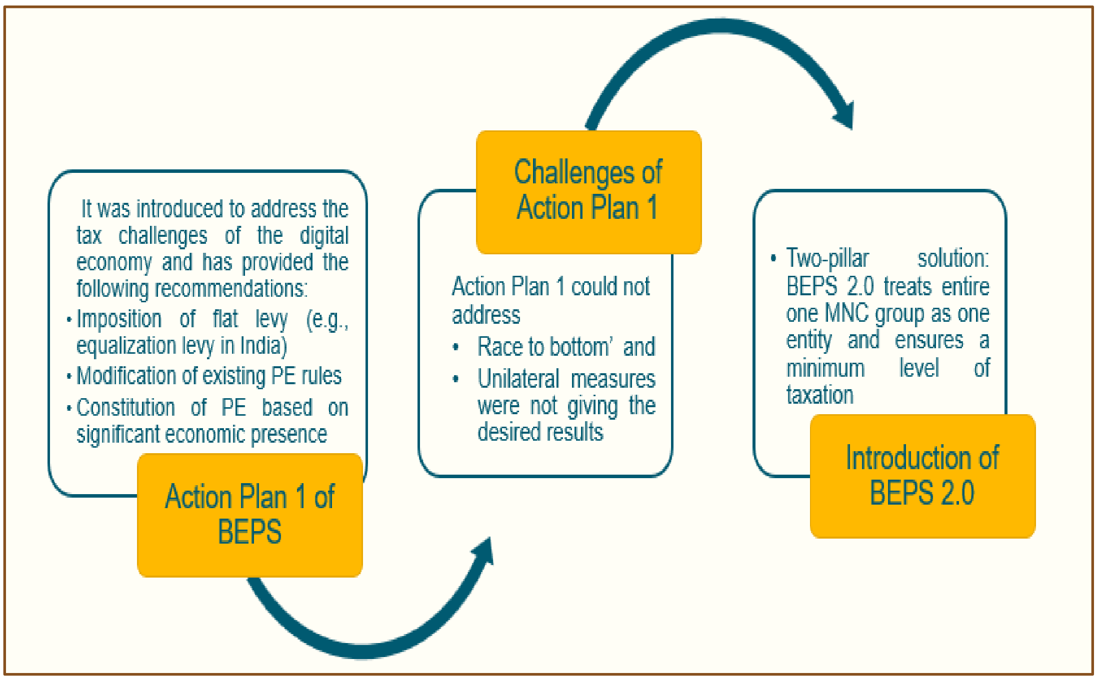
28.3.1 Overview

Digital transformation spurs innovation, generates efficiencies, and improves services while boosting more inclusive and sustainable growth and enhancing well-being. At the same time, the breadth and speed of this change introduce challenges in many policy areas, including taxation.

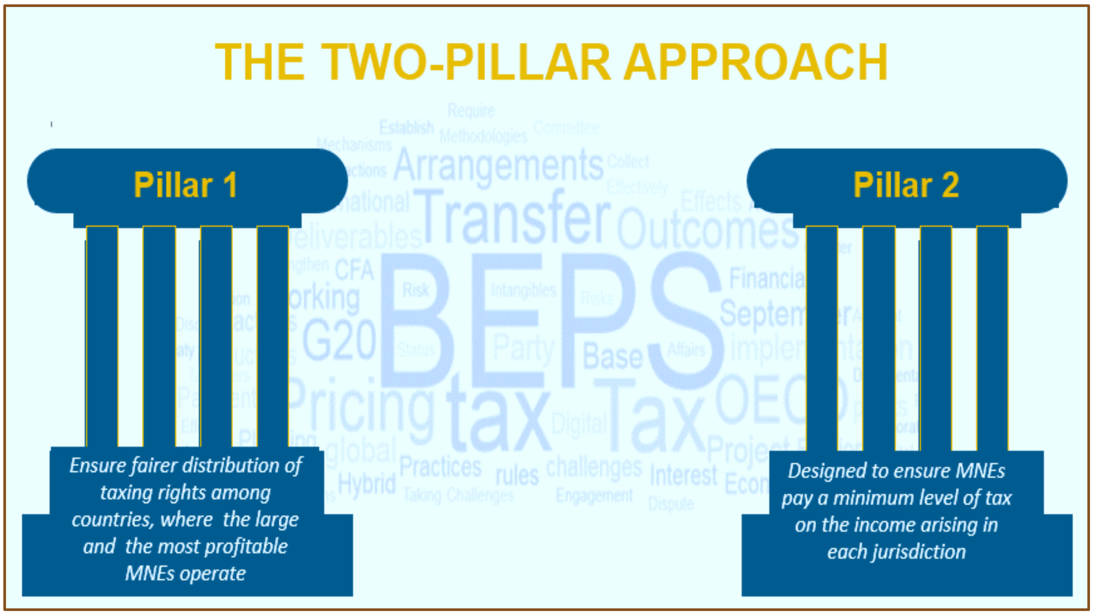
Reforming the international tax system to address the tax challenges arising from the digitalisation of the economy, restore stability to the international tax framework and prevent further uncoordinated unilateral tax measures has therefore been a priority of the international community for several years, with commitments to deliver a consensus-based solution.

These tax challenges were first identified as one of the main areas of focus of the OECD/G20 BEPS Project, leading to the 2015 BEPS Action 1 Report (the Action 1 Report) (OECD, 2015). The Action 1 Report found that the whole economy was digitalising and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy.

The 2015 Action 1 report provided the options to safeguard against BEPS on account of digitalisation, however, it did not provide any recommendations and left it to the discretion of the countries to resort to these measures as part of their domestic law. The report also indicated that it was agreed between the members to continue to monitor developments in respect of the digital economy.



Pursuant to this, the OECD Inclusive Framework on BEPS came up with a consensus-based solution for tax challenges arising out of digitalisation (commonly known as BEPS 2.0), framed within two complementary pillars, namely, **Pillar One and Pillar Two**.



