

Recent Controversies in treaty interpretations in India



Seventh International Tax Planning Conference



December 7, 2001

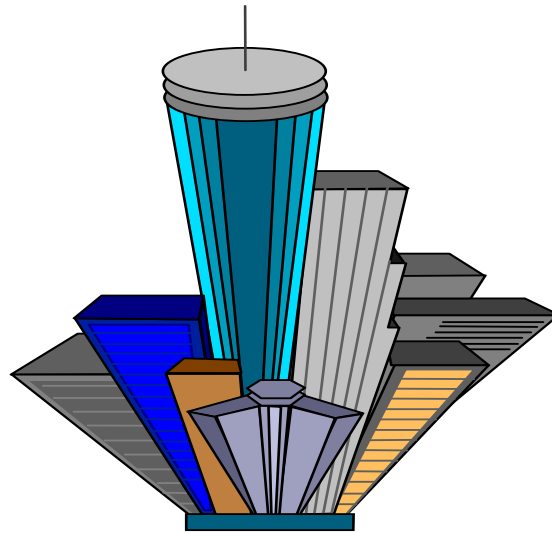
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Recent DTC Interpretation Controversies

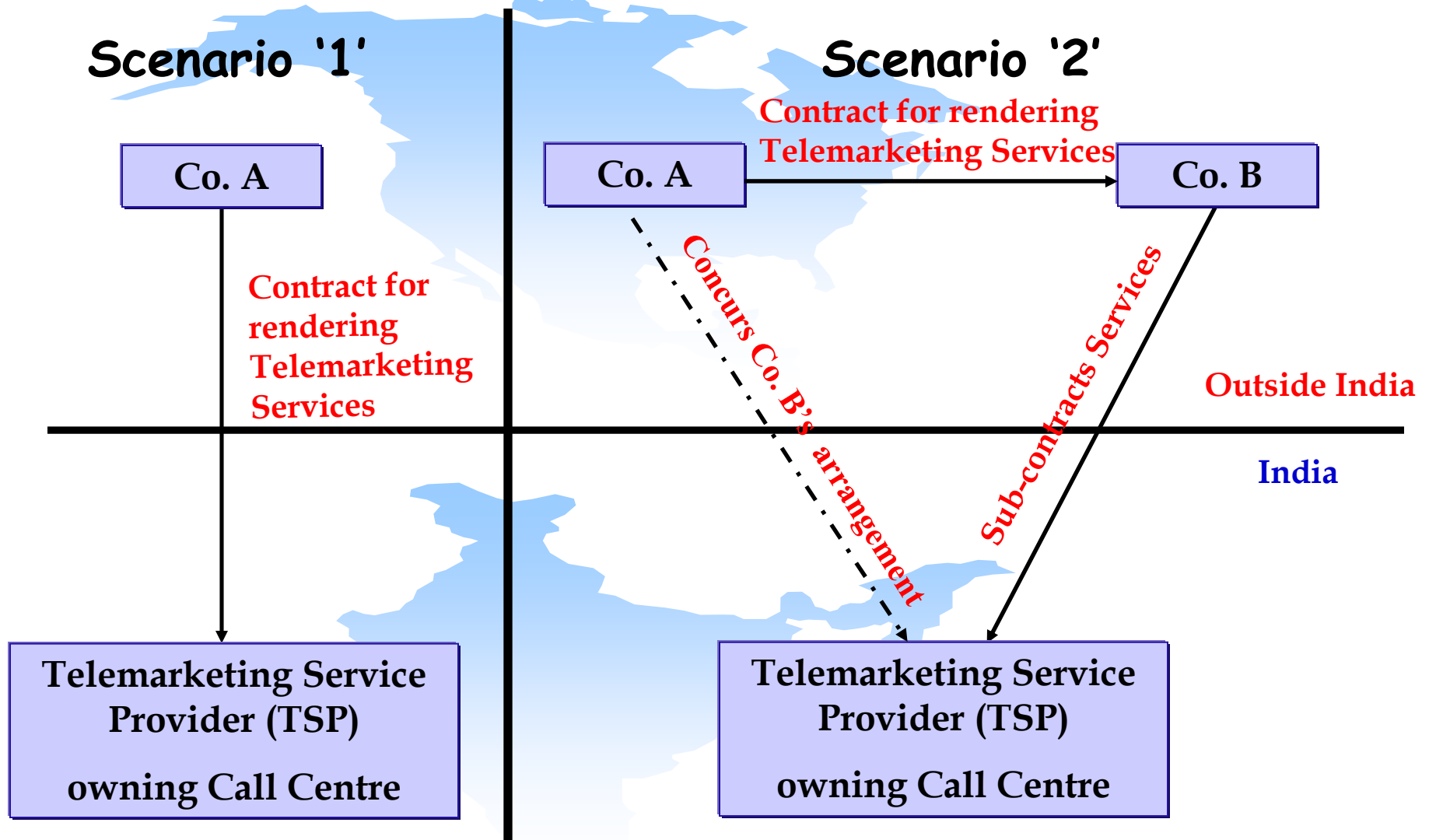
- Permanent Establishment
- Characterization of income
- DTC benefits under MFN clause
- Non-Discrimination Clause



