# Tax Avoision Through Double Taxation Avoidance Agreements by Trans National Corporations

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# CERTIFICATE

This is to certify that the thesis entitled "Tax Avoision Through Double Taxation Avoidance Agreements by Trans National Corporations" and submitted by C.P. Ramaswami, ID No. 2002 PHX F 043 for the award of Ph.D Degree of the Institute embodies original work done by him under my supervision.

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Signature

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LIST OF ABBREVIATIONS

| | |
|---|---|
| AAR | Authority for Advanced Ruling |
| ABA | Azadi Bachao Andolan |
| AIG | American Insurance Group |
| AOA | Agreement on Agriculture |
| AR | Authorised Representative |
| BBC | British Broadcasting Corporation |
| BCL | Bennet Coleman Company Ltd |
| BRI | Brown & Root Inc. |
| C.T | Contributory Trust |
| CBDT | Central Board of Direct Taxes |
| CDN | Central Data Network |
| CIT | Commissioner of Incometax |
| CPU | Central Processing Unit |
| CTBT | Comprehensive Test Ban Treaty |
| CTO | Commercial Tax Officer |

| | |
|---|---|
| CWT | Commissioner of Wealth-Tax |
| DR | Departmental Representative |
| DTAA/ DTC | Double Taxation Avoidance Agreement / Double Taxation Convention |
| DTAC | Double Taxation Avoidance Convention |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FEMA | Foreign Exchange Management Act, 1999 |
| FIPB | Foreign Investment Promotion Board |
| GAIL | Gas Authority of India Ltd |
| GATT | General Agreement on Trade and Tariff |
| HHI | Hyundai Heavy Industries Co Ltd |
| I.T Act | Income Tax Act, 1961 |
| IAC | Inspecting Assistant Commissioner |
| IC | Investment Company |
| ICC | International Chamber of Commerce |

| | |
|---|---|
| IFA | International Fiscal Association |
| IFS | Indian Financial Services Company |
| IM | Investment Manager |
| IRC | Inland Revenue Commissioner |
| IRS | Indian Revenue Service |
| ITAT | Income-tax Appellate Tribunal |
| ITD | Income tax Tribunal Decisions |
| ITR | Income Tax Reporter |
| JV | Joint Venture |
| MAT | Minimum Alternate Tax |
| MC | Model Convention |
| MDL | Mazagaon Dock Ltd |
| MFN | Most Favoured Nation |
| MOBAA | Mauritius Offshore Business Activities Authority |
| NASDAQ | National Association of Securities Dealers |
| OECD | Organisation for Economic Co-operation and Development |
| OEEC | Organisation for European Economic Co-operation |

| | |
|---|---|
| ONGC | Oil and Natural Gas Corporation |
| PE | Permanent Establishment |
| PSU | Public Sector Undertaking |
| RBI | Reserve Bank of India |
| SAARC | South Asian Association for Regional Co-operation |
| SCM | Subsidies and Countervailing Measures |
| T.V.M Ltd | TV Mauritius Ltd |
| TC | Tax Cases |
| TDS | Tax Deducted at Source |
| TNC | Transnational Corporation |
| TPR | Transfer Pricing Regulations |
| TSB | Tekniskil (Sendirian) Berhard |
| TVI | TV India Ltd |
| UAE | United Arab Emirates |
| UK | United Kingdom |
| UN | United Nations |
| UOI | Union of India |
| USA/US | United States of America/ United States |

| | |
|---|---|
| VCLT | Vienna Convention on the Law of Treaties |
| WB | World Bank |
| WTO | World Trade Organisation |

# CHAPTER-I

## NATURE OF CORPORATE TAX AVOISION

**Introduction:-** Tax 'avoision' is the new nomenclature for intelligent tax evasion. The word avoision is a fusion between avoidance and evasion, coined by Ingo Walter in his book 'Secret Money'(1) - a study on black money at the global level. Tax avoision covers transactions in business, which are apparently legitimate tax avoidance measures but actually result in tax evasion. In other words, in form these are tax avoidance schemes but in substance, tax evasion schemes. And Trans National Corporations (TNCs) excel in this activity. These are aided and buttressed by Chartered Accountants and Advocates world wide. Such activities have been growing depending on the demand for foreign investments into developing countries. Consequently, TNCs erase political boundaries of nations. Their religion is only 'money making'.

1.1 Horace said on 'Business Ethics' in Circa 20 B.C, "Make money, make it if you can, fair and square. If not, make it any way"(2). To that end TNCs take on a pro-active role in fostering governments and bringing them down when 'their business interests' are jeopardized. Ambrose

Bierce defined a corporation "as an ingenious device for making individual profit without individual responsibility"(2). The TNCs have further refined this definition and manage to make huge 'tax-free-profit' by locating their corporate headquarters in tax havens, by over-invoicing cost of plant and machinery supplied to developing countries and by constantly changing the characteristics of certain receipts from fees for technical services and royalty to some new nomenclature and by managing on paper, the non-existence of a permanent establishment.

1.2 Corporations are some fictions introduced by the State authority for certain beneficial purposes of society or administration. Once the State or the Statute has invested legal personality in a corporation or a company, it would be ordinarily difficult to wish-away its corporate existence on the ground of its being an inanimate being, whose body cannot be "cooked" and whose soul cannot be "damned"(3).

1.3 Normally corporate tax liability arises from its residential status. In turn, the residential status is fixed by the place at which the effective management and control of the corporation exists. In the international scenario also this basic concept of liability to tax depends on the corporate residential status. When actual business is carried on in one country and

the effective management and control remains in another country, a conflict arises as to in which country the tax liability would arise. The conflict gets further enlarged when the tax rates in the source country and the country of origin vary.

1.4 Tax avoision is a product of human nature. The character and caliber of the persons running the corporation overtake the corporate policies. Ingo Walter said in his book *'Secret Money'*(1): "People lie. People cheat. People commit crimes. People are driven to protect what they regard as theirs. People elect or tolerate governments, foster political and economic diversity and uncertainty. People take advantage of the misery of others. A true international market for secret money is the inevitable result; a market though itself is appropriately cloaked in secrecy. While it may change form and substance over the years, human nature will ensure that the market will continue to thrive".

1.5 Corporate tax or income tax on corporations is leviable the moment any corporation starts earning income. In the general scheme of taxation, the principle of 'pay-as-you-earn' would be prevalent in most of the countries. In the process of earning income one is prepared to incur expenses, legitimate or otherwise. However, attachment to the money

earned becomes very strong, after it is earned. Consequently, the main outflow out of the income earned viz income tax, if evadable or avoidable, one would do his best to achieve that result. This is true of personal taxation as well as corporate taxation. Big money and big capital are invested in the corporate sector. Consequently, the degree of greed in improving the bottom line has no limits in the minds of those who control the corporations.

1.6 *Adam Smith* observed as follows in 'The Wealth of Nations'-(4). Every tax ought to be so contrived as both to take as possible, over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those

unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must rise in proportion to the temptation. The law, contrary to all the ordinary principles of justice, first creates the temptations, and then punishes those who yield to it; and it commonly enhances the punishment too in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime. Fortunately, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign."

1.7 The above statements mirror the element of human nature involved in building up corporate secret money – not outside the books of accounts but inside. The methods might be cloaked in secrecy. There might be half truths and half lies. Full truths might be embedded in the labyrinths

of extensive documentation structured according to tax laws of different countries, when such exercises are carried out by TNCs.

1.8 World over, income of any person is chargeable to tax on two factors viz., 'residence' and 'source'. In general, chargeability of income to tax does not depend upon citizenship.

1.9 In case of incorporated companies also generally the same two factors are applicable. Broadly, if a company is doing business in a country other than its country of incorporation, then it would be subjected to tax on its global income in its home country, based on its residence. Besides, it will also be taxed in the host country based on its source of income. Thus double taxation could arise. Consequently, there is a need to provide for avoidance of double taxation, with a view to –

(a) encouraging free flow of international trade and investment,
(b) encouraging transfer of technology,
(c) preventing discrimination between taxpayers,
(d) providing a reasonable element of legal and fiscal certainty to investors and traders and
(e) arriving at an acceptable basis of sharing tax revenues between the two states.

1.10 In this context, what Pandit Jawaharlal Nehru, prophetically observed in 1930s in his 'Glimpses of World History'(5):

*"The world to-day is becoming, and has largely become, a single unit that is to say, that life, activities, production, distribution, consumption, etc., all tend to be international and world-wide, and this tendency is increasing. Trade, industry, the money system, are also largely international. There is the closest connection and interdependence between different countries, and an event in any one of them has reactions in others. In spite of all this internationalism, governments and their policies continue to be narrowly nationalistic. Indeed, this narrow nationalism has become worse and more aggressive during the post-war years, and is to-day a dominating factor in the world. The result is a continuous conflict between the actual international events of the world and the nationalistic policy of governments. You may look upon the international activities of the world as a river flowing down to the sea, and the national policies as attempts to stop it and dam it and divert it, and even to make it flow backwards. It is obvious that the river is not going to flow backwards, nor is it going to be stopped. But it may occasionally be diverted a little, or a dam may result in floods. So these nationalisms of to-day are interfering with the even flow of the river and creating floods and backwaters and stagnant pools, but they cannot stop the ultimate progress of the river.*

*In trade and the economic sphere we thus have what is called "economic nationalism". This means that a country is to sell more than it buys, and to produce more than it consumes. Every nation wants to sell its goods, but, then, who is to buy? For every sale there must be a seller as well as a buyer. It is obviously absurd to have a world of sellers only. And yet this is the basis of economic nationalism. Every country puts up tariff walls, economic barriers to keep out foreign goods, and at the same time it wants to develop its own foreign trade. These tariff walls interfere with and kill international trade, on which the modern world is built up. As trade languishes, industry suffers and unemployment increases. This again results in a fiercer attempt to keep out foreign goods, which are supposed to interfere with home industries, and tariff walls are raised higher. International trade suffers still more and the vicious circle goes on.*

*The modern industrial world has really advanced beyond the stage of nationalism. The whole machinery of production of goods and distribution does not fit into the nationalist structure of governments and countries. The shell is too small for the growing body inside, and it cracks.*

*These tariffs and obstacles in the way of trade really profit some classes only in each country, but as these classes are dominant in their respective countries, they shape the country's policy. So each country tries to overreach the other, and in the result all of them suffer together, and national rivalries and hatreds increase. Repeated attempts are made to settle mutual differences by conferences, and the best of intentions are expressed by the statesmen of different countries, but success eludes them.*

*These classes that profit by tariffs and other methods of encouraging economic nationalism, such as bounties and subsidies and special railway freights, etc., are the owning and manufacturing classes, who profit by these protected home markets. Vested interests are thus built up under protection and tariffs, and,, like all vested interests, they object very strongly to any change which might injure them. This is one of the reasons why tariffs, once introduced, stay on, and why economic nationalism goes on in the world although most people are convinced that it is bad for everybody. It is not easy for any nation to take a solitary lead in such a matter. If all the countries would agree to act together and put an end to, or greatly reduce, the tariffs, perhaps it might be done. Even then there would be difficulties, as industrially backward countries would suffer, as*