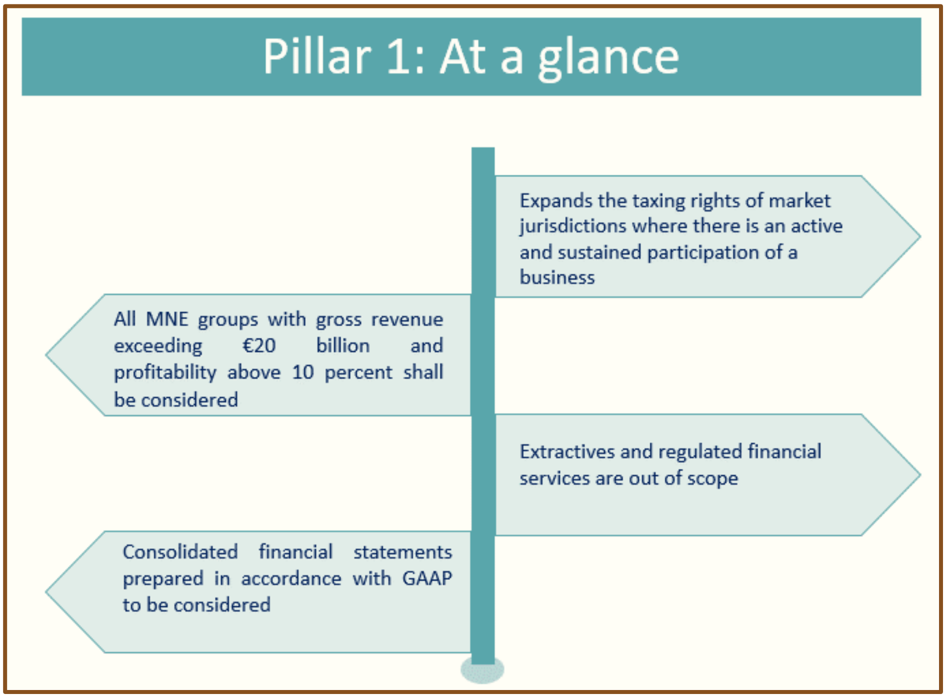
As already discussed above, 2021 October Statement was agreed upon by 137 countries and jurisdictions. The agreement demonstrates that developing countries can indeed play an active and influential role in international standard setting through their participation in the Inclusive Framework. This is not to say that the agreement reflects developing country preferences in all respects since all participants have recognised the need for compromise.

28.3.2 Pillar One

(1) Introduction

Pillar One is designed to deliver a sustainable taxation framework reflective of today's digitalising economy, with the potential to achieve a fairer and more efficient allocation of taxing rights.

It aims to ensure a fairer distribution of taxing rights among countries with respect to the largest and most profitable MNEs. It will reallocate taxing rights over a portion of the residual profits of MNEs to the market countries and jurisdictions where they have business activities, regardless of whether they have a physical presence there.

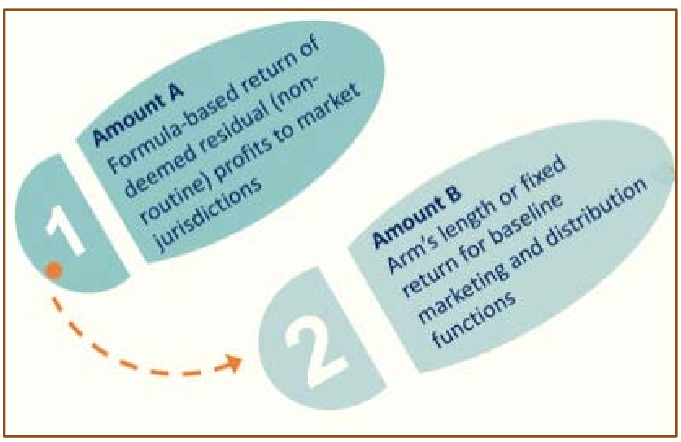


(2) Scope

In-scope companies are the MNEs with global turnover above 20 billion euros and profitability above 10% (i.e., profit before tax/revenue).

Extractives and regulated financial services are out of the scope of Pillar 1.

Under Pillar 1, an MNE is treated as a consolidated entity, and taxing rights are allocated on some predetermined formulas and assumptions which are briefly discussed in this chapter. These are primarily classified into two parts, Amount A and Amount B.



(3) Amount 'A' and Amount 'B'

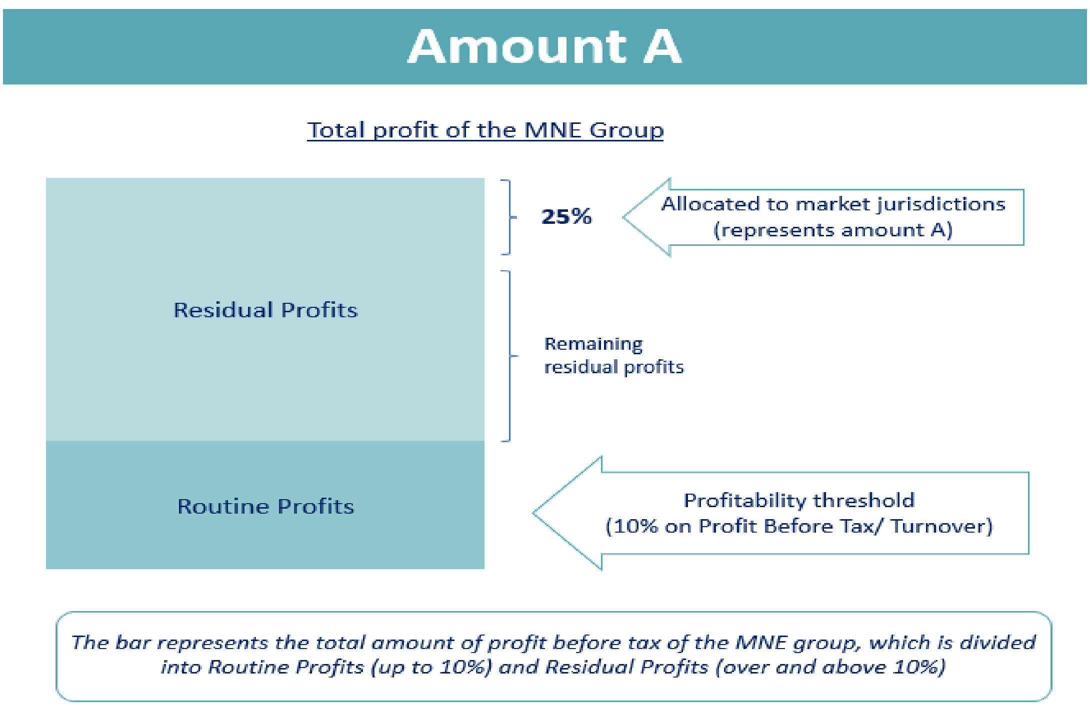
Overview

Pillar 1 modifies nexus and profit allocation rules, redistributing super-profits to market jurisdictions of the MNE Groups. This allocated profit is termed as 'Amount A'. Market jurisdictions must fulfil the nexus test to be eligible for 'Amount A' allocation.