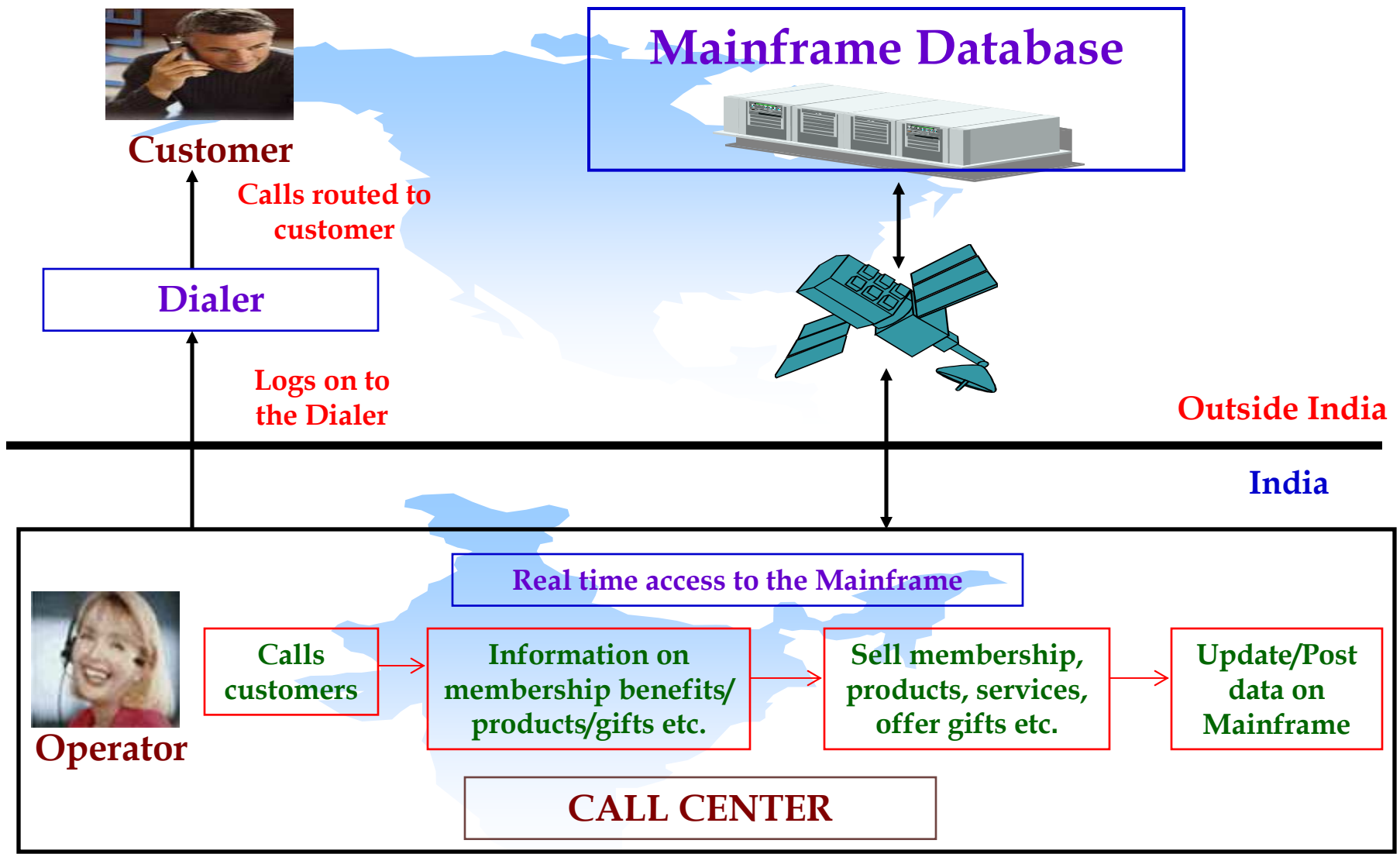
Permanent Establishment



Telemarketing Services -Scenario



Telemarketing Services - Mechanics



Telemarketing Services - Issues...



Given the fact that TSP has authority to conclude contracts under the tele-marketing arrangement, the issues that arise are:

- Scenario 1**
- Whether TSP constitutes a PE of Co. A in India
 - TSP could be an Agency PE of Co. A unless an independent agent
-
- Scenario 2**
- Whether TSP constitutes a PE of Co. A in India
 - TSP appointed by Co. B with concurrence of Co.A
 - Co. A bound by the contracts concluded by TSP
 - TSP could be an Agency PE of Co. A unless an independent agent
 - Whether TSP constitutes a PE of Co. B in India
 - Co. B allowed by Co. A to authorize TSP to conclude contracts
 - Co. B authorizes TSP to conclude contracts for Co. A
 - TSP could be an Agency PE of Co. B unless an independent agent

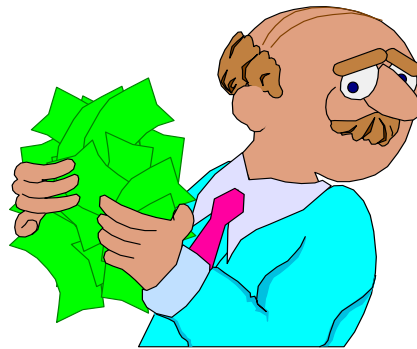
PE - Article 5(5) of India-US Treaty

- **First Limb** - Excludes independent Agent from constituting a PE
- **Second Limb** - Lays down two cumulative conditions for excluding certain independent Agents
- **Issue**