*they would not be able to compete on equal terms with advanced countries. No industries are often built up under the shelter of a protective duty.*

*Economic nationalism discourages and prevents trade between nations. Thus the world market suffers. Each nation becomes a monopoly area with a protected market; the free market goes. Within each nation also, monopolies increase and the free and open market tends to disappear. Big trusts, big factories, big shops swallow up the smaller producers and the petty shopkeepers, and thus put an end to competition. In America, Britain, Germany, Japan and other industrial countries these national monopolies developed at a tremendous pace, and power was thus concentrated in a few hands. Petrol, soap, chemical goods, armaments, steel, banking, and ever so many other things were monopolized. All this has a curious result. It is the inevitable consequence of the growth of science and the development of capitalism, and yet it cuts at the root of this very capitalism. For capitalism began with the world market and the free market. Competition was the breath of life of capitalism. If the world market goes, and so also the free market and competition within national boundaries, the bottom is knocked out of this old capitalist structure of society. What will take its place is another*

*matter, but it seems that the old order cannot continue for long with these mutually contradictory tendencies."*

1.11 Thus evolved the need for a regulatory mechanism of tax collection in international trade and business. Consequently, countries have entered into bilateral Double Taxation Avoidance Agreements (DTAA). Such agreements are made use of for double non-taxation also. In the name of avoidance of double taxation, even single taxation is avoided. This paper is an analysis of some of those exercises of avoision of double nay, even single taxation through DTAAs. The analysis leads one to certain factums of international business namely:

a) There is a demand for tax avoision by TNCs.

b) This demand necessitates the need for DTAAs

c) Consequently, there is a supply of tax avoision methods by way of treaty shopping, interpretation of DTAAs, etc.

1.12 Objectives of the Research:

Thus the objectives of the research are

a) Analysing the provisions of the Income Tax Act, 1961 in conjunction with Double Taxation Avoidance Agreements between India and other countries.

b) Identifying loopholes between the statute and the treaties being used to siphon off tax-free income or income being subjected to least amount of tax.

c) Making recommendations to plug the loopholes in the Indian context.

**1.13 Scope and limitation:**

a) Tax avoision is a fusion between avoidance and evasion and different from tax mitigation. It covers transactions in international business – those falling in gray areas – which are apparently called as legitimate tax avoidance measures but actually result in tax evasion. It is mainly a conflict between form and substance. In form, these are tax avoidance schemes but in substance, tax evasion.

b) Globalisation has constricted the world into a global village. As the old adage goes, 'whomsoever reigns, the business reigns'. And TNCs excel in influencing economic policy decisions of various Governments to their own advantage. Tax havens add fuel to the fire of making income and not parting with it.

c) TNCs erase political boundaries in their pursuit of making money. Horace said on business ethics '*Make money. Make it if you can, fair and square. If not, make it anyway*'. Ambrose

Bierce said in 'Devil's dictionary', 'Corporation is a ingenious device for making individual profits without individual responsibility'. Thus the scope for making money is unlimited but the power to tax the same is limited.

d) The biggest limitation is the generally accepted principle that tax treaties override domestic law and not vice versa. This principle is made use of by TNCs for paying less and less tax through the medium of DTAAs.

e) Confidentiality in business coupled with economic nationalism limit the scope for access to data and the methods of tax avoision. Even the Income Tax Departments, world over, observe strict confidentiality in parting with any worthwhile information. Consequently, the main source of literature available is only in the form of reported case laws in national and international journals.

f) Between developed countries there is two-way flow of investment and technology. But when such flow is from the developed to the developing countries, the sharing of revenues is generally to the detriment of developing countries. This limitation has made the task of the developing countries very difficult while entering into tax treaties with the developed countries.

Consequently, business contracts between the 'technology-haves' and the 'technology-have-nots' are one-sided in favour of the 'haves'. Accordingly, the interpretation of the DTAAs is also weighted against the 'have-nots'.

1.14 **Methodology**:

a) Thus, the methodology adopted is not based on any empirical data because such data is not available. It is based on a thorough analysis of reported judgments of cases before various judicial forums including the Supreme Court of India and the Authority for Advance Ruling in India.

b) Study of the Constitutional source of power vested in the Executive for entering into DTAAs has brought to the surface the faith bestowed by the constitutional makers in the Executive. Indeed, the sovereign right to tax has been, in a curious way, surrendered by Parliament to the Executive by virtue of Article 73 of the Constitution. This aspect is discussed in detail and the first major recommendation of the thesis is made on this lacuna.

## CHAPTER-II

## DEMAND FOR CORPORATE TAX AVOISION

2.1 Tax avoision means obtaining for a tax payer a reduction in his taxable income without suffering any financial loss or expenditure (6). This attitude of so arranging one's affairs with a view to minimising the tax burden is a product of human nature.

2.2 TNCs run amuck of money in their unstinted pursuit of improving the bottom line, driven by a managerial avarice. In such an endeavour they erase political boundaries. In the name of economic development and exchange of goods and services and movements of capital, technology and persons, the ultimate objective of making more and more money is stretched to the maximum. The human failings of the personnel managing the TNCs get manifested in their operations.

2.3 It is a paradoxical situation. TNCs can carry on business in different countries only thanks to the existence of civilization. Justice Oliver Wendell Holmes of U.S Supreme Court said "By paying taxes I buy civilization". However, TNCs do not want to buy civilization by paying taxes. Given an option, they would like to make use of the civilization and take back the money.

**Judicial Benediction:**

2.4 It is interesting to note that courts of different countries have repeatedly recognized the tax payers' rights in so organising their affairs as to reduce the tax liability. The shortest definition of tax avoidance is "the art of dodging tax without breaking the law." Much legal sophistry and judicial exposition have gone into the attempt to differentiate the concepts of tax evasion and tax avoidance and to discover the invisible line supposed to exist, which distinguishes one from the other. Tax avoidance, it seems, is legal; tax evasion is illegal.

2.5 For some time it looked as if tax avoidance was even viewed with affection. Lord Sumner in *IRC vs. Fisher's Executors* (7) said, "My Lords, the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any expressed terms or any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame."

2.6 Lord Tomlin, echoing what Lord Sumner had said, observed in *IRC v. Duke of Westminster* (8) as follows, typifying the prevalent attitude towards tax avoidance at that time: *"Every man is entitled if he can to*

*order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax gatherers may be of his ingenuity, he cannot be compelled to pay an increased tax."*

2.7 The attitude of the courts towards avoidance of tax perceptibly changed and hardened and in *Lord Howard de Walden v. IRC,*(9) Lord Greener, M.R., dealing with the construction of an anti-avoidance section, said: *"For years a battle of maneuver has been waged between the legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle, the Legislature has often been worsted by the skill, determination and resourcefulness of its opponents, of whom the present appellant has not been the least successful. It would not shock us in the least to find that the Legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers."*

2.8 Expressing the same sentiment and dissertating on the moral aspects of tax avoidance, Lord Simon in *Latilla vs. IRC* said (10) "My Lords, of recent years much ingenuity has been expended in certain quarters in

attempting to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residence in this country while receiving the equivalent of such income, without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."

2.9 In several cases, *Griffiths v. Harrision (Watford) Ltd.*(11), *Morgan vs. IRC*(12) and *Public Trustee v. IRC* (13), Lord Denning repeatedly referred to tax avoidance schemes and described them as magic performance by *lawyers-turned-magicians*. Lord Harman, almost in the same words as Lord Denning, described a tax avoidance scheme as one "which smells a little of the lamp" and said "*It is a splendid scheme... It is almost too good to be true. In law quite good to be true. It won't do.*" (14) Stamp J. in *In re Westem's Settlement* observed. "...There must be some

limit to the devices which this court ought to countenance in order to defeat the fiscal intentions of the legislature. In my judgement, these proposals overstep that limit.... I am not persuaded that this application represents more than a *cheap exercise in tax avoidance which I ought not sanction, as distinct from a* legitimate avoidance of liability to taxation."

2.10 The march of the law against tax avoidance schemes continued and came a significant departure from the *Westerminster* and the *Fisher's Executors* principle. In *W.T. Ramsay Ltd. v. IRC* (15), the House of Lords had to consider a scheme of tax avoidance which consisted of a series or a combination of transactions each of which was individually genuine, but the result of all which was avoidance of tax. Lord Wilberforce, with great force, observed (15)"Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well known principle of *Inland Revenue Commissioners v. Duke of Westminster* (8).

2.11.1 The Supreme Court of India also followed the above line of thinking and came down heavily against such colourable devices of tax avoision in the case of *McDowell & Co. Ltd v. CTO*(16). Chinnappa Reddy J. laid down the law as under:

*"We think that the time has come for us to depart from the Westminster principle as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J. and similar observations made elsewhere. The evil consequence of tax avoidance are manifold. First, there is substantial loss of much needed public revenue, particularly in a welfare state like ours. Next, there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation. Then there is "the large hidden loss" to the community (as pointed out by Master Sheactroft in 18 Modern Law Review 209) by some of the best brains in the country being involved in the perpetual war waged between the tax-avoider and his expert team of advisers, lawyers and accountants on the one side and the tax-gatherer and his perhaps not so skillful advisers on the other side. Then again there is the "sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it". Last, but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of the "artful dodgers". It may, indeed, be difficult for lesser mortals to attain the state of mind of Mr. Justice Holmes, who said, "Taxes*

*are what we pay for a civilized society. I like to pay taxes. With them I buy civilization.". But, surely, it is high time for the judiciary in India too to part its ways from the principle of Westminster and the alluring logic of tax avoidance. We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it. A hint of this approach is to be found in the judgement of Desai J. in Wood-Polymer Ltd.,In re & Bengal Hotels Limited, In re* (17), *where the learned judge refused to accord sanction to the amalgamation of companies as it would lead to avoidance of tax.*

*2.11.2 It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up*

*to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of "emerging" techniques of interpretation as was done in Ramsay, Burma Oil and Dawson, to expose the devices for what they really are and to refuse to give judicial benediction."*

## 2.12 Contra views of Jurist Nani A. Palkhivala

The above pronouncements were considered by the legal fraternity as a brazen statement of law by the Supreme Court contrary to the intended use of the decisions of House of Lords quoted above.

2.12.1 Noted jurist Nani A. Palkhivala wrote in an article published on 29 June 1990 in the Times of India (18) *"Among the propositions sanctified by the case-law of a century are the following. The citizen has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax. Avoidance of tax is not tax evasion and it carries no ignominy with it; for it is sound law, and certainly not bad morality, for anybody to so arrange his affairs as to reduce the brunt of taxation to a minimum. The subject cannot be taxed by ignoring the legal position and regarding "the substance*

*of the transaction". The supposed doctrine that in revenue cases "the substance of the matter" may be looked at as distinguished from the form or the strict legal position, has been given its quietus by the House of Lords, by the Privy Council and by our Supreme Court in a catena of decisions.*

*2.12.2 The principles set out above represent the correct state of the law, today as always in the past. However, in McDowell v. CTO (16), the Supreme Court took the view that the legal position in cases of tax avoidance should be taken as altered in the light of three judgments of the House of Lords - Ramsay v IR*(15) *; IR v Burmah Oil*(19)*; and Furniss v Dawson*(20).

