

# An Overview of International Taxation – Double Taxation Avoidance Agreement (DTAA) & Concepts of Transfer pricing



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# Agenda

- ❖ **Scheme of Taxation for Non-residents**
- ❖ **Concept of DTAA**
- ❖ **Basic Tenets of DTAA**
- ❖ **Basic Structure of DTAA**
- ❖ **Protocol / Termination of DTAA**
- ❖ **Interpretation of DTAA**
- ❖ **Case Law – Azadi Bachao Andolan**

# Agenda....

## ✧ **Background**

- ✧ **Transfer Pricing Evolution OECD's view**
- ✧ **Objective of Transfer Pricing Regulation**
- ✧ **Evolution of Transfer Pricing Regulation**
- ✧ **Arm's length standard – Universal Standard**
- ✧ **Global TP Enforcement**

## ✧ **Indian Perspective**

# Scheme of Taxation for Non Residents

- ✧ **Section 4 – Income Tax shall be charged at the rates for that assessment year in accordance with the provisions of the Income Tax Act, 1961 (Act) in respect of the total income of the previous year of every person**
- ✧ **Section 2(31) – Person includes**
  - ✧ An Individual
  - ✧ HUF
  - ✧ A Company
  - ✧ A Firm
  - ✧ AOP or BOI whether incorporated or not
  - ✧ Local authority and
  - ✧ Every artificial juridical person, not falling above
- ✧ **Non-resident as defined u/s 2(30) of the Act would include all the persons as defined u/s 2(31) of the Act**

# Scheme of Taxation for Non Residents under Income Tax Act, 1961

- ✧ Section 5(2) – The total income of any previous year of a person who is non-resident includes all income which
  - ✧ Is received or deemed to be received in India; or
  - ✧ Accrues or arises or is deemed to accrue or arise to him in India
- ✧ Section 2(30) – A non-resident means a person who is not resident and includes a person who is resident but not ordinarily resident for the purposes of TP

# **Scheme of Taxation for Non Residents under Income Tax Act, 1961....**

- ✧ Section 9(1) - Income Deemed to Accrue or Arise in India**
  - i. All income accruing or arising, whether directly or indirectly through or from any business connection, or property, or asset or source of income or through transfer of capital asset situate in India**
  - ii. Income from salaries, if earned in India**
  - iii. Income from salaries payable by Govt. to citizen of India for service outside India**

# **Scheme of Taxation for Non Residents under Income Tax Act, 1961....**

## **✧ Section 9(1)**

- iv. Income by way of dividend paid by Indian company outside India**
- v. Income by way of Interest**
- vi. Income by way of Royalty**
- vii. Income by way of Fees for Technical Services**

# Concept of DTAA

- ✧ **DTAA is an agreement between the two sovereign governments, concerning taxes, the main purpose of which is to regulate tax matters**
- ✧ **Under Income Tax Act, 1961 (Act) the government has been delegated the power to enter into a DTAA with any country or specified territory or adopt the agreement between specified association of any specified territory by notifying in the official gazette**



# Concept of DTAA....

- ✧ **Section 90 of the Act, 1961 (Act) –**
  - ✧ **The central government may enter into an agreement with the government of any country outside India or specified territory outside India for –**
    - **Relief from and avoidance of Double taxation**
    - **To exchange information to prevent tax evasion or avoid double taxation**
    - **To initiate tax recovery under the Act**

# **Application of Domestic Law vis-à-vis DTAA – Treaty overrides Domestic Law**

- ✧ Section 90(2) – Where the DTAA has been entered into by the Government of India with the Government of other country, for granting relief of tax, or avoidance of double taxation, as the case may be, provisions of the domestic law i.e. the Income Tax Act or the DTAA shall apply to the extent that they are more beneficial to the assessee**
- ✧ Circular No 333 [F. No. 506/42/81-FTD], dated 2-4-1982 – Where a DTAA provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions of the Income Tax Act**

# Basic Tenets of DTAA

- ❖ **Elimination of Double Taxation**
- ❖ **Certainty of Tax Treatment**
- ❖ **Reduced Tax Rates**
- ❖ **Lower Compliance Cost**
- ❖ **Prevention of Fiscal Evasion**
- ❖ **Prevention of Tax Discrimination**
- ❖ **Resolution of Tax Disputes**
- ❖ **Provide for Tax Sparing**
- ❖ **Exchange of Information**

# When does double taxation occur?

**Double taxation occurs when –**

- ✧ **Majority of States, levy taxes not only on domestic assets and domestic economic transactions but levy taxes on capital and transactions situated abroad to the extent that they are earned by the resident tax payers (global taxation of residence)**
- ✧ **Further, no State waives its right for taxation of capital or transactions within its own territory, even if they belong to non-residents**
- ✧ **When a person is resident of two or more countries**
- ✧ **Over-lapping of source rules i.e. the same economic transaction being taxed in two countries**
- ✧ **Taxation of the same economic transaction both income and / or capital in the hands of two different tax payers in different countries (i.e. Economic Double Taxation)**