Amount B is a critical component of Pillar One. While the work on Amount A updates the international taxation framework with respect to large and very profitable multinational enterprises (MNE), Amount B simplifies the existing transfer pricing rules for all taxpayers. It is focused on the application of transfer pricing rules to so called baseline marketing and distribution activities, likely the most frequent fact pattern that MNEs encounter in the jurisdictions where they operate. Amount B is intended to increase tax certainty, reduce compliance and administrative costs and in particular assist low-capacity jurisdictions that often suffer from the absence of local market comparables.

Model rules on Pillar One are yet to be released and the work is under process by the Inclusive Framework. Broadly, the material released by OECD till date, explain Amount A as under:

Amount A is **25% of the residual profit** defined as profit in excess of 10% of revenue that will be allocated to market jurisdictions with nexus using revenue-based allocation keys.



Allocation of Amount A is majorly based on the following two factors:

(i) Nexus Test

(ii) Revenue Sourcing Rules

Nexus test

The new special-purpose nexus rule applies solely to determine whether a jurisdiction qualifies for profit reallocation under Amount A. These rules will not alter the nexus for any other tax or non-tax purpose. Amount A is allocated to the market jurisdiction only if the nexus exists. To determine whether an MNE in-scope of Amount A satisfies the nexus test for Amount A in a jurisdiction, it will have to apply the **revenue sourcing rules** to identify the jurisdiction in which revenue arises for purposes of Amount A.

To establish nexus, the market revenue thresholds is:

- Greater than or equal to €1 million for jurisdiction with annual GDP >= €40 billion
- Greater than or equal to €250,000 for jurisdiction with annual GDP <= €40 billion

It transfers taxing rights over residual profits to jurisdictions with business activities regardless of the physical presence.

Revenue sourcing rules

Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions will be developed. In applying the sourcing rules, an MNE must use a reliable method based on the MNE's specific facts and circumstances.

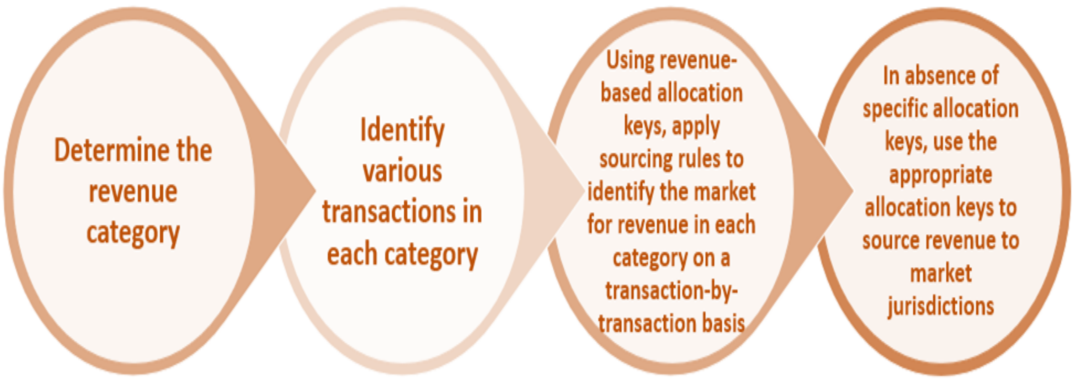
Revenues must be sourced according to the category of Revenues earned. Revenues that fall under more than one category are sourced according to their predominant character. Revenues derived from Supplementary Transactions may be sourced in accordance with the revenue sourcing rule that applies to the Revenues that they supplement.

Specific revenue sourcing rules provide a common basis for identifying an MNE's market countries that will benefit from Amount A, categorised per type of revenue. For revenues from online advertising, for example, the sourcing principle is based on the "eyeballs" of the viewer, and not on the location of the advertiser. To identify the viewer, the MNE should use data points that reliably indicate the location of the viewer, such as IP address or geolocation, or other reliable commercial information.

In some cases, it will be very challenging for an MNE to locate the end-user. This may be the case, for example, for revenues from cloud computing services, where the MNE may not have information available on where its customer's employees use the service. In order to provide certainty in these more challenging cases, the MNE is allowed to use targeted proxies or allocation keys, which approximate the market country (such as allocation keys based on statistical information on aggregated headcount data or macroeconomic proxies). This is a way to balance the compliance burden while ensuring that Amount A profits are reliably reallocated in all cases.

Once an MNE has determined how much revenue it generates in each of its market countries, Amount A profit will be reallocated only to the market countries where the MNE meets a new quantitative special purpose nexus test.

Process to be followed while applying the nexus test and the revenue sourcing rules is summarized as under:



28.3.3 Pillar Two

(1) Introduction

This pillar explores the design of a system to ensure that MNEs pay a minimum level of tax. This pillar is intended to address the remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions that tax these profits at below the minimum rate.

Pillar Two consists of the Global Anti-Base Erosion (GloBE) Rules and a treaty-based Subject to Tax Rule (STTR). The GloBE Rules introduce a 15% global minimum tax that applies to MNE groups with consolidated revenues of at least EUR 750 million. They consist of a coordinated system of rules, under a common framework, which ensures in-scope MNE groups pay at least the agreed minimum level of tax on the income arising in each of the jurisdictions in which they operate. The minimum level of tax may also be imposed locally under a qualified domestic minimum top-up tax.

Common Approach: The jurisdictions are not required to adopt the GloBE rules, but if they choose to do so, they agree to implement them in a way that is consistent with the agreed outcomes.