*In McDowell's case the Supreme Court had to decide a simple question under the Andhra Pradesh sales tax law - the uncomplicated issue being whether excise duty voluntarily paid directly to the state by the buyer should be charged to sales tax.*

*The manufacturer contended that sales tax was payable only on the contractual sale price which did not include excise: the law permitted the buyer to pay excise directly and did not include excise so paid in the artificial definition of "sale price". The court had merely to decide whether the manufacturer could legitimately reduce the sales-tax liability in this manner.*

*2.12.3 This article is not concerned with the correctness or otherwise of the Supreme Court's decision on the question arising under the sales tax law. But it is of great public importance to consider the validity of the ruling of the Supreme Court blurring the distinction between tax avoidance which is legitimate and tax evasion which is not. It is submitted that the court's pronouncement obliterating such distinction is patently incorrect and proceeds on a total misreading of the three decisions of the House of Lords.*

*2.12.4 First, the three decisions of the House of Lords were rendered in the context of facts which were entirely dissimilar to the facts before the Supreme Court. Those decisions do mark a significant change in judicial approach - but only in cases where "the safe channel of acceptable tax avoidance shelves into the dangerous shallows of unacceptable tax evasion". The House of Lords was dealing with sham cases of "ready made schemes" (usually purchased off the shelf) which involved a series of inter-connected transactions which were "self-cancelling", i.e., the taxable gains were artificially neutralized by a pre-arranged loss, the loss being "the mirror image of the gain". Thus the loss was not real – it was "manufactured" or "created" or "produced". Several transactions (basic to the schemes) were commercially inert, only intended to be fiscally active on the*

*assumption that a make-believe scheme is sufficient to produce a tax effect.*

2.12.5 *Secondly, the House of Lords expressly reaffirmed the basic principle, "A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides."*

2.12.6 *Thirdly, the House of Lords expressly reaffirmed the cardinal principle of Duke of Westminster v IR*(8) *"Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance". They only ruled against the principle being overstated or overextended.*

2.12.7 *Fourthly, both the Court of Appeal and the House of Lords have unanimously upheld in a recent case the assessee's right to form a partnership with a foreign company, expressly ruling that the fact that "the course adopted by the assessee could reasonably be described as a device to avoid tax" was irrelevant.*

2.12.8 *Fifthly, in a later judgment - Craven v White*(21) *- the House of Lords made it clear that the principles laid down in the earlier three cases did not apply to a single, genuine transaction even if the motive was*

*tax avoidance, but were confined to only preordained or prearranged schemes involving a series of inter-connected transactions entered into for no purpose other than the mitigation of tax. In fact, in those earlier cases, the Law Lords themselves were at pains to state expressly that they were not laying down the law for a single transaction of tax avoidance.*

*2.12.9 In Britain itself, the three House of Lords cases have never been sought to be applied by the Inland Revenue to the type of facts which existed in McDowell. In India unfortunately, the misinterpretation of those cases in McDowell has been compounded by the indiscriminate and thoughtless manner in which that judgment has been sought to be applied to genuine and legitimate cases of tax avoidance.*

*2.12.10 It is reassuring that the Supreme Court itself has decided to reconsider McDowell' s case and has already held in a later judgment that when the language of a deed of settlement is clear, an attempt to invoke McDowell would be futile even if the deed results in tax avoidance (CWT v Arvind)*(22) .

*2.12.11 While McDowell's case is pending reconsideration(the review petition was dismissed by the Supreme Court) by the Supreme Court, the High Courts have sensibly refused to apply that ruling to cases of*

*tax planning. Is the Income-tax Department entitled to ignore a genuine partition of a Hindu undivided family where the members are honest enough to admit that the partition was motivated by a desire to reduce tax liability? Considerations of justice, equity and the rule of law - as well as the true interests of the public exchequer - demand that the Supreme Court should categorically reaffirm the clear distinction between tax avoidance and tax evasion.*

2.12.12 *In the words of Sabyasachi Mukharji, the Chief Justice of India, "One would wish that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary taxpayers very often, in a country of shortages, with ostentatious consumption, and deprivation for the large masses, ask is, does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in government spending are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance".*

## 2.13 Extraneous Reasons for Tax Avoision:

The reliance placed by Palkhivala on the obiter dictum of Justice Sabyasachi Mukharji takes one to the issue:- What should be the optimum amount of tax collected in any country?

2.14 No doubt, there is no quid pro quo for tax payment. But even a regular tax payer may be dissuaded from paying the taxes, when he sees that the revenue collected is spent on ostentatious expenditure by the State. Further, the tax dodger himself seems to indulge in ostentatious consumption by dipping into the Treasury.

2.15 One should draw inspiration from a story in Mahabharata(5A) relating to Agastya Muni, who set out as an ordinary Brahmana, to beg of various kings for sufficient wealth to live with his wife in ease and comfort.

2.15.1 When Agastya went to a king who was reputed to be very wealthy, the king presented a true picture of the income and expenditure of the State and told him he was free to take what he deemed fit. The sage found from the accounts that there was no balance left. The expenditure of a State turns out always to be at least equal to its income. This seems to have been the case in ancient times also.

2.15.2 Seeing this, Agastya said: "To accept any gift from this king will be a hardship to the citizens. So, I shall seek elsewhere," and the sage was about to leave. The King said that he would also accompany him and both of them went to another State where also they found the same state of affairs.

2.15.3 Vyasa thus lays down and illustrates the maxim that a king should not tax his subjects more than necessary for rightful public expenditure and that if one accepts as gift anything from the public revenues, one adds to the burden of the subjects to that extent.

2.16 Indeed, the S.C held in UOI vs. ABA(23) that despite the 'hiccups' in McDowells, Westminster principle is still 'alive and kicking'. This pronouncement was made in the context of upholding the constitutional validity of a circular issued by CBDT directing the Assessing Officer in India to accept the residential status of corporate assessees having an electronic existence in Mauritius. It is well settled that DTAAs generally override domestic laws except in USA where treaty override is achieved by a latter statute of domestic law.

2.17 This kind of justification by jurists and courts for any corporate assessee to indulge in tax avoision only encourages more people to follow suit. Thus what is not paid by some is to be borne by others.

## CHAPTER-III

## MODELS OF DTAAs

3.1 These are also known as Double Taxation Convention (DTCs). As the title suggests, DTAAs are meant to avoid double taxation of the same income of the same person in the same year in two different countries.

3.2 **Types of Double Taxation**

There are two types of double taxation:

(a) Economic double taxation
(b) Juridical double taxation

3.3 When the same income is taxed twice in the hands of two different taxpayers, it results in 'economic double taxation'. For instance, many countries levy tax on dividend. Here, firstly tax is levied on the profits of the company and secondly the dividend paid out of post-tax profits is again taxed in the hands of shareholders. Thus the same income is taxed twice resulting in economic double taxation.

3.4 When a particular income is taxed in two different jurisdictions in the hands of the same tax payer it results in 'juridical double taxation'. OECD (Organization for Economic Co-operation and Development) has defined juridical double taxation as the imposition of comparable taxes in two or more States on the same taxpayer in respect of the same income and

for identical periods. Its harmful effects on the exchange of goods and services and movement of capital, technology and persons are well known. It is scarcely necessary to stress the importance of removing the obstacles double taxation presents to the development of economic relations between the countries.

3.5 International juridical double taxation arises mainly because many countries levy tax on the world income of the resident taxpayers. In the source country, the income is taxed on accrual basis and in the country of residence, the income is taxed on deemed accrual basis. In India, certain incomes arising to non-residents are charged to tax on deemed accrual basis. In countries like USA, Mexico and Philippines their citizens are taxed on the worldwide income even when they are residents of another country and so arises double taxation. If juridical double taxation is not curbed, international trade and commerce will not prosper and proliferate. Thus, prima-facie, the need for avoidance of double taxation has led to evolution to DTAAs. However, DTAAs are also used for various purposes like economic co-operation and development, besides presentation of fiscal evasion and exchange of information.

## 3.6 Evolution of DTAAs

In 1920 the International Chamber of Commerce (ICC) thought of the need for some arrangement to reduce the incidence of double taxation or avoid it altogether. The ICC requested the League of Nations to help overcoming international double taxation with each country having a different tax system. The need for a Model Tax Agreement was felt – to provide consistency and uniformity for sharing of tax revenues between the States. The first draft of Model Convention (MC) was prepared by the League of Nations in 1927. The Fiscal Committee of the UN Social and Economic Council published the MC in 1946 at Geneva. The Organization for European Economic Cooperation (OEEC) took over the task and published its draft MC in 1963.

3.7 In 1961 the OECD was set up with the developed countries as its members, as successor of OEEC. The OECD approved the draft prepared by the OEEC and the MC was finalized in 1977. In 1992 a new model was published and the same was revised in the years 1995, 1997 and 2000. The OECD model was accompanied by a detailed 'Commentary' explaining the technical expressions and clauses in the MC. The Commentary is widely used in practice for the interpretation of the provisions of DTAA and many courts have recognized the commentary for its authenticity in interpreting the treaties.

3.8 OECD members are generally developed nations. The original member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States. Some more countries became members through accession. These are Japan, Finland, Australia, New Zealand, Mexico, The Zech Republic, Hungary, Poland, Korea and The Slovak Republic.

3.9 Thus the OECD model was deemed as suitable for bilateral treaties between two developed nations. As there is two way flow of investments and technology between developed nations, the sharing of revenues on the resident member was considered appropriate and adequate.

3.10 With regard to vicissitudes of developing nations, the need for a different model was felt – because the flow of investments and capital is not necessarily two way. More often than not, it is from the developed nation to the developing nation. Consequently, the developing country cannot get its legitimate share of revenue from the non-resident. Therefore a new model called the UN Model was developed in 1968 and an expert group was formed for the purpose. In 1980, this group finalized the UN Model Convention in its present form. The UN Model is based on the

OECD Model and so there are significant similarities in the language of the two models and their commentaries.

3.11 The UN Model is a compromise between the 'source member' and the 'resident member'. It gives more weightage to the 'source member'. It is designed to encourage the flow of investment from the developed to the developing countries and takes into account the sharing of tax revenues with the country providing the capital. Withholding tax rates for dividend, interest and royalties are left with the bilateral negotiations between the two countries as against specific rates mentioned in OECD Model.