# How can double taxation be eliminated?

- ❖ **Double Taxation can thus be eliminated by:**
  - ❖ **Avoiding Juridical Double Taxation and Economic Double Taxation**
  - ❖ **Allocation of exclusive right to tax either to the State of Residence or to the State of Source or Situs**
  - ❖ **Sharing taxing rights between the State of Residence and the State of Source or Situs**
  - ❖ **Wherever the treaty confers on the State of Source a full or limited right to tax, the State of Residence relieves double taxation by giving exemption or credit for taxes paid in the State of Source**

# Basic Structure

- ❖ **Article 1 & 2 – Persons Covered and Taxes Covered**
- ❖ **Article 3 – Definitions governing the DTAA**
- ❖ **Article 4 – Rules of Residence**
- ❖ **Article 5 – Defines the meaning of term Permanent Establishment**
- ❖ **Article 6 to 21 – Provides for Distributive Rule regarding Income Taxes**
- ❖ **Article 22 – Taxes on Capital**
- ❖ **Article 23 – Elimination of Double Taxation**
- ❖ **Article 24 to 29 – Special Provisions**
- ❖ **Article 30 & 31 – Final Provisions**

# Protocol and Termination of DTAA

## ✧ Protocols / MOUs:

- ✧ Generally provides amendments to the existing treaties
- ✧ Provides explanations to the treaty provisions – specific in case of Indo-US Treaty

## ✧ Termination:

- ✧ Treaty remains in force until terminated
- ✧ Sometimes treaty provides for a period during which the treaty cannot be terminated (Eg. Indo-US Treaty)
- ✧ Termination requires notice through Diplomatic Channels
- ✧ Some Treaties provide for period of notice and some do not

# Interpretation of DTAA

- ❖ Principles adopted in the interpretation of statutory legislation are not applicable in interpretation of treaties
- ❖ A tax treaty is to be interpreted in good faith in accordance with the ordinary meaning given to the treaty;
- ❖ Provisions of the treaty are required to be construed in harmony with each other as the treaty is required to be interpreted as a whole
- ❖ One can depart from the plain meaning of the language of the treaty and in a manner, if so required, so as to avoid absurdity and to make it workable rather than be redundant

Source: Vienna Convention on the Law of Treaties



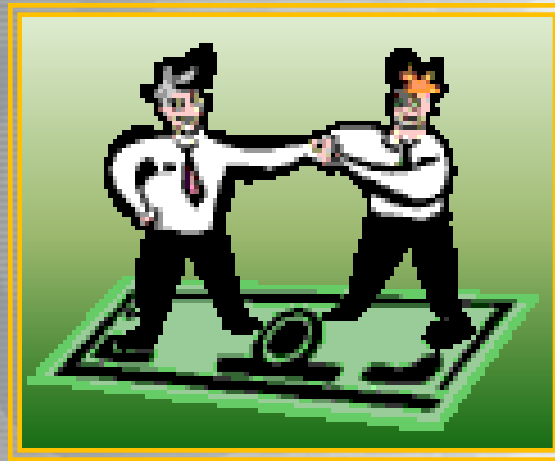
# Interpretation of DTAA.....

- ✧ **The words are to be understood with reference to the subject matter. The words employed in the treaty are to be given general meaning (general to lawyers and general to layman)**
- ✧ **When the treaty does not define the term employed in it, and the context of the treaty so requires, it can be given a meaning different from domestic law thereof. The meaning of the undefined terms in a treaty should be determined by reference to all of the relevant information and relevant context**

# **Case Law -Azadi Bachao Andolan V UOI (132 Taxman 373)**

- ✧ **The act of an assessee which is otherwise valid in law cannot be treated as untenable on the basis of underlying motive**
- ✧ **The provisions of a treaty would override the provisions of Income Tax Act, if the treaty provisions are more favourable**
- ✧ **A treaty is entered into by two sovereign States bearing in mind many aspects of development, international trade, etc. Thus, tax aspects should be seen in light of this background**
- ✧ **'Treaty Shopping' should be understood in scope of global economy. Hon'ble Supreme Court accepted the legality of Treaty Shopping and did not impose limitation on its use**

# Transfer Pricing



# Background



# Transfer pricing Evolution - OECD's View

✧ “Transfer Pricing can deprive governments of their fair share of taxes from global corporations and expose multinationals to possible double taxation. No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing. The arm’s length principle can help.”