(2) Key highlights of Pillar 2

Jurisdictional Blending	• Tax liability to be determined on a jurisdictional basis and will arise when the effective tax rate (ETR) of a jurisdiction in which the MNE Group operates is below the agreed minimum rate
Minimum Tax Rate	• Pillar 2 prescribes minimum rate of tax liability to be applied on MNEs, i.e., 15% under GloBE rules and 9% under STTR
Rule Order	• Under the model rules, a priority order is prescribed to be followed while applying the Pillar 2 rules
Deminimus Exclusion	• A simplification measure to exclude jurisdictions from the GloBE rules that have less than a certain percentage of the MNE Group's profit
Substance based Income Exclusion	• Provided to exclude a fixed return for substantive activities within a jurisdiction from the application of the GloBE Rules

(3) STTR and Globe Rules

As already mentioned, Pillar Two consists of the Global Anti-Base Erosion (GloBE) Rules and a treaty-based Subject to Tax Rule (STTR). However, STTR rules works in prior to GloBE Rules. The model rules stipulate an order for applicability of the same, as provided under:

Subject to Tax Rules (STTR)

Overview

Works in priority to GloBE rules, STTR is a treaty-based rule that enables developing countries (source jurisdictions) to tax certain inter-company payments at source which are subject to nominal corporate income tax (at rates below the STTR minimum rate, i.e., **9%)**

The objective is to prevent base erosion in 'developing countries' which are defined to have a gross national income per capita, calculated using the World Bank Atlas method, of USD 12,535 or less in 2019 (to be regularly updated).

Applicability

– Applicable only to covered payments, by an entity in a developing country, made to a group entity in another country, i.e., connected persons.

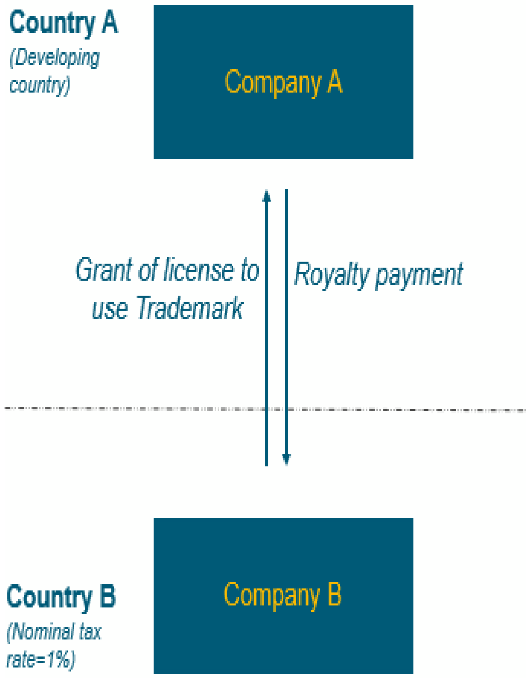
– Applies only if the total sum of covered income arising in the source country exceeds threshold of €250,000 or €1 mn per year (depending on the GDP of source country is above or below €40 bn).

Covered payments constitute Interest; Royalties; Payments for distribution rights for a product or service; Insurance or reinsurance premiums; Payments of guarantee or financing fees; Rental payments for industrial, commercial, or scientific equipment; Payments for services, etc.

Connected persons are defined to have legal (direct or indirect ownership of more than 50% of the interests) or de facto control relationship.

Specified rate

The STTR specified rate is equal to the difference between 9% and the nominal rate applied in the resident State, further reduced by any source taxation already allocated to the source jurisdiction in accordance with other articles of the treaty.



Country A and Country B incorporated STTR provisions under their Tax Treaty	Rate
STTR rate	9%
Nominal tax rate applied in the resident jurisdiction [Country B]	1%
The payor jurisdiction [Country A] retains the 5% withholding tax right under the tax treaty	5%
STTR Specified rate [Country A to tax under STTR]	**3%**

Facts

– Company A is a company resident in Country A (a developing country) and has entered into a royalty agreement (payable in respect of the grant of license to use trademark owned by Company B) with Company B (resident of Country B). Accordingly, Country A shall be the 'source jurisdiction' and Country B shall be the 'resident jurisdiction.'

– In consideration, royalty is payable by Company A to Company B.

– Country A and B has entered into a DTAA, i.e., Double Tax Avoidance Agreement or Tax Treaty, wherein the source jurisdiction retains withholding taxing rights @ 5% on royalty payments.

– Royalty payments are taxable @ 1% in Country B.

Observations

In the above example, if a payor jurisdiction can impose a 5% withholding tax on a payment of Covered Income and the recipient is subject to a 1% nominal tax rate, the payor jurisdiction retains the 5% withholding tax right. However, as per the STTR, the payor jurisdiction can impose an additional tax equal to 3% of the Covered Income amount (9% - 5% - 1% = 3%).

GloBE Rules

Scope

The GloBE Rules apply to Constituent Entities that are members of an MNE Group that has annual revenue of EUR 750 million or more in the Consolidated Financial Statements of the Ultimate Parent Entity (UPE) in at least two of the four Fiscal Years immediately preceding the tested Fiscal Year.

MNE Group means any Group that includes at least one Entity or Permanent Establishment not located in the jurisdiction of the Ultimate Parent Entity whereas a Group means a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses, and cash flows of those Entities are included in the Consolidated Financial Statements of the Ultimate Parent Entity.

Entities that are 'Excluded Entities' are not subject to the GloBE Rules. However, their revenue is still taken into account for the purposes of the consolidated revenue test. The Excluded Entities are Government entities, international organizations, non-profit organizations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organizations or funds. However, this exclusion does not affect the MNE Group owned by such entities, which will remain in scope of the GloBE rules if the group as a whole otherwise meets the consolidated revenue threshold.

Overall design

Pillar Two consists of the following rules (together the GloBE rules):

(i) **Qualified Domestic Minimum Top-up Tax (QDMTT):** QDMTT imposes a jurisdictional top-up tax on the constituent entity located in a low-taxed jurisdiction (LTJ). It allows the LTJ to collect the top-up tax computed in accordance with the GloBE rules.