3.12 The United States has brought out its own Model in 1976 as the basis for US Treaty negotiations with other countries. That Model has been revised in 1977 and 1981. In September 1996, its new version along with technical explanation has been published. There is strong identity between the provisions of OECD Model and US Model. The US Model reflects the fact that it has drawn heavily on the work of the OECD Model. The technical explanation compares and contrasts between the US and OECD Models – thus bringing out both similarities and differences. While concluding any tax treaty, the US will carry out variations that are necessary to address a particular aspect of the Treaty Partner's tax Laws. For example, Article 14 of Indo-US DTAA dealing with 'Permanent Establishment Tax' provides that a resident company of US may be

subjected to tax in India at a rate higher than that applicable to domestic companies but the difference shall not exceed 15%. Similarly, Article 24 of Indo-US Treaty is a unique article on the 'Limitation of Benefits' under the Treaty. This is a provision for avoidance of double non-taxation. As an anti-avoidance provision, it is a unique feature of US Model.

## 3.13 Structure of DTAA

3.13.1 Chapters I and II deal with the application of the tax treaty i.e., defining the scope of the Convention and important definitions.

3.13.2 Chapter III is the most important chapter, and contains Articles 6 to 21. These Articles contain the distributive rules regarding income taxes depending upon the nature and source of income between a residence State and a source State.

3.13.3 Chapter IV contains the distributive rule for capital taxes in Article 22 - Chapter V provides two methods for "Elimination *of* Double Taxation", namely, " Exemption Method" (Article 23A) and "Credit Method" (Article 23B). (The US Model provides only for Credit Method). Thus, this Article provides relief from double taxation on any income which may be taxed in both the Contracting States as per the distributive rules contained in Articles 6 to 21. Some treaties signed by developing nations also contain the provisions for "tax sparing" under this chapter. For example, the lndoMauritius tax treaty provides (Article 23) for deemed

credit in the State of residence in respect of taxes foregone by the State of source.

3.13.4 Chapter VI contains special provisions regarding Non-discrimination (Article 24) a Mutual Agreement Procedure (Article 25) for resolving differences of opinion and uncertainties. Article 26 provides for the Exchange of Tax Information and Article 27 contains reservation for the tax privileges of Diplomats and Consular Officers.

3.13.5 Final provisions in Chapter VII regulate the Entry into Force and the Termination of the DTAA.

## 3.14 The Purpose and Consequence of DTAAs between India and Other Countries

It would be necessary to understand the purpose and necessity of Double Taxation Treaties, Conventions or Agreements, as diversely called. The Income-tax Act, 1961, contains a special Chapter IX which is devoted to the subject of "Double Taxation Relief".

## 3.15 Historical Perspective

The purpose of section 90 becomes clear by reference to its legislative history. Section 49A of the Indian Income-tax Act, 1922, enabled the Central Government to enter into an agreement with the Government of any country outside India for the granting of relief in

respect of income which, both income-tax (including super-tax) under the Act and income-tax in that country under the Income-tax Act and the corresponding law in force in that country, had been paid. The Central Government could make such provisions as necessary for implementing the agreement by notification in the Official Gazette.

3.16 When the Income-tax Act, 1961, was introduced, section 90 contained therein initially was a reproduction of section 49A of the 1922 Act. The Finance Act, 1972, modified section 90 and brought it into force with effect from April, 1972. The object and scope of the substitution was explained by a circular No.108 of the Central Board of Direct Taxes (CBDT)(dated March 20,1973) as to empower the Central Government to enter into agreements with foreign countries, not only for the purpose of avoidance of double taxation of income, but also for enabling the tax authorities to exchange information for the prevention of evasion or avoidance of taxes on income or for investigation of cases involving tax evasion or avoidance or for recovery of taxes in foreign countries on a reciprocal basis.

3.17 In 1991, the existing section 90 was renumbered as sub-section (1) and sub-section (2) was inserted by the Finance (No. 2) Act, 1991, with retrospective effect from April 1, 1972. CBDT Circular No. 621 dated December 19,1991 (24), explains its purpose as follows (page 187) :

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"Taxation of foreign companies and other non-resident taxpayers:

*" Tax treaties generally contain a provision to the effect that the laws of the two contracting States will govern the taxation of income in the respective State except when express provision to the contrary is made in the treaty. It may so happen that the tax treaty with a foreign country may contain a provision giving concessional treatment to any income as compared to the position under the Indian law existing at that point of time. However, the Indian law may subsequently be amended, reducing the incidence of tax to a level lower than what has been provided in the tax treaty.*

*Since the tax treaties are intended to grant tax relief and not put residents of a contracting country at a disadvantage vis-a-vis other taxpayers, section 90 of the Income-tax Act has been amended to clarify that any beneficial provision in the law will not be denied to a resident of a contracting country merely because the corresponding provision in the tax treaty is less beneficial."*

3.18 Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of the taxable entity, maintenance of a permanent establishment, and so on. A country might choose to emphasise one or the other of the aforesaid factors for exercising fiscal jurisdiction to tax the

entity. Depending on which of the factors is considered to be the connecting factor in different countries, the same income of the same entity might become liable to taxation in different countries. This would give rise to harsh consequences and impair economic development. In order to avoid such an anomalous and incongruous situation, the Governments of different countries enter into bilateral treaties.

3.19 The power of entering into a treaty is an inherent part of the sovereign power of the State. Its source is traced to Entry 14 List 1 of Seventh Schedule in the Constitution of India. By Article 73, subject to the provisions of the Constitution, the executive power of the Union extends to the matters with respect to which Parliament has power to make laws. Our Constitution makes no provision for parliamentary ratification, for the entry into force an international treaty in time either of war or peace. The executive power of the Union is vested in the President and is exercisable in accordance 'with the Constitution. The executive is qua the State competent to represent the State in all matters international and may by agreement, convention or treaty incur obligations which in international law are binding upon the State. But the obligations arising under the agreement or treaties are not by their own force binding upon Indian nationals. The power to legislate in respect of treaties lies with Parliament under Entry 10 of List I of the Seventh Schedule read with Article 253 of

the Constitution. But making of law under that authority is necessary when, the treaty or agreement operates to restrict the rights of Citizens or others or modifies the law of the State. If the rights of the citizens or of others which are justiciable are not affected, no legislative measure is needed to give effect to the agreement or treaty (see in this connection *Maganbhai Ishwarbhai Patel v. Union of India* (25).

3.20 When it comes to fiscal treaties dealing with double taxation avoidance, different countries have varying procedures. In the United States such a treaty becomes a part of municipal law upon ratification by the Senate. In the United Kingdom such a treaty would have to be endorsed by an order made by the Queen in Council. Since in India such a treaty would have to be translated into an Act of Parliament, a procedure which would be time consuming and cumbersome, a special procedure was evolved by enacting section 90 of the Act.

3.21 Section 90 reads:

"90. *Agreement with foreign countries* (l) The Central Government may enter into an agreement with the Government of any country outside India-

(a) for the granting of relief in respect of income on which have been paid both income-tax under this Act and. income-tax in that country, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(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 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, and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or, as the case may be, 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.

*Explanation-* For the removal of doubts, it is hereby declared that the charge of tax in respect of 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, where such foreign company has not made the prescribed arrangement for declaration and payment within India, of the dividends (including dividends on preference shares) payable out of its income in India.

3.22 Section 4 provides for charge of income-tax Section 5 provides that the total income of a resident includes all income which: (a) is received, deemed to be received in India, or (b) accrues, arises or is deemed to accrue or arise in India, or (c) accrues or arises outside India, during the previous year. A person "resident" in India would be liable to income-tax on the basis of his global income unless he is a person who is "not ordinarily" resident within the meaning of section

3.23 The concept of residence in India is indicated in section 6. A company is said to be "resident" in India in any previous year, if it is an Indian company or if during that year the control and management of its affairs is situated wholly in India.

3.24 India has entered into comprehensive DTAAs with 60 countries and limited tax treaties with 17 countries and the list is as under:

| S.No | Name of the country | Date of Signing | Date of Notification | Assessment Year Effective from |
|---|---|---|---|---|
| 1. | AUSTRALIA | 25.7.1991 | 22.1.1992 | 1993-94 |
| 2. | AUSTRIA | 24.9.1963 | 5.4.1965 | 1963-64 |
| 3. | BANGLADESH | 27.8.1991 | 8.9.1992 | 1993-94 |
| 4. | BELGIUM (R) | 26.4.1993 | 31.10.1997 | 1999-2000 |
| 5. | BELARUS | 27.9.1997 | 17.7.1998' | 1999-2000 |
| 6. | BRAZIL | 26.4.1988 | 31.3.1992 | 1994-95 |
| 7. | BULGARIA | 26.5.1994 | 9.5.1996 | 1997 –98 |
| 8. | CANADA (R) | 11.1.1996 | 15.1.1998 | 1999-2000 |
| 9. | CHINA | 18.7.1994 | 5.4.1995 | 1996-97 |

| | | | | |
|---|---|---|---|---|
| 10. | CYPRUS | 13.6.1995 | 26.12.1995 | 1994-95 |
| 11. | CZECH REPUBLIC *(0)* | 27.1.1986 | 25.5.1987 | 1986-87 |
| 12. | DENMARK (R) | 8.3.1989 | 25.9.1989 | 1990-91/1991-92 |
| 13 | FINLAND (R) | 10.6.1983 | 20.11.1984 | 1985-86 |
| 14. | FRANCE (R) | 29.9.1992 | 7.9.1994 | 1996-97 |
| 15. | F.R.G. (R) | 19.6.1995 | 29.11.1996 | 1998-99 |
| 16. | G.D.R. (R) | 26.7.1989 | 2.3.1990 | 1985-86 |
| 17. | GREECE | 11.2.1965 | 17.3.1967 | 1964-65 |
| 18. | HUNGARY | 30.10.1986 | 13.3.1987 | 1989-90 |
| 19. | INDONESIA | 7.8.1987 | 4.2.1988 | 1989-90 |
| 20. | ISRAEL | 29.1.1996 | 26.6.1996 | 1995-96 |
| 21. | ITALY (R) | 19.2.1993 | 25.4.1996 | 1997 –98 |
| 22. | JAPAN (R) | 7.3.1989 | 1.3.1990 | 1991-92 |
| .23. | JORDAN | 20.4.1999 | 13.12.1999, | 2001-2002 |
| 24. | KAZAKSTAN | 9.12.1996 | 31.10.1997 | 1999-2000 |
| 25. | KENYA | 12.4.1985 | 28.8.1985 | 1985-86 |
| 26. | LIBYA | 2.3.1981 | 1.7.1982 | 1983-84/1984-85 |
| 27. | MALAYSIA | 25.10.1976 | 1.4.1977 | 1973-74 |
| 28. | MALTA | 28.9.1994 | 22.11.1995 | 1997-98 |
| 29. | MAURITIUS | 24.8.1982 | ")...6.12.1983 | 1983-84 |
| 30. | MONGOLIA | 22.2.1994 | 16.9.1996 | 1995-96 |
| 31. | NAMIBIA | 15.2.1997 | 8.3.1999 | 1999-00/2000-01 |
| 32. | NEPAL | 18.1.1987 | 5.12.1988 | 1990-91 |
| 33. | NETHERLANDS | 30.7.1988 | 27.3.1989 | 1990-91 |
| 34. | NEW ZEALAND | 17.10.1986 | 27.3.1987 | 1988-89 |
| 35. | NORWAY (R) | 31.12.1986 | 9.9.1987 | 1988-89 |
| 36. | OMAN | 2.4.1997 | 23.9.1997 | 1999-2000 |
| 37. | PAKISTAN | - | 10.12.1947 | - |
| 38. | PHILLIPPINES | 12.2.1996 | 25.3.1996 | 1996-97 |
| 39. | POLAND (R) | 21.6.1989 | 26.10.1989 | 1991-92 |
| 40. | ROMANIA | 10.3.1987 | 8.2.1988 | 1989-90 |
| 41. | RUSSIAN FEDER. | 25.3.1997 | 21.8.1998 | 2000-2001 |
| 42. | SINGAPORE (R) | 24.1.1994 | 8.8.1994 | 1995-96 |
| 43. | SOUTH AFRICA | 4.12.1996 | 21.4.1998 | 1999-2000 |
| 44. | SOUTH KOREA * | 19.7.1985 | 26.9.1986 | 1985-86/1985-86 |
| 45. | SPAIN | 8.2.1993 | 21.4.1995 | 1997 –98 |
| 46. | SRI LANKA (R) | 27.1.1982 | 19.4.1983 | 1981-82 |
| 47. | SWEDEN (NEW) | 24.6.1997 | 17.12.1997 | 1999-2000 |