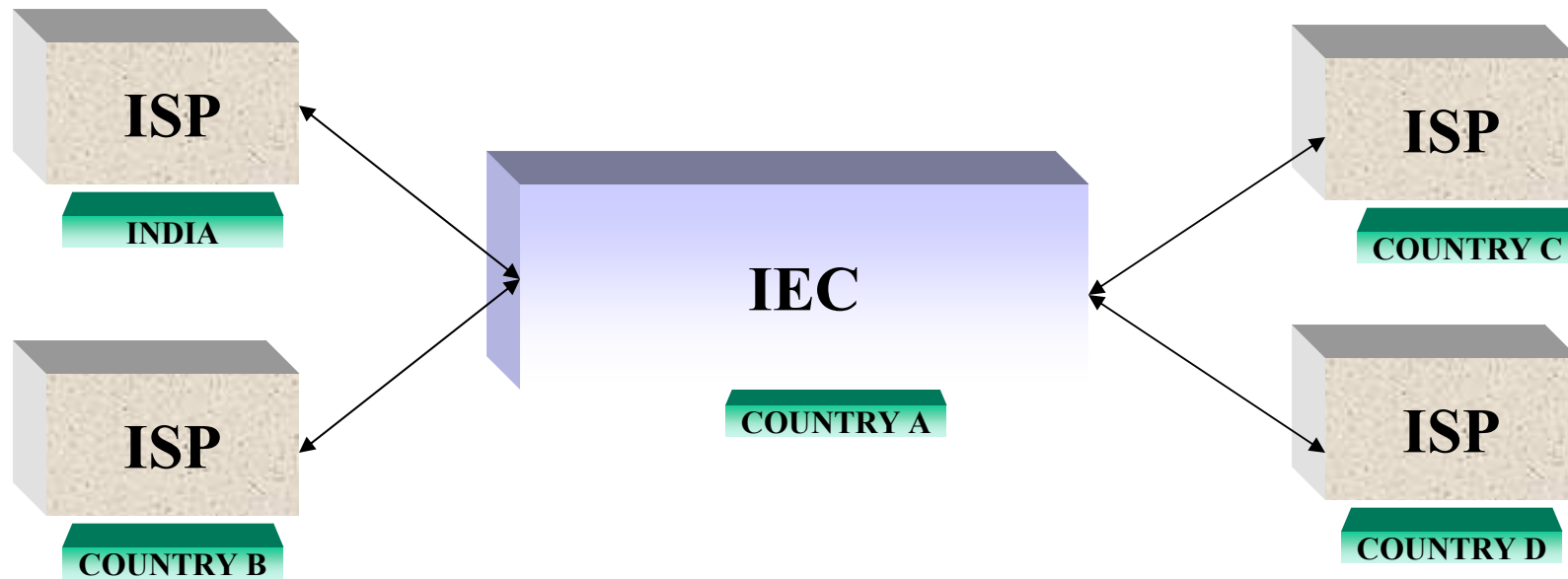


- Is only Second limb of Article 5(5) conclusive for determining independent agency?
- Can a dependent agent be considered an *independent agent* (and therefore, not a PE) if he does not satisfy the two *cumulative* conditions of the second limb
 - Attendent Issue - Transfer Pricing if the agent and principal are associated enterprises

Characterisation of Income



Payment for Port Access Facility...



- **Internet Service Provider (ISP)** - Company providing access to the internet to its customers
- **Internet Exchange Company (IEC)** - A company owning infrastructure that facilitates inter-connection between the member ISPs so as to achieve cost effective and quick access to the Internet

...Payment for Port Access Facility



- Royalties definition of Treaties generally includes payment for *“use of industrial, commercial and scientific equipment”*
- Royalty Definition in the IT Act also recently amended to the above effect



Whether payments
to IEC constitute
“Royalties”

Final OECD - TAG Report on Treaty Characterisation...



- **Para 27 to 31 - Evaluates Payments for use of Computer Equipment on real time basis in light of the Royalties Definition**
- **Para 28 - Enlists factors for determining Lease against Service Agreement**
 - **Customer has physical possession/control of property**
 - **Property not concurrently used to provide significant services to unrelated entities**
 - **Risk of substantially diminished receipt/increased expenditure in the event of non-performance not borne by the contractor**
 - **Total payment does not substantially exceed the rental**

...Final OECD - TAG Report on Treaty Characterisation