QDMTT provides the right to the LTJ to collect the jurisdictional top-up tax by way of the introduction of QDMTT in its domestic tax laws. This would preserve a jurisdiction's primary right of taxation over its own income.

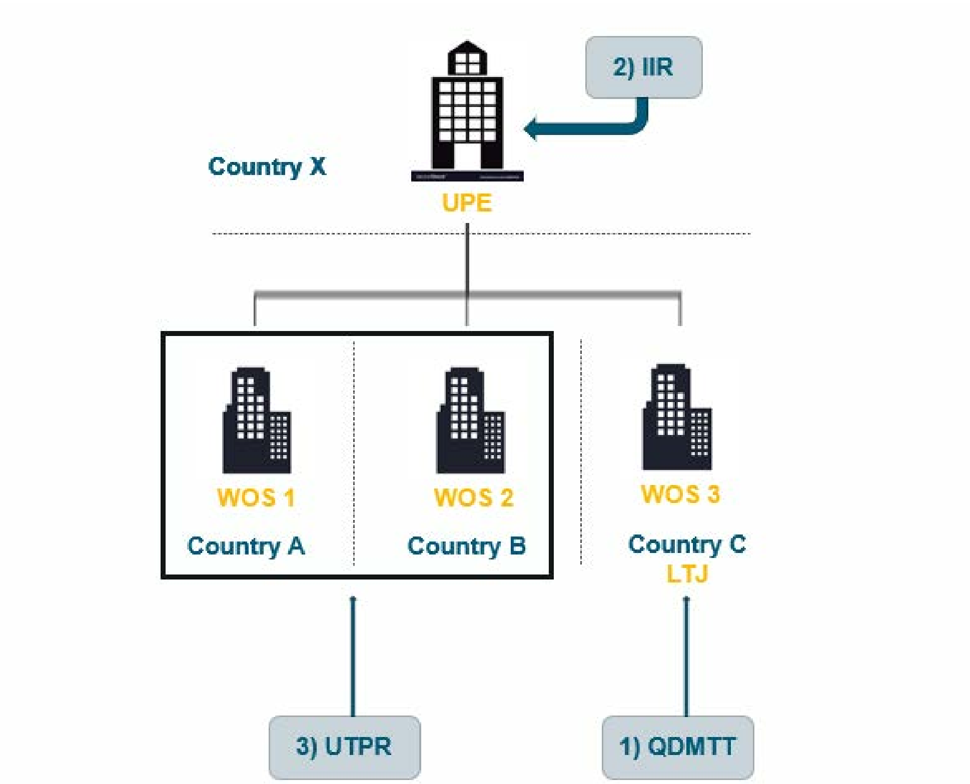
(ii) Income Inclusion Rule (IIR): IIR imposes a top-up tax on a parent entity in respect of the constituent entity located in low-taxed jurisdiction.

A Constituent Entity, that is the UPE of an MNE Group, located in a GloBE implementing jurisdiction that owns (directly or indirectly) an Ownership Interest in a Low-Taxed Constituent Entity at any time during the Fiscal Year shall pay a tax in an amount equal to its Allocable Share of the Top-Up Tax of that Low-Taxed Constituent Entity for the Fiscal Year.

(iii) Undertaxed Payment Rule (UTPR): UTPR imposes deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.

UTPR is triggered where the UPE jurisdiction does not implement IIR or does not adopt GloBE rules. Thus, UTPR serves as a backstop to IIR. UTPR transfers the levy of top-up tax to other constituent entities of the MNE group located in the jurisdiction where the GloBE rules are implemented.

Let us understand the mechanism of these three rules from the example below:



Observations

The UPE of an MNE group located in Country X has three wholly owned subsidiaries ("WOS") in Country A, B, and C. Let's say, Country C is a low-taxed jurisdiction ("LTJ"). The priority ranking as per the model GloBE rules prescribes that:

Priority 1 – Where Country C imposes QDMTT in its jurisdiction, the jurisdictional top-up tax shall be imposed on WOS 3 (refer to the diagram above).

Priority 2 – Where Country C does not impose QDMTT in its jurisdiction, the UPE of an MNE Group located in Country X which has implemented IIR under GloBE rules shall be liable to pay a tax in an amount equal to its Allocable Share of the Top-Up Tax of WOS 3 in Country C

Priority 3 – At last where neither Country C nor Country X implements QDMTT or IIR respectively, and Country A and Country B has implemented UTPR under GloBE rules, WOS 1 and WOS 2 shall be liable to pay jurisdictional top-up (pertaining to WOS 3) tax under UTPR in their jurisdictions, i.e., Country A and B respectively.

Other Important Topics under GloBE Rules

(i) **Effective Tax Rate (ETR):** The GloBE rules will operate to impose a top-up tax using an **effective tax rate** test that is calculated on a **jurisdictional basis.** If the jurisdictional ETR is below the 15% minimum rate, the jurisdiction is treated as a low-tax jurisdiction and the constituent entities are treated as low-taxed constituent entities (LTCE). The Effective Tax Rate of the MNE Group for a jurisdiction shall be calculated for each Fiscal Year.

Effective Tax Rate = Total of Adjusted Covered Taxes of each Constituent Entity located in the jurisdiction / Net GloBE Income of the jurisdiction

Where,

– Adjusted Covered Taxes are the taxes attributable to the income of a Constituent Entity.

The amount of a Constituent Entity's Covered Taxes is determined by taking the Constituent Entity's current taxes for the Fiscal Year, adjusted to reflect certain timing differences. Covered Taxes are allocated from one Constituent Entity to another in certain cases. To the extent there are changes in tax liability after filing, additions or reductions to taxes are identified and allocated to a particular jurisdiction and time period.

– the Net GloBE Income of a jurisdiction for a Fiscal Year is the positive amount, if any, computed in accordance with the following formula:

Net GloBE Income = GloBE Income of all Constituent Entities – GloBE Losses of all Constituent Entities

Under the OECD Model Rules, the jurisdictional net GloBE income is the total GloBE income of all constituent entities in the jurisdiction, less any GloBE losses of constituent entities in the jurisdiction.