| | | | | |
|---|---|---|---|---|
| 48. | SWISS CONFEDR. | 2.11.1994 | 21.4.1995 | 1996-97 |
| 49. | SYRIA | 6.2.1984 | 25.6.1985 | 1983-84/1976-77 |
| 50. | TANZANIA | 5.9.1979 | 16.10.1981 | 1982-83/1983-84 |
| 51. | THAILAND | 22.3.1985 | 27.6.1986 | 1987 -88/1988-89 |
| 52. | TURKEY | 31.1.1995 | 3.2.1997 | 1995-96 |
| 53. | TURKMENISTAN | 25.2.1997 | 25.9.1997 | 1999-2000 |
| 54. | UAE | 20.4.1992 | 18.11.1993 | 1995-96 |
| 55. | UAR | 20.2.1969 | 30.9.1969' | 1969-70/1970-71/ 1961-62/1962-63 (AIR) |
| 56. | UK (REVISED) | 25.1.1993 | 11.2.1994 | 1995-96 |
| 57. | USA | 12.9.1989 | 20.12.1990 | 1992-93 |
| 58. | UZBEKISTAN | 29.7.1993 | 13.11.1996 | 1994-95 |
| 59. | VIETNAM | 7.9.1994 | 28.4.1995 | 1997-98 |
| 60. | ZAMBIA | 5.6.1981 | 18.1.1986 | 1979-80 |

Abbreviations:

(0) Old Agreements
(R) Revised Agreements
(SP) Supplementary Protocol
(P) Protocol
(EoN) Exchange of Notes

Notes:

* In respect of South Korea, the Agreement has been initialed at the delegation level on 8.9.1983.

** The agreement with USSR was extended by a notification to the Russian Federation until the new Agreement comes into force.

**A list of Countries with whom India has limited tax treaties is as below:**

| S. No. | Name of The country | Signed on | Notification No. & Date |
|---|---|---|---|
| 1. | AFGHANISTAN | 14.9.1975 | 514(E)/30.9,1975 |
| 2. | BULGARIA | 18.11.1976 | 184(E)/15.4.1977 |
| 3. | CZECHSLOVAKIA | 3.11.1978 | 286(E)/3.6.1980 |
| 4. | ETHIOPIA | 25.11.1976 | 8(E)/4.1.1978 |
| 5. | GERMAN DEMOCRATIC REPUBLIC | 9.1.1979 | 282(E)/27.4.1979 |

| | | | |
|---|---|---|---|
| 6. | IRAN | 29.3.1973 | 284(E)/28.5.1973 |
| 7. | KUWAIT | 21.4.1982 | 302(E)/31.3.1983 |
| 8. | LEBANON | 22.2.1968 | 1552/28.6.1969 |
| 9. | PAKISTAN | 31.12.1988 | 792(E)/29.8.1989 |
| 10. | RUSSIAN FEDERATION | 30.12.1992 | GSR 952(E) |
| 11. | SAUDI ARABIA | 14.11.1991 | 1950(E)/29.12.1992 |
| 12. | U.S.S.R. | 19.7.1976 | 943(E)/23.12.1976 |
| 13. | U.A.E. | 3.3.1989 | 969(E)/8.11.1989 |
| 14. | UNITED IUNGDOM | 3.4.1956 | 38(E)/30.6.1956 |
| 15. | U.S.A. | 12.4.1989 | 626(E)/15.6.1989 |
| 16. | YEMEN ARAB REPUBLIC | 30.12.1986 | 7084(E )/1.1.1987 |
| 17 | YEMEN (PEOPLE'S DEMOCRATIC REPUBLIC OF) | 12.8.1988 | GSR 857(E) |

## CHATPER-IV

## INTERPRETATION OF DTAAs

4.1 "Language is at best an imperfect instrument for the expression of human thoughts and behaviour" so said one of the leading judges in India. Verily true. Ninety per cent of disputes are attributable to the "communication gap", and taxation is no exception to it. The danger of communication gap is even greater in case of passive communication where the reader and the communicator are not in direct contact with one another. The reader reads a sentence and tries to interpret the meaning the writer meant to assign. The quality of "interpretation" depends upon the quality of the reader i.e. his level of understanding, knowledge and interpretational skill. It is crucial to arrive at the "intention" and exact "meaning" the writer wanted to communicate. Therefore, it is equally important for one to understand and interpret any term or a sentence in the same context in which the writer has written it. Many cases come before the courts on these interpretational issues.

4.2 In cases of DTAAs, the interpretation issues assume significance, as it is an agreement between two sovereign States. DTAA, being an international agreement, falls within the domain of public international law.

The interpretation of tax treaties would be governed by general principles for interpretation of international agreements.

4.3 These general principles are contained in Vienna Convention on the Law of Treaties of 23rd May, 1969 (VCLT). This Convention came into effect on 27th January,1980. More than 34 States have accepted and ratified this Convention. India is not a signatory to this convention. However, it hardly matters, as the convention to a great extent, merely codifies existing norms of customary international law and therefore the general rules of interpretation would equally be applicable in case of Indian treaties as well. In Thiel v. FCT(23), the Australian High court upheld the use of the rules of the Vienna Convention as a basic law on the interpretation of DTAA even by States, which have not yet ratified the Vienna Convention.

4.4 The International Fiscal Association supported this view by passing a special resolution in 1993 at its annual congress held in Florence, Italy. According to Prof. Klaus Vogel, VCLT constitutes customary international law. There are three Articles in VCLT, which deal with interpretation of international (cross-border) agreements, namely,

- Article 31 on General rules of interpretation
- Article 32 on Supplementary means of interpretation and
- Article 33 on Interpretation of treaties authenticated in two or more languages.

4.5 Article 31 (1) of the VCLT stipulates that a treaty shall be interpreted in good faith. The interpretation must be by using the ordinary meaning of the term. The term may derive its meaning from uniform legal usage in the course of international business or may have been extensively used by OECD MC and its commentary. Prof. Klaus Vogel states that "the intention of the parties is only significant to the degree to which it has been expressed in the text of the agreement." Thus, the intention of the parties should be clear and specific and one cannot arrive at it with the help of presumptions.

4.6 Notes and letters exchanged at the time of signing of the treaty, minutes of the negotiations held, etc, may form part of the "supplementary materials" which are created in the context of treaty negotiations in terms of Articles 31 & 32 of the VCLT. Such material is useful to establish the intention and context of a particular provision in the treaty and thus a useful aid in treaty interpretation.

4.7 Article 33 of the VCLT provides that when a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides that in case of divergence, a particular text shall prevail. For example, the Indo-Mauritius tax treaty is executed in two languages, namely Hindi and English, and it is provided that in case of divergence between the two texts, the English text alone

shall be operative.

Commentary

4.8 OECD has published a detailed commentary as a guide for interpretation of the various provisions of the OECD Model Convention. The commentary is revised from time to time, the latest revision being in the year 2000. The other commentary on the subject is published by the UN, which is based on the OECD commentary to the extent the provisions of UN Model Convention are identical with that of OECD Model Convention. USA has its own model and has published "technical explanation", which provides a basic explanation on each Article thereof. This explanation is very useful in understanding the US treaty policy. Commentaries are. cited before many courts while arguing a particular point of law. In fact, it is common in Indian courts, as well as Authority for Advance Ruling(AAR, for short), to refer to the OECD and other Commentaries for interpretation of tax treaties.

4.9 What is "liable to taxation"

Fiscal residence

The concept of "fiscal residence" of a company assumes importance in the application and interpretation of DTAAs. In *Cahiers De Droit Fiscal International*, Jean Maic Riviar(Volume LXXII, pages 47-76), it is said that under the OECD and UN Model Convention, "fiscal residence" is a place where a person, amongst others a corporation, is subjected to

unlimited fiscal liability and subjected to taxation for the worldwide profit of the resident company. At para. 2.2, it is pointed out:

> *"The UN Model Convention takes these two different concepts into account. It has not embodied the second sentence of article 4, paragraph 1 of the OECD Model Convention, which provides that the term 'resident' does not include any person who is liable to tax in that State in respect only of income from sources in that State. In fact, if one adhered to a strict interpretation of this text, there would be no resident in the meaning of the convention in those States that apply the principle of territoriality."*

*4.9.1 Again in paragraph 3.5 it is said:*

> *"The existence of a company from a company law standpoint is usually determined under the law of the State of incorporation or of the country where the real seat is located. On the other hand, the tax status of a corporation is determined under the law of each of the countries where it carries on business, be it as resident or non-resident."*

4.10 In paragraph 4.1 it is observed that the principle of universality of taxation, i.e., the principle of worldwide taxation, has been adopted by a majority of States. One has to consider the worldwide income of a company to determine its taxable profit. In this system it is crucial to define

the fiscal residence of a company very accurately. The State' of residence is the one entitled to levy tax on the corporation's worldwide profit. The company is subject to unlimited fiscal liability in that State.

4.11 In the case of a company, however, several factors enter the picture and render the decision difficult. First, the company is necessarily incorporated and usually registered under the tax law of a State that grants it corporate status. A corporation has administrative activities, directors and managers who reside, meet and take decisions in one or several places. It has activities and carries on business: Finally, it has shareholders who control it. Hence, it is opined:

> *"When all these elements coexist in the same country, no complications arise. As soon as they are dissociated and I scattered' in different States, each country may want to subject the company to taxation on the basis of an element to which it gives preference; incorporation procedure, management functions, running of the business, shareholders' controlling power. Depending on the criterion adopted, fiscal residence will abide in one or the other country.*
>
> *All the European countries concerned, except France, levy tax on the worldwide profit at the place of residence of the company considered.*

*South Korea, India and Japan in Asia, Australia and New Zealand in Oceania follow this principle."*

4.12 In paragraph 4.2.1 it is pointed out that the Anglo-Saxon concept of a company's "incorporation test", which is applied in the United States, has not been adopted by other countries like Australia, Canada, Denmark, New Zealand and India and instead the criterion of incorporation amongst other tests has been adopted by them. For instance, the Indo-Mauritius DTAA, article 4, clearly defines the term "residence" in a "Contracting State".