- Applying above factors, Group concluded that:
 - ⊖ the payment for use of computer equipment is a service income
 - ⊖ the service provider:
 - owns the equipment and maintains/uses the software to provide services to customers
 - provides access to many customers at the same time
 - replaces the software at will
 - retains possession/control of the software/equipment
- Para 31 - Data Warehousing Transactions considered as Service Transactions

Based on OECD, can payments to IEC be regarded as service income
Can such service income be non-taxable in India if IEC is situated in a jurisdiction having restricted FTS definition (e.g. USA, Singapore, etc)

Indian Scenario...

- **Foreign Guidelines may have persuasive value but not binding on the tax authorities**
- **Ruling of AAR (Amex) - Payment to IEC could be held as Royalties**
- **Skycell's decision 251 ITR 53 (Mad)**
 - **Installation & operation of sophisticated equipment to earn income - allowing customers to avail benefit of the user of such equipment - does not result in the provision of technical service**

...Indian Scenario

- **Draft Report of CBDT's High Powered Committee on "E-Commerce and Taxation"**
 - **Examines the E-Commerce transactions covered in TAG Final Report from Indian tax perspective**
 - **Deals with characterization of payment made to Application Service Provider (ASP)**
 - **ASP providing means to customers to automate and manage their transactions with third parties**
 - **Customer not having any right to copy or control/possession of the software**
 - **TAG considers such payment as Business Profits**
 - **High Powered Committee considered such payment as "Royalties"**

Non-Discrimination Clause



Non-Discrimination Clause...