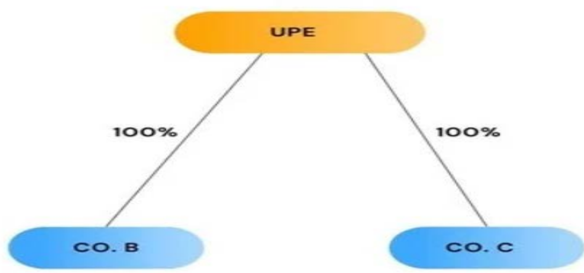
If there is a net GloBE loss, this means the ETR need not be calculated. In most cases this would mean no top-up tax would be due.

(ii) **Jurisdictional Blending:** The ETR computation is determined on a **jurisdictional blending basis**. **Jurisdictional blending** allows all the profits, losses, and taxes of the Constituent Entities of the MNE Group located in the same jurisdiction to be blended for purposes of the effective tax rate calculation.

Note - For the purpose of determining the applicability of the GloBE Rules, global revenue is considered. However, for determining ETR, the calculation is done on jurisdictional basis.

Let us understand the above concepts with the help of following example:

UPE Co. (Country A) has wholly owned subsidiaries B Co. and C Co. in Country B.



Details related to both the subsidiaries are as follows:

Particulars	Company B	Company C
GloBE income	5,000,000 euros	10,000,000 euros
Adjusted covered taxes	1,000,000 euros	1,000,000 euros
Investments in qualifying local tangible assets and payroll costs	10,000,000 euros	20,000,000 euros

The calculation of ETR:

Adjusted Covered Taxes of Country B (i)	2,000,000 euros
Net GloBE Income in Country B (ii)	15,000,000 euros
ETR (i)/(ii)	13.3333%

Thus, the ETR of the above MNE group for Country B is 13.3333%.

Further, if Company B had incurred losses of 5,000,000 euros, the net GloBE income for Country B would have been 5,000,000 euros instead of 15,000,000 euros. This is because of the concept of jurisdictional blending.

(iii) Substance-based Income exclusion (SBIE) or Substance-based carve-outs: The Net GloBE Income for the jurisdiction shall be reduced by the Substance-based Income Exclusion for the jurisdiction to determine the Excess Profit for purposes of computing the Top-up Tax.

The GloBE rules provides the SBIE amount for a jurisdiction which is the sum of the payroll carve-out and the tangible asset carve-out for each Constituent Entity in that jurisdiction. The amount of this substance-based income exclusion is equal to the sum of (i) 5% of the carrying value of tangible assets located in the jurisdiction and (ii) 5% of the payroll costs for employees who perform activities in the jurisdiction. The GloBE rules also provide for a 10-year transition period in recognition of the potential impact of the GloBE rules on existing incentives and existing investment. It shall be 8% of carrying value of eligible tangible assets and 10% of eligible payroll costs, both will phase down to 5% over 10 years.

A substance carve-out based on assets and payroll costs allows a jurisdiction to continue to offer tax incentives that reduce taxes on routine returns from investment in substantive activities, without triggering additional GloBE top-up tax.

(iv) Top-up Tax: The Jurisdictional Top-up Tax for a jurisdiction for a Fiscal Year is equal to the positive amount, if any, computed in accordance with the following formula:

Jurisdictional Top-up Tax = (Top-up Tax Percentage X Excess Profit) + Additional Current Top-up Tax – Domestic Top-up Tax

Where,

– the Top-up Tax Percentage for a **jurisdiction** shall be the positive percentage point difference, if any, computed in accordance with the following formula:

Top up Tax Percentage = Minimum Rate – Effective Tax Rate [ETR]

– the Excess Profit for the jurisdiction is the positive amount, if any, computed in accordance with the following formula:

Excess Profit = Net GloBE Income – Substance Based Income Exclusion

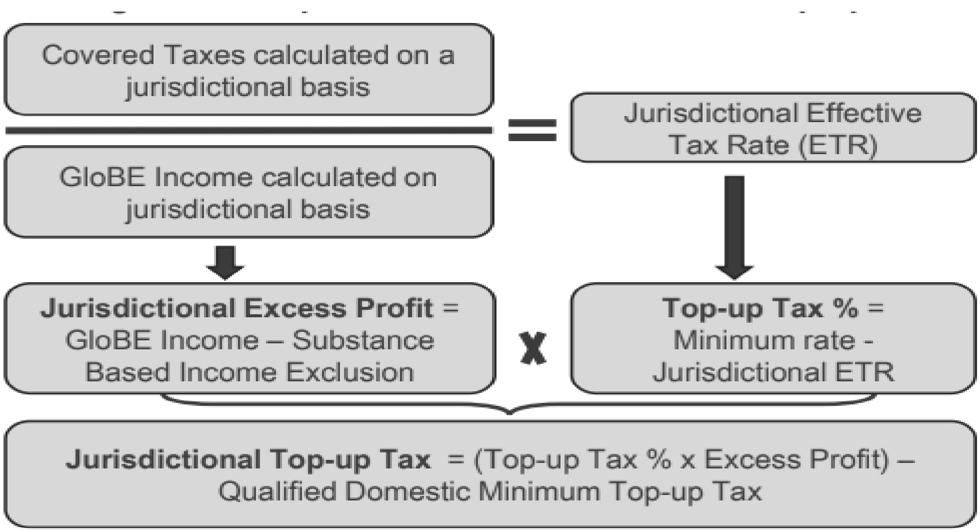
Note: The Top-up tax percentage is calculated based on the aggregate profits, i.e., Net GloBE income. However, it is applied to the excess income, i.e., Net GloBE income – substance-based income inclusion in order to provide the benefits of incentives to MNEs.

Continuing our example, we refer to the information collated below:

Minimum tax rate (i)	**15%**
ETR (ii)	13.333%
Net GloBE Income in Country B (iii)	15,000,000 euros
Substance-based income exclusion [2] (iv)	1,500,000 euros
Top up Tax Percentage (i) - (ii)	**1.6667%**
Excess Profit (iii) - (iv)	**13,500,000 euros**
Top-up tax for Country B*	**225,004 euros**

*Assuming there is no additional top-up tax or any tax payable under a qualifying domestic top-up tax.