4.13 In *A Manual on the OECD Model Tax Convention on Income and on Capital*, at paragraph 4B.O5, while commenting on article 4 of the OECD Double Tax Convention, Philip Baker points out that the phrase "liable to tax" used in the first sentence of article 4.1 of the Model Convention has raised a number of issues, and observes: *"It seems clear that a person does not have to be actually paying tax to be 'liable to tax' -otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the convention. It also seems clear that a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, if the exemption were repealed, or the person no longer qualified for the exemption, the person would be liable to comprehensive taxation."*

4.14 Interestingly, Baker refers to the decision of the AAR in *Mohsinally Alimohammed Rafik, In re*(27 ). An assessee, who resided in Dubai claimed the benefits of the UAE-India Convention of April 29, 1992, even though there was no personal income-tax in Dubai to which he might be liable. The Authority concluded that he was entitled to the benefits of the convention. The Authority subsequently reversed this position in the case of Cyril Eugene Pereira, In re *(28)* where a contrary view was taken. This decision of the AAR was not approved by the Supreme Court in Union of India vs. Azadi Bachao Andolan *(23)*

4.15 In *John N. Gladden v. Her Majesty the Queen[* as quoted in (23)], the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed: "*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."*

4.15.1 *Gladden* was a case where. an American citizen resident in USA owned shares in two privately controlled Canadian companies. Upon his death, the question arose as to the capital gains which would arise as a

result of the deemed disposition of the said shares. The Canadian Revenue took the position that there was a deemed disposition of the shares on the death of the tax payer and capital gains tax was chargeable on account of the deemed disposition. This view of the Revenue was upheld in appeal by the Tax Court of Canada. Upon further appeal to the Federal Court it was held that capital

gains were exempt from tax under the Canada-USA Tax Treaty as Canada had no capital gains tax when it entered the treaty and it could not unilaterally amend its legislation.

4.15.2 Interpreting the relevant article of the Double Taxation Avoidance Treaty the trial court held: "*The parties could not have negotiated to avoid double taxation on a tax which did not exist in Canada". The Federal Court emphasised that in interpreting and applying treaties the courts should be prepared to extend" a liberal. and extended construction" to avoid an anomaly which a contrary construction would lead to. The court 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.*"

4.15.3 Interpreting the article of the Treaty against avoidance of double taxation, the Federal Court said (at page 5) : "*The non-resident can benefit*

*from the exemption regardless of whether or not he is taxable on that capital gain in his own country. If Canada or the U. S. were to abolish capital gains completely, while the other country did not, a resident of the country which had abolished capital gains would still be exempt from capital gains in the other country."*

4.16 According to Klaus Vogel "Double Taxation Convention establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax-claims are expected, or at least theoretically possible. In other words, the Contracting States mutually bind themselves not to levy taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other contracting States either entirely or in part. Contracting States are said to 'waive' tax claims or more illustratively to divide 'tax sources', the 'taxable objects', amongst themselves.

4.17 Double taxation avoidance treaties were in vogue even from the time of the League of Nations. The experts appointed in the early 1920s by the League of Nations describe this method of classification of items and their assignments to the Contracting States. While the English lawyers called it 'classification and assignment rules', the German jurists called it 'the distributive rule' (Verteilungsnorm). To the extent that an exemption is agreed to, its effect is in principle independent of both whether the other

contracting State imposes a tax in the situation to which the exemption applies, and of whether that State actually levies the tax.

4.18 Commenting particularly on the German Double Taxation Convention with the United States, Vogel comments: "*Thus, it is said that the treaty prevents not only 'current', but also merely 'potential' double taxation*". Further, according to Vogel, only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one Contracting State dependent upon whether the income or capital is taxable in the other Contracting State, or upon whether it is actually taxed there.

4.19 The decision of the Federal Court of Australia in *Commissioner of Taxation v. Lamesa Holdings* [as quoted in (23)] is illuminating. The issue before the Federal Court was whether a Netherlands company was liable to income-tax under the Australian Income Tax Act on profits from the sale of shares in an Australian company and whether such profits fell within article 13 (alienation of property) of the Netherlands-Australia Double Taxation Agreement, so as to be excluded from article 7 (business profits) of that Agreement.

4.19.1 One Leonard, Green, a principal of Leonard Green and Associates a limited partnership established in the United States, became aware of a potential investment opportunity in Australia. Armico Resources and Mining Company NL ("Armico"), a company listed on the Australian

Stock Exchange, which had a subsidiary called Armico Mining Pty. Limited engaged in gold mining activities, was the subject of a hostile takeover bid, at a price which Green was advised was less than the real value of Armico. With this knowledge Green decided to mount a takeover offer for the subsidiary company.

4.19.2 Then followed a series of steps of formation of a number of companies with interlocking shareholdings where each company owned 1005 shares of a different subsidiary company. Lamesa Holdings was one such intermediary company of which 100 per cent. shares were held by Green Equity Investments Ltd. The share transactions brought about a profit to Lamesa Holdings which would be assessable to tax under the Australian Income Tax Act. Lamesa, however, relied on the provisions of the article 13(2) of the DTAC between Netherlands and Australia and claimed that the income was not taxable in Australia by reason thereof. This income was wholly exempt from tax in Netherlands by reason of the income tax law applicable therein.

4.19.3 The Federal Court found that under article 13(2) (a) (ii) of the DTAC shares in a company were treated as personality, that since the place of incorporation of a company or the place of situs of a share may be the subject of choice, the place of incorporation or the register upon which shares were registered would not form a particularly close connection with

shares to ground the jurisdiction to tax share profits. It was held: *"It happens to be the case, because of unilateral relief granted by the law of the Netherlands, that no tax will be payable in the Netherlands. That of itself cannot affect the interpretation of the agreement. If the relevant mining property had happened to be in the Netherlands so that the issue was between taxation there on the one hand and taxation in Australia on the other, the situation would have been one where tax would clearly have been payable on the alienation of the shares in Australia without the benefit of any exemption. Yet the Agreement must operate uniformly, whether the realty is in the Netherlands or in Australia."*

4.20 **Documentation in connection with DTAAs.**

Treaties are finalized after completion of the negotiation between two countries. Therefore, various documents, which are generated in the process of negotiation, can be of great help in establishing the intent of the parties on a particular provision. Correspondence between the two countries, exchange of notes while signing the treaty, minutes of the meeting held for negotiations and protocol are all relevant documents in understanding and interpreting treaty provisions. Although, many of these documents are not publicly available, they are useful at the time of resolving disputes through the mutual agreement procedure.

## 4.21 Protocol to the Tax Treaty

Many treaties contain protocol at the end of the treaty by way of annexure as a supplement to the treaty. Protocols are entered into in order to clarify and record the understanding arrived at between treaty partners. Often, various terms or provisions are explained by way of examples. Other important objectives of the Protocol include the Most Favoured Nation (MFN) clause and the provisions of tax sparing.

4.21.1 MFN clause is usually found in Protocols and Exchange of Notes to DTAAs. Under the MFN clause, one country agrees to give/extend specific benefits to the residents of the treaty partner, which it has promised or given under a treaty to the residents of another country. The benefit may be in the form of lower rate of tax or a limit on the income liable to tax or a higher deduction in respect of executive and general administrative expenses of head office, etc. Tax sparing is a provision whereby deemed credit is given by the State of residence in respect of taxes, which are otherwise not paid or payable owing to exemptions granted by the State of source.

## 4.22 DTAAs are self-contained Agreements

DTAAs are to be interpreted as self-contained agreements. It means that the scope or applicability of the treaty can not be enlarged by assigning

meaning, which is not intended or explicitly provided in the treaty. For Example, Article 10 of the Indo- Mauritian tax treaty provides that benefit of the lower rate of tax as per the treaty provision is applicable provided the beneficial owner of the dividend is a resident of either contracting State.

4.22.1 In the case of Natwest Ruling(One of the case studies in Chapter-IV infra) AAR denied the benefit of Indo-Mauritian tax treaty in respect of dividend income as the beneficial owner (the parent co. - Natwest) was not a resident of Mauritius. However, Article 13 on Capital Gains of the said DTAAs does not prescribe the condition of 'beneficial ownership' by the resident of the contracting State and hence the AAR observed that the benefit of Article 13 was applicable to the Mauritian subsidiary.

4.23 **Meanings of the Terms not defined in the Treaty**

If a particular term is not defined in the treaty, its meaning may be ascertained from the domestic tax law of the country applying the treaty under certain circumstances. However, such an ascertainment largely depends on the context.

4.23.1 Another issue could arise when a treaty refers to the provision of the domestic laws of a contracting State for assigning meaning to a particular term and subsequently, the domestic law of the contracting State applying the treaty undergoes changes. In such a situation, a question arises as to what meaning should be attached to such term, i.e. whether the meaning

that was prevailing under the domestic law as on the date of signing the treaty (i.e. the static approach) or the meaning that is prevailing on the date of application of the treaty (ie. an ambulatory approach).

.4.24 OECD Model commentary 1995 as well US technical explanation explicitly recognize ambulatory approach in interpretation of terms, which are to be interpreted according to the domestic tax laws of the contracting State. However, an ambulatory approach cannot be applied where there is a radical amendment in the domestic law where the change will have substantial implication in the application of the treaty provision. In such a situation, explicit agreement (may be by way of exchange of notes, or protocol) between both the contracting States is essential.

### 4.25 Application of DTAA - DTAA v/s National (Domestic) tax law

4.25.1 In case of conflicting provisions under a national law vis-a-vis international law (e.g. DTAA), a question arises as to which provision would prevail. The supremacy of one law over another would depend upon one of the two prevalent international views. One view is known as 'Monistic view', wherein, International Law and National Law are part of the same system of Law and provisions of the DTAA could override provisions of the national law e.g. Argentina, Italy, France, Netherlands, etc. follow the 'monistic view'.

4.25.2 The other view is known as 'Dualistic view', wherein International law and National law are separate systems and DTAA becomes part of the national legal system by specific incorporation/ legislation. In case of Dualistic view, DTAAs may be made subject to provisions of the national law.

4.25.3 Thus, it follows that a State with a Monistic view of DTAAs cannot impose procedural requirements between the obligations undertaken by the State and those who are entitled to the benefits resulting from those obligations, if those requirements are viewed as diminishing the effect of the obligation. In contrast, in a Dualistic State, the national legislation by which the obligations are incorporated may impose procedural requirements for applying the obligations e.g. Austria, Australia, Germany, Norway, etc. follow the 'Dualistic view'.