- **Non-discrimination clause in Tax Treaties -**
 - Restricts either of the contracting countries from giving preferential treatment in taxing its own citizens vis-à-vis foreign persons

Issue - Whether non-resident being subjected to higher rate of taxation than residents a discrimination

Chronicle

- **Societe Generale Ruling (236 ITR 103)(AAR) -**
 - The word “taxation” in non-discrimination article does not include “rate of tax”
 - No discrimination if rate of tax levied on foreign companies higher than that of Indian company

...Non-Discrimination Clause...



- **ABN Amro's case (Cal Trib)**
 - ⊖ Held AAR as not correct
- **Recently Supreme Court sets aside the Societe Generale Ruling upon the assessee seeking so (Ref. 251 ITR 657)**
- **Bank of America's case (78 ITD 1)(Mum. Trib.)**
 - ⊖ Held that if as per the Agreement between the two countries there is a restriction in the rate of tax chargeable in the case of foreign companies, the effect shall have to be given to the provisions of the Agreement in preference to the provisions of the Act

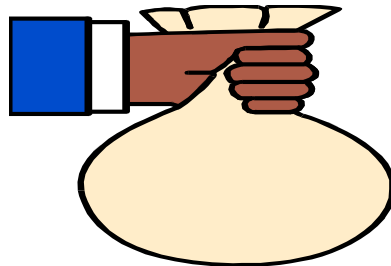
...Non-Discrimination Clause



- **Recent Amendment in the Domestic Law**
 - Explanation inserted to Section 90(2) of IT Act to provide that higher tax rate on foreign companies not to be regarded as less favourable charge/levy of tax than domestic companies
 - A unilateral change diluting the effect of the treaties

- **Whether Unilateral Change made by Government overrides the treaty**
- **Do Treaties still prevail as if explanation was never inserted**

MFN Clause



Treaty Benefits under MFN clause...

- India-France and India-Netherlands DTAA Protocol 



- Scope and rate of tax to be restricted as per treaty/protocol between India and OECD member State

- India-France and India-Netherlands DTAA contain a broad definition of FTS with a high rate of tax



- India enters into India-Germany and India-USA DTAA in which the FTS definition is restricted and rate of tax is lower



- To give effect to the respective protocols Government of India issues notification

- India-Netherlands DTAA stands modified - Rate/Scope reduced

...Treaty Benefits under MFN clause...



- India-France DTAA amended - Only Rate reduced without restricting the scope
 - Similar notification also issued by France only restricting the Rate
- Issue

Whether the scope of FTS under India-France DTAA can be restricted relying on Protocol

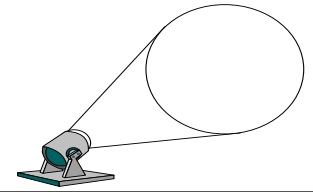
Is Intention of Government to restrict scope of FTS definition?

...Treaty Benefits under MFN clause

- **TISCO's case (66 TTJ 464)(Mum. Trib.)**
 - ◊ **Government authorised to issue notification, however, to be read down if conflicting with terms of DTAA**
 - ◊ **Notification cannot affect rights of assessee (Rate and scope of taxation) unless agreement entered afresh**
 - **Miscellaneous Application of Tax authorities rejected by Tribunal [Ref - (66 TTJ 463) & (66 TTJ 464)]; Rejection also affirmed by Bombay High Court (Ref.-164 CTR 63)**



Conclusion



- **Controversies continuing to expand with introduction of new regulations**
- **MAP could be a useful tool to address controversies in application and interpretation of DTC**
- **Pragmatic approach by the revenue authorities for settlement of issues arising from differing interpretations**