The concepts explained in the above points are summarized as under:



[2] calculated@5%of eligible tangible assets and eligible payroll costs

(v) De-minimis Exclusion: The GloBE rules, at the election of the Filing Constituent Entity, provides a jurisdictional exclusion for LTCEs of an MNE Group on meeting the following criterion:

– the Average GloBE Revenue of such jurisdiction is less than EUR 10 million; and

– the Average GloBE Income or Loss of such jurisdiction is a loss or is less than EUR 1 million

The policy intent underlying the above exclusion is to avoid the complexities of a full ETR computation in cases where the amount of any Top Up Tax would not seem to justify the associated compliance and administrative costs.

Resources: The discussion on Pillar One and Pillar Two contained in this chapter is primarily based on the content available at the website http://www.oecd.org

NOTES

ANNEXURE

ANNEXURE – 1

Rule 115 - Rate of exchange for conversion into rupees of income expressed in foreign currency

(1) The rate of exchange for the calculation of the value in rupees of any income accruing or arising or deemed to accrue or arise to the assessee in foreign currency or received or deemed to be received by him or on his behalf in foreign currency shall be the telegraphic transfer buying rate of such currency as on the specified date.

Explanation: For the purposes of this rule,—

(1) "telegraphic transfer buying rate" shall have the same meaning as in the Explanation to rule 26;

(2) "specified date" means—

(a) in respect of income chargeable under the head "Salaries", the last day of the month immediately preceding the month in which the salary is due, or is paid in advance or in arrears;

(b) in respect of income by way of "interest on securities", the last day of the month immediately preceding the month in which the income is due;

(c) in respect of income chargeable under the heads "Income from house property", "Profits and gains of business or profession" not being income referred to in clause (d) and "Income from other sources" (not being income by way of dividends and "Interest on securities"), the last day of the previous year of the assessee;

(d) in respect of income chargeable under the head "Profits and gains of business or profession" in the case of a non-resident engaged in the business of operation of ships, the last day of the month immediately preceding the month in which such income is deemed to accrue or arise in India ;

(e) in respect of income by way of dividends, the last day of the month immediately preceding the month in which the dividend is declared, distributed or paid by the company;

(f) in respect of income chargeable under the head "Capital gains", the last day of the month immediately preceding the month in which the capital asset is transferred :

__Provided__ that the specified date, in respect of income referred to in sub-clauses (a) to (f) payable in foreign currency and from which tax has been deducted at source under rule 26, shall be [the date on which the tax was required to be deducted] under the provisions of the Chapter XVII-B.

(2) Nothing contained in sub-rule (1) shall apply in respect of income referred to in clause (c) of the Explanation to sub-rule (1) where such income is received in, or brought into India by the assessee or on his behalf before the specified date in accordance with the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973).

Rule 26 - Rate of exchange for the purpose of deduction of tax at source on income payable in foreign currency

For the purpose of deduction of tax at source on any income payable in foreign currency, the rate of exchange for the calculation of the value in rupees of such income payable—

(i) to an assessee outside India;

(ii) to a Unit located in an International Financial Services Centre;

(iii) by a Unit located in an International Financial Services Centre to an assessee in India,

shall be the telegraphic transfer buying rate of such currency as on the date on which the tax is required to be deducted at source under the provisions of Chapter XVIIB by the person responsible for paying such income.

Explanation — For the purposes of this rule,—

(i) "International Financial Services Centre" shall have the meaning assigned to it in clause (q) of section 2 of the Special Economic Zones Act, 2005 (28 of 2005);

(ii) "telegraphic transfer buying rate", in relation to a foreign currency, means the rate or rates of exchange adopted by the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), for buying such currency, having regard to the guidelines specified from time to time by the Reserve Bank of India for buying such currency, where such currency is made available to that bank through a telegraphic transfer;

(iii) "Unit" shall have the meaning assigned to it in clause (zc) of section 2 of the Special Economic Zones Act, 2005 (28 of 2005).

ANNEXURE – 2

Rule 128 Foreign Tax Credit

(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule :

***Provided** that in a case where income on which foreign tax has been paid or deducted, is offered to tax in more than one year, credit of foreign tax shall be allowed across those years in the same proportion in which the income is offered to tax or assessed to tax in India.*

(2) The foreign tax referred to in sub-rule (1) shall mean,—

(a) in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A, the tax covered under the said agreement;

(b) in respect of any other country or specified territory outside India, the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in clause (iv) of the Explanation to section 91.

(3) The credit under sub-rule (1) shall be available against the amount of tax, surcharge and cess payable under the Act but not in respect of any sum payable by way of interest, fee or penalty.

(4) No credit under sub-rule (1) shall be available in respect of any amount of foreign tax or part thereof which is disputed in any manner by the assessee:

***Provided** that the credit of such disputed tax shall be allowed for the year in which such income is offered to tax or assessed to tax in India if the assessee within six months from the end of the month in which the dispute is finally settled, furnishes evidence of settlement of dispute and an evidence to the effect that the liability for payment of such foreign tax has been discharged by him and furnishes an undertaking that no refund in respect of such amount has directly or indirectly been claimed or shall be claimed.*

(5) The credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:—

(i) the credit shall be the lower of the tax payable under the Act on such income and the foreign tax paid on such income :

***Provided** that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess shall be ignored for the purposes of this clause;*

(ii) the credit shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted.

(6) In a case where any tax is payable under the provisions of section 115JB or section 115JC, the credit of foreign tax shall be allowed against such tax in the same manner as is allowable against any tax payable under the provisions of the Act other than the provisions of the said sections (hereafter referred to as the "normal provisions").

(7) Where the amount of foreign tax credit available against the tax payable under the provisions of section 115JB or section 115JC exceeds the amount of tax credit available against the normal provisions, then while computing the amount of credit under section 115JAA or section 115JD in respect of the taxes paid under section 115JB or section 115JC, as the case may be, such excess shall be ignored.