4.25.4 In principle, India follows Dualistic view, with the right for Parliament to enact a law to make international law part of the domestic law. A view could be held that practically India follows the Monistic view. This view follows from the fact that by delegation of powers under the Income Tax Act, the Parliament has made DTCs part of the domestic tax system and further, CBDT has clarified that DTC provisions would prevail over inconsistent domestic tax law.

4.25.5 The United States Convention is a compromise between these two positions, with international agreements and national legislation being accorded equal status with precedence being given for the latter position prevailing.

## 4.26 Andean Model – Distinguishing Features

It is a regional level Model Convention developed in 1971. A group of lesser and medium developed Latin American countries have adopted this Model, namely, Bolivia, Columbia, Chile, Ecuador, Peru, and Venezuela. It provides for almost exclusive taxation in source country except in cases of international traffic. P.E. concept is not adopted This model is not used by other countries.

## 4.27 Authority for Advance Ruling(AAR)

With a view to expediting a ruling qua-transaction, many countries have created an Authority for Advance Ruling (AAR). Almost 57 countries (from Argentina to Venezuela) have introduced this concept of advance ruling to enable the entrepreneurs to get certain ruling regarding the tax consequences of a particular transaction. Certainty and predictability are particularly important in the context of pre-transaction ruling. Even if a post-transaction ruling would serve to expedite the assessment process thereby reducing drastically the cost of litigation, so

that the tax payers may plan in a better manner for future undertakings. More over, an advance ruling also affords the tax payers the opportunity to alter a proposed transaction where the adverse ruling is issued. A ruling procedure provides a number of advantages to the tax administration also as it permits a greater tax payers confidence in the system. Consequently, the compliance cost to the tax payers as well to the tax authorities comes down.

4.28 In India the scheme of advance rulings was thus introduced by Finance Act,1993. Chapter-XIX-B of the Income Tax Act deals with advance ruling. It came into force w.e.f 01.06.1993. The Authority is headed by a retired Supreme Court Judge and two members – one drawn from I.R.S and another from the Ministry of Law.

4.28.1 Any ruling pronounced by the AAR(under section 245S) shall be binding only

a) on the applicant who had sought it
b) in respect of the transaction in relation to which the ruling had been sought and
c) on the Commissioner and Income Tax Authorities subordinate to him in respect of the applicant and the said transaction.

4.28.2 The duration of the ruling generally coincides with that of the transaction and as long as there is no change in law or in the facts of the

transaction. If the ruling is obtained by any fraud or misrepresentation, it shall become void.

4.28.3 Many a foreign company has adopted this route for the apparent benefits embedded therein in obtaining an advance ruling.

4.29 The Indian Courts have treated these commentaries as authentic and have applied the same while interpreting DTAAs entered into between India and other countries. In a number of cases starting from CIT vs. Visakhapatnam Port Trust(29) and ending with Union of India vs. Azadi Bachao Andolan(23), the following ratios have been reiterated:-

a) The provisions of Section 4 & 5 of Income Tax Act (I.T Act-for short) are expressly made 'subject to the provisions of the Act' which means that they are subject to the provisions of Section 90 also. By necessary implication they are subject to the terms of the DTAAs entered into by the Government of India.

b) Consequently, total income specified in Sections 4 & 5 chargeable to IT Act is also subject to the provisions of the DTAAs to the contrary, if any.

c) In case of inconsistency between the terms of DTAAs and the taxation statute, the DTAAs alone would prevail. In other words, the correct legal position is that where a specific provision is made in the DTAA, the same will prevail over the general provisions

contained in the I.T Act, 1961. Where there is no specific provision in the DTAAs, it is the basic law i.e. the I.T Act that would govern the taxation of income.

d) If no tax liability is imposed under the I.T Act, the question of resorting to the DTAA would not arise. No provision of the DTAA can possibly fasten a tax liability where the liability is not imposed by the I.T Act. If a tax liability is imposed by the I.T Act, the DTAA may be resorted to for negating or reducing it and in that context, at the risk of repetition, it has to be borne in mind that the provisions of DTAAs prevail over those of the Act and can be enforced by the appellate authorities and the court.

e) In this regard the CBDT is enabled and empowered by Section 90 to issue notifications for implementation of the terms of DTAA and such notifications are also at par with DTAAs. Consequently, the provisions of the Act are subject to such notifications also.

f) Circulars issued by CDBT are binding on the authorities administering the tax department [ as quoted in (23)].

g) Such circulars are binding on all officers and employees employed in the execution of the Act, even if they deviate from the provisions of the Act *[ as quoted in (23)]*.

h) CBDT has power, inter-alia, to tone down the rigour of the law and ensure a fair enforcement of its provisions *[ as quoted in (23)]*.

i) An exemption notification has the effect of suspending the collection of tax. It does not make items which are subject to levy of tax as not leviable to such tax. It only suspends the levy and collection of the tax, whole or partial, and subject to such conditions as may be laid down in the notification by the Government in 'pubic interest'. Such an exemption by its very nature is susceptible of being revoked or modified or subjected to other conditions [as quoted in (23)].

## CHAPTER-V

## DTAAs SUPPLY METHODS OF CORPORATE TAX AVOISION

5.1 Where there is demand supply follows. In international business the lobbies always work in favour of the 'haves' to the prejudice of the 'have nots'.

5.2 In the recent history of GATT and WTO there had been great tussles of tug-of-war between the developed nations on one side and the developing nations and the under-developed nations on the other side. The effort has been from the developed nations to strangle the economy of less developed nations through 'GATTastrophe' and the WTO measures. The WTO prohibits export subsidies. There are two kinds of subsidy agreements in the WTO, one for industrial or manufactured products and this is governed by the Subsidies and Countervailing Measures (SCM) agreements. In addition, agricultural products have special treatment and that is governed by the Agreement on Agriculture (AOA). For industrial products, the SCM divides export subsidies into three categories – red, amber and green. Hence, this is known as the traffic light principle. Red

export subsidies are prohibited by the WTO and the trading partner can take action if such prohibited export subsidies are used. Action means levying countervailing duties against such subsidised exports. Amber export subsidies are permitted by the WTO. But if such export subsidies are used, the trading partner can still take action. Green export subsidies are permitted by the WTO and trading partners are not allowed to take action against these.

5.3 Section 80HHC of the Income Tax Act or their variants and a lower rate of interest on export credit are instances of red export subsidies. They are prohibited. However, there is a catch. A country that has a per capita income of less than 1000 US dollars is freed from this prohibition. Because India's per capita income is lower than 1000 US dollars, the prohibition on red export subsidies does not therefore, apply to India. If subsidies like section 80HHC are progressively being phased out, that's because of unilateral and internal reform compulsions. Not because of something the WTO requires. There is further caveat to this 1000 US dollars kind of clause. If in any particular product, a country is globally competitive on the world market, for that particular product, one cannot have red export subsidies even if the per capita income is less than 1000 US dollars. Globally competitive is interpreted as accounting for more than a 2.5 per cent share of the world market for that product. For

example, India is globally competitive in diamonds and jewellery and we can't have red export subsidies for this category. The deadline for elimination was January 2003.

5.4 It is also reported that developed countries like USA, EU, Japan or South Korea have export subsidies on exports of agricultural products and that distorts world markets. Absolutely true. Agriculture was first liberalized in the course of the Uruguay Round (1986-94) and the liberalization is incomplete and imperfect. Developed countries were supposed to reduce budgetary payments on agro export subsidies by 36 per cent and the volume of subsidized agro exports by 24 per cent. There are lower stipulations for developing countries, but India has no export subsidies specific to agriculture, as opposed to general export subsidies. There are many reasons why developed countries have been able to circumvent this reduction commitment, the most important being that the initial base of export subsidies (on which reductions are to take place) was set artificially high.

5.5 It is said that who ever reigns, business reigns. This adage is very much in vogue in the global village run by TNCs. In 1930s (as noted in the earlier chapter), Jawaharlal Nehru thought that the capitalist control will give away to a socialistic society. History has proved it is not to be. It

is the age of turbo capitalism. Wars are mounted or imposed with the avowed objective of putting an end to terrorists but camouflaging the real monopolistic interest of gaining control over oil resources and keeping the corporates manufacturing warfare and arms and ammunitions in good humor. Direct tax payments are a significant outflow after the money is earned. Hence, the demand for avoiding or reducing direct tax payments out of income earned in cross border ventures. And this exercise is sought to be indulged in an apparently legitimate manner. Thus the evolution of OECD and UN and US models of direct tax conventions, besides the ANDEAN model adopted by a group of lesser and medium developed Latin American countries. These models have laid the foundation and the platform for supplying the methods of tax avoision to all those corporate world as well as non-corporate world.

5.6 Let us examine the methods available for tax avoision, being indulged in by the TNCs.

5.7 As seen in Chapter-4, interpretation of DTAAs is an important tool in the financial re-engineering of TNCs through tax avoision.

5.8 The methods already provided in these DTAAs can be classified under five heads:-

a) Complete avoidance of taxation in the source country through simple provisions in DTAAs, example- income of shipping and airline businesses.

b) Complete avoidance of taxation in the source country through treaty shopping – i.e. by routing the business deals through tax havens which have entered into favourable DTAAs with the source country.

c) Avoidance of taxation in source country even on business profits by not having PE.

d) Partial reduction or concession in the rate of tax in the source country, example- specific sources of income like business profits, dividend, interest, royalties and fees for technical services, etc –by reclassifying the remittances.

e) Getting an advance ruling from an AAR either pre-transaction or post business transaction. In case the decision of the AAR is against the interest of the foreign company, then suitably alter the transaction or even withdraw the application itself.

5.9 In the following chapters, the methods falling under (b), (c) (d) & (e) above are explored based on illustrative case studies:-

Chapter-6 - on 'Treaty Shopping'

Chapter-7 - on 'Absence of PE'

Chapter-8 - on 'Treaty Override'

Chapter-9 - on "Business Profits'

Chapter-10 - on 'Reclassification of Remittances'

Chapter-11 - on 'Abuse of AAR route'

CHAPTER-VI

# CASE STUDIES ON TREATY SHOPPING

## 6.1 NATWEST CASE - Advance Ruling No.P.9 of 1995 (30)

**FACTS**

- Two companies incorporated in Mauritius are wholly owned by a British company. These two Mauritian companies held shares in an Indian company. The two Mauritian companies sought ruling on benefits available in respect of dividends received by the Mauritian companies from the Indian company as also the capital Gains under the DTAA between Mauritius and India under Article 10 and 13 respectively.
- The board meetings of the companies are held in Mauritius. The board consisted of two Chartered Accountants from Mauritius and a banker in Hong Kong. The registered office of the companies was at the same address of the two Chartered Accountants and this was also the place where board and general meetings were held.

**Questions raised before the Authority**

1. Whether the dividend received by the Mauritian companies in respect of shares held in Indian Company would be subject to a withholding rate of 5%? (Article 10)
2. Whether the capital gains on the transfer of shares held by the Mauritian companies in Indian Company would be exempt from capital gains? (Article - 13)

**Decision of the A.A.R.**

**Issues considered and the process of arriving at the decision**

i) There already exists a DTAA between India and U.K. notified in early 1994.