*By John Neighbour*

*Organisation for Economic Co-operation and Development ‘OECD’ Centre for Tax Policy and Administration*

# Objectives of Transfer Pricing Regulations (TPR)

- ✧ **Protection of tax base**
- ✧ **Equitable sharing of tax revenues between the nations – i.e. Residence and Source countries**
- ✧ **Principles should be internationally acceptable to avoid economic double taxation**
- ✧ **Practical difficulties in applying the regulations should be recognised by both countries**
- ✧ **No discrimination between Multinational Enterprise (MNE) groups and Independent Enterprises – the standard of comparability should be impartial**

# Evolution of TPR...

- ✧ **Embedded in the Double Taxation Avoidance Agreement ('DTAA') Article (9) of the OECD Model Convention**
- ✧ **The OECD Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines), is the Foundation**

**Above principles serve the dual objectives**  
**- Securing the appropriate tax base in**  
**each jurisdiction and avoiding double taxation**

# Arm's Length standard – The Universal Standard (ALS)

- ✧ **The Arm's length Standard (ALS) is the Universal Standard that is applicable to the various intra-group transactions of a Multinational Enterprise (MNE). It is based on the separate – entity approach and is enshrined in the DTAAAs signed by the various countries.**

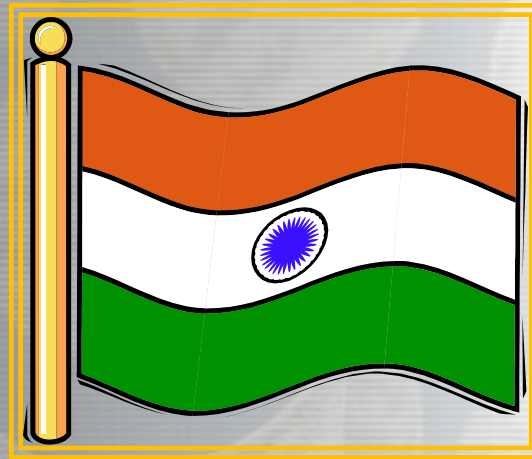




# Global Transfer Pricing Enforcement

1995	1996 - 1998	1999 - 2000	2001 - 2002	2003 - 2004	2005 - 2006	2006 - 2008	2008 - 2009	2009 - 2010
Australia South Africa USA	China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Taiwan Hungary Colombia Malaysia Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Poland Norway Kazakhstan Singapore Vietnam Ecuador Denmark Taiwan Hungary Colombia Malaysia Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Switzerland Chile Finland Ireland Israel Spain Philippines Sweden Turkey Kenya Austria Poland Norway Kazakhstan Singapore Vietnam Ecuador Denmark Taiwan Hungary Colombia Malaysia Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Indonesia Luxembourg Switzerland Chile Finland Ireland Israel Spain Philippines Sweden Turkey Kenya Austria Poland Norway Kazakhstan Singapore Vietnam Ecuador Denmark Taiwan Hungary Colombia Malaysia Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA	Hong Kong Romania Malawi Indonesia Luxembourg Switzerland Chile Finland Ireland Israel Spain Philippines Sweden Turkey Kenya Austria Poland Norway Kazakhstan Singapore Vietnam Ecuador Denmark Taiwan Hungary Colombia Malaysia Thailand Portugal Peru India Netherlands Germany Russia Belgium Venezuela Argentina Canada UK China Czech Republic Slovakia Brazil Japan Italy New Zealand Mexico Korea France Australia South Africa USA

# Indian Perspective



# An Indian Perspective

- ✧ Income arising to “Associated Enterprises” from “International Transactions” shall be computed having regard to the “Arm’s Length Price”
- ✧ The Arm’s Length Price (ALP) denotes a price which is applied or proposed to be applied in a
  - ✧ comparable transaction between
  - ✧ unrelated independent parties in
  - ✧ uncontrolled conditions
  - ✧ Usually corresponds to the open market price

# Associated Enterprise

- ✧ Means direct or indirect participation in management control or capital:
  - ✧ by one enterprise into another enterprise; or
  - ✧ by the same person in both the enterprises
- ✧ Equity holding, Control of Board of Directors / Appointment of one or more Executive Director, mutual interest will also constitute Associated Enterprise
- ✧ Either or both of Associated Enterprises should be non-residents

# Associated Enterprise .....

- ✧ **Deemed Associated Enterprises” includes:**
  - ✧ **Holding of 26% of voting power**
    - ✧ by one enterprise into another enterprise; or
    - ✧ by the same person in both the enterprises
  - ✧ **Dependence on intangible assets**
  - ✧ **Sale of goods**
    - ✧ influence on price and conditions of supply by buyer
  - ✧ **Control by individual or his relative**
  - ✧ **Financial transaction**
    - ✧ **Loan - 51% or more of book value of total assets of the borrowing enterprise**
    - ✧ **Guarantee - 10 % or more of the total borrowings of an enterprise**

# International Transaction

✧ Means “transaction” between 2 or more Associated Enterprises:

- Transaction between two or more associated enterprises  
(at least one of which will be non-resident) of purchase, sale or lease of tangible and intangible property, provision of services, financing, cost sharing / cost contribution arrangements

OR

- affecting profits, losses, income, assets or liability of the enterprise

# Computing Arm's Length Price

- ✧ **Arm's Length Price to be computed as per “Most Appropriate Method”, to be selected out of:**
  - ✧ **Transaction based method**
    - ✧ **Comparable Uncontrolled Price Method (CUP)**
    - ✧ **Resale Price Method (RPM)**
    - ✧ **Cost Plus Method (CPM)**
  - ✧ **Profit based method**
    - ✧ **Profit Split Method**
    - ✧ **Transactional Net Margin Method (TNMM)**

# Thank You



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