(8) Credit of any foreign tax shall be allowed on furnishing the following documents by the assessee, namely:—

(i) a statement of income from the country or specified territory outside India offered for tax for the previous year and of foreign tax deducted or paid on such income in Form No.67 and verified in the manner specified therein;

(ii) certificate or statement specifying the nature of income and the amount of tax deducted therefrom or paid by the assessee,—

(a) from the tax authority of the country or the specified territory outside India; or

(b) from the person responsible for deduction of such tax; or

(c) signed by the assessee:

***Provided** that the statement furnished by the assessee in clause (c) shall be valid if it is accompanied by,—*

(A) an acknowledgement of online payment or bank counter foil or challan for payment of tax where the payment has been made by the assessee;

(B) proof of deduction where the tax has been deducted.

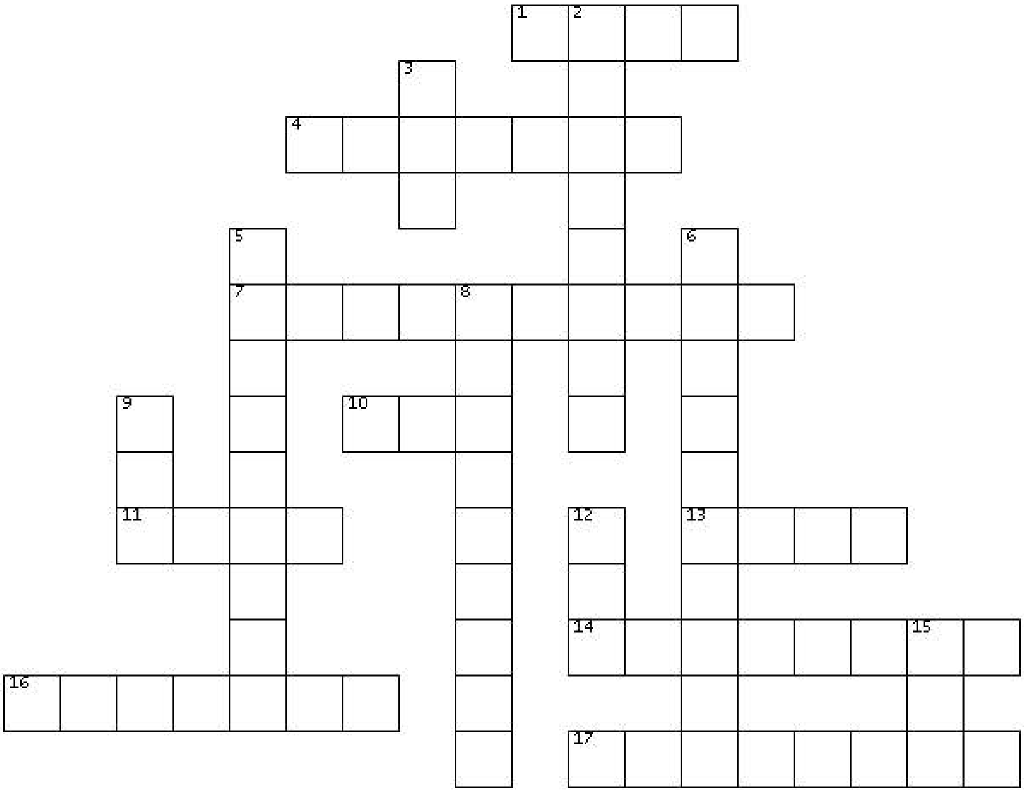
(9) The statement in Form No. 67 referred to in clause (i) of sub-rule (8) and the certificate or the statement referred to in clause (ii) of sub-rule (8) shall be furnished on or before the end of the assessment year relevant to the previous year in which the income referred to in sub-rule (1) has been offered to tax or assessed to tax in India and the return for such assessment year has been furnished within the time specified under sub-section (1) or sub-section (4) of section 139:

Provided that where the return has been furnished under sub-section (8A) of section 139, the statement in Form No. 67 referred to in clause (i) of sub-rule (8) and the certificate or the statement referred to in clause (ii) of sub-rule (8) to the extent it relates to the income included in the updated return, shall be furnished on or before the date on which such return is furnished.

(10) Form No.67 shall also be furnished in a case where the carry backward of loss of the current year results in refund of foreign tax for which credit has been claimed in any earlier previous year or years.

Explanation — For the purposes of this rule 'telegraphic transfer buying rate' shall have the same meaning as assigned to it in Explanation to rule 26.

CROSSWORD PUZZLE



ACROSS

1. …….. (acronym) Model Convention is essentially a model treaty between two developed nations.

4. Section 285 contains provision for submission of statement by a non-resident operating in India through a ………….. office.

7. ………….. income of a non-resident Indian derived from a foreign exchange asset is chargeable to tax@20% under section 115E.

10. Master file, local file and …… (acronym) report are the documents mandated by BEPS for a standardised approach to transfer pricing documentation.

11. The residential status of a foreign company is dependent on whether its ……..…. (acronym) is in India in the relevant previous year.

13. In …………...(acronym), adjusted net profit margin is taken into account to arrive at the arm's length price.

14. Section 44BBA contains the special provision for computing profits and gains of the business of operation of ………….. in the case of non-residents.

16. As per section 9(1)(vi), …………. will always be deemed to accrue or arise in India in the hands of the non-resident recipient, when it is payable by the Government.

17. Rule 10MA provides that the advance pricing agreement shall contain the ………….. provision in respect of an international transaction.

DOWN

2. Significant ……………. presence of a non-resident in India shall also constitute business connection in India.

3. Article 25 of UN Model Convention deals with ……… (acronym).

5. ………….. relief may be granted through Exemption Method or Tax Credit Method.

6. India grants …………….. relief through credit method under section 91 to its residents for taxes paid in the country, with which India does not have a DTAA.

8. ……………. adjustment means an adjustment in the books of accounts of the assessee and its associated enterprise to reflect that the actual allocation of profits between the assessee and its associated enterprise are consistent with the transfer price determined, thereby removing the imbalance between cash account and actual profit of the assessee.

9. ……….. (acronym) method is applied to determine arm's length price, where there are similar transactions between unconnected parties.

12. An …….. (acronym) is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future.

15. Rule 128 provides that ….. (acronym) is available against the amount of tax, surcharge and cess payable under the Income-tax Act, 1961, but not available in respect of any sum payable by way of interest, fee or penalty.

CROSSWORD PUZZLE

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