Had the British Bank invested directly in the shares of the Indian Bank, it would have been entitled to a relief under the DTAA with U.K. and dividend taxed at 15% under Article 11(3) of the DTAA with U.K.

Capital gains arising as a result of alienation of the shares would be chargeable to tax both in India as well as in the United Kingdom.

In contrast to this, the resident of Mauritius investing in shares of Indian company would not be liable to tax in India in respect of capital gains (as there is no capital gains tax in Mauritius), and could claim that tax on dividends in India would not exceed 5% in certain situations and 15% in all other cases.

ii) Coupled with the above background, the chronological sequence of events indicated below:

a) The revised DTAA between India and the U.K. was notified in early 1994.

b) The applicant companies were incorporated in Nov. 1994 and the investments in the Indian Company were made in early 1995.

c) The present claims of the applicant were put up before the Authority soon thereafter.

These events prima facie support the view that the purpose of investment in this manner could only be for purposes of avoidance of income tax.

Hence, application was liable to be rejected under clause (c) of the proviso to subsection (2) of section 245R of the Act. It would be apt to recapitulate the provision, which states "The AAR shall not allow the application where the question raised in the application relates to

a transaction which is designed prima facie for the avoidance of income tax".

iii) **Other useful observations of the AAR**

a) **Concessional tax treatment of Dividend**

In order to be eligible for concessional tax rate of 5% on Dividend under Article 10 of the Treaty, the Mauritian companies had to be beneficial owners of the shares in Indian companies. As they were the 100% subsidiaries of the sole shareholder, namely, a British Bank in U.K., they were merely the legal owners but the beneficial owner was the British Bank. Hence, under Article 10 of the Treaty, the concessional tax of 5% on Dividend was not permissible.

b) **On Exemption of Capital Gains**

However, this was not so under Article 13 of the Treaty in regard to the capital gains arising on sale of shares of Indian company held by the Mauritian companies, as the Article did not contain any precondition that the Mauritian companies should be the beneficial owners of shares. Hence, capital gains on such shares are entitled to exemption under Article 13 of the Treaty.

c) **On Residential Status - Tests for determination**

The Mauritian companies were resident both in Mauritius and India because of which they were liable to tax both in Mauritius and India on their incomes. However, the litmus test in the case of companies was the place of effective management, while considering their residential status under the Treaty. In the instant case, the effective management was sited in Mauritius considering the fact that the day to day affairs were carried on factually and effectively from Mauritius.

**Comments:**

This is a typical illustration of "Treaty Shopping" with a view to avoiding tax altogether. The AAR could see through the real purpose of creation of two Mauritius Companies by the British Bank. Hence the refusal of the AAR to grant judicial benediction to such a tax avoision scheme.

## 6.2 TEKNISKIL (SENDIRIAN) BERHARD'S CASE - Advance Ruling - AAR No.254 of 1995 (31)

Re.: i) Taxability of amounts received from Korean Company by the applicant outside India, a Malaysian Company for supply of skilled labour to a Korean Company for a ONGC project in India.

ii) Existence of Permanent Establishment of Malaysian Company on account of supply of skilled labour from outside India, to Korean Company for ONGC project in India.

**Facts:**

TSB, a Malaysian company entered into a contract with HHI having its registered office in Korea. HHI had to execute the projects in the Neelam Process Complex and NQP Process Complex in the Bombay High, awarded to it by the ONGC. The projects involved offshore installation works which commenced on 8-10-1993 and came to a conclusion in April 1994. TSB had to provide 56 welders, 24 riggers, 4 winch operators, 6 barge oilers, 6 mechanics and 4 electricians (total 100) and HHI was to pay these workmen, wages as per rates schedule. These workmen had to work on two barges belonging to HHI. The work done on two barges had to be supervised by experienced supervisors of TSB. It was the responsibility of

the TSB to have the workers duly certified by an appropriate agency. The workers had to function under the direction and supervision of the HHI which could terminate the services of the workmen in case of poor performance or any grounds mentioned in the contract. TSB was to pay salary, insurance premium, charges for mobilization and demobilization from Bombay, all taxes, medical treatment at onshore sites, including transportation by helicopter, application for visa and passport to enter India, and work permit and security pass issued by HHI.

The charges paid by HHI apparently included a margin to cover all the expenses incurred by the applicant in the procurement of necessary labour force.

In response to the application made on 11-12-93 of the HHI to the Deputy Commissioner of Income Tax, Bombay, to determine the rate of tax at which the payments made to TSB to be deducted, the Deputy Commissioner of Income Tax, passed an order u/s 195(2) of the Act, directing the HHI to deduct income tax @ 6.5% on payments to TSB relatable to work done in India and @ 0.65% of payments relatable to work done outside India.

Not satisfied with this, TSB applied to Deputy Commissioner of Income Tax, Dehradun, on 4-4-1995 praying for a certificate u/s 197 of the Act, permitting HHI to make payments without deducting tax at source u/s 195 of the Act, as TSB felt that the amounts paid by HHI to TSB under the contract would not be chargeable to tax in India. The Deputy Commissioner dismissed the application as misconceived by a letter dated 10-4-1995.

Subsequently, TSB made application to the Authority on Nov. 22, 1995 seeking its ruling on the question of taxability in India of the amount paid by HHI to TSB and the presence of Permanent Establishment of TSB, based on the nature of activities and the facts.

**Questions raised before the Authority**

1. Whether based on the stated facts of the case, the amounts received by the applicant outside India are taxable in India?
2. Whether based on the stated facts of the case, the nature of activities performed by the applicant in India, constitute a Permanent Establishment (PE) in India as per the provisions of Article 7 of the DTAA between Indian and Malaysia?

**Decision of the A.A.R.**

**Issues considered and the process of arriving at the decision**

1. The contract came to a conclusion in April 1994 and the application to the Authority was made on 22-11-1995, much after the activity was over.

2. The Deputy Commissioner of Income Tax, Bombay passed the order u/s 195(2) based on the special provisions u/s 44BB of the Act, relating to computation of profits and gains in connection with business of exploration etc. of mineral oils, and estimated profits of the business @ 10% of gross receipts and had passed the order u/s 195(2) on that basis.

3. The department's contention was that the fees in question were obviously fees for technical services and in the absence of specific provision to tax such receipts under the DTAA, they would be chargeable u/s 9(1)(vii) of the Act as income accruing or arising in India. Even if one went by the assumption that profits arose from business, the same would be taxed at concessional rate as provided u/s 44BB of the Act.

4. The applicant however claimed complete exemption of receipt of fees from HHI outside India on the basis of DTAA between Malaysia and India. Under Article 7 of the DTAA the fees received by the applicant from HHI arises out of a business in supply of skilled labour carried on by it and governed by Article 7 of DTAA. Such receipts cannot be taxed in India, as TSB did not have Permanent Establishment in India (fixed place of business) under Article 5(1) of the DTAA. Hence, fees received by TSB from HHI will not be taxable in India.

5. The department's counter to this was that the applicant's income fell under "fees for technical services" similar to "royalties" and such income should not be equated as income from business as there is no specific provision in the DTAA dealing with such receipts. In the absence of specific provision in the DTAA it should be treated as provided in the Income Tax Act u/s 9(1)(vii) read with section 44BB. As provisions under Article 7 (Business profits) pertain to a different head altogether, fees for technical services should not be roped in under it. Alternatively, the presence of skilled workers and two supervisors of TSB on two barges would constitute fixed place of business in India (Permanent Establishment) from which the applicant is carrying on its business. Hence, the receipt would be taxable under Article 7 itself.

6. The Authority did not accept both the contentions. It held that even if it is accepted that the fees constitute fees for technical services, they would be governed by Article 7 (in the absence of specific provision in the DTAA re fees for technical services) as they are received in the course of business. The various DTAAs, especially the ones with Australia (Article 11 (4)), Canada [Article XII (SC)] or U.S.A. (Article 12(6)) confirm this fact, where such fees arise in the course of business, though there is a separate Article dealing with fees for technical services/royalty.

7. It is thus confirmed that such receipts can be taxed only if they are attributable to a P.E. in India under Article 5(1) or 5(2) of the DTAA.

8. Presence of barges in Indian territory could not be held to constitute fixed place of business because applicant's job was merely to dispatch labour recruited by it to India and involved no other operations in India. The installation work was done by HHI under HHI's supervision and control and at "site". TSB was not concerned with any other operations in India except to look after its workers' welfare. TSB also did not have recruitment office for labour, no organization to impart training or to conduct tests and to issue certificates and other related activities. There were also no supervisory activities in India carried on by TSB because the entire contract was of HHI and carried out under direct supervision of HHI. Under these clear circumstances, TSB did not have any P.E. in India under Article 5(1) (2) and 5(4)(a) of DTAA.

9. Based on the above facts and the analysis, the Authority gave the following ruling.

**The Ruling of the Authority**

1. Whether based on the stated facts of the case, the amounts received by the applicant outside India are taxable in India? Held, No.
2. Whether based on the stated facts of the case, the nature of activities performed by the applicant in India, constitute a Permanent Establishment (PE) in India as per the provisions of Article 7 of the DTAA between Indian and Malaysia? Held, No.

**Comments:**

This is a case of "Body Shopping" of technical personnel by the Malaysian Company for ONGC project in India. Once it was held as business profits, the requirement of PE is mandated by the DTAA. Further PE in the

context of the present case should have been in existence for more than six months.

This requirement of a PE for more than six months itself is begging the question because any non-resident is liable to tax in the country of source only to the extent of income accruing therefrom. Not on the global income. If that be so, where is the need for a PE? If business can be carried on without a PE, then any income earned in such business activity should be taxable – may be at a concessional rate in the country of source. Paragraph-3 of Article-7 of DTAA between India and Malaysia provides for deduction of expenses 'wherever incurred for the purpose of PE' to be allowed against the income earned. The term 'wherever incurred' means, whether incurred in the State in which the PE is situated or elsewhere. As a natural corollary, atleast income earned in the State of source should be liable to tax even in the absence of a PE.

## 6.3 AIG'S CASE - ADVANCE RULING P.NO.10 OF 1996(32)

**Facts**

1. The applicants were Investment Company (IC) and Investment Manager (IM), both incorporated in Mauritius.
2. The principal motivator was an American company having active participation in Asian economies, having vast connection with investors the world over. It also had subsidiaries in Bermuda, Hong Kong, U.S and other countries.

3. a) The players in the scheme of things and their background would be essential to understand the entry strategies adopted through the Mauritian route.

b) The Principal players are:

1. **American Company**

Having a number of subsidiaries, vast resources and presence in the Asian economies as an important investor in Infrastructure and Core sectors, now it wants to explore the Indian sector, pump in its funds in select sectors on long term basis.

2. **Investment Company (I.C.)**

Incorporated in Mauritius; shareholding by three subsidiaries of American Company, located in Bermuda, Hong Kong and the D.S. Initial share capital only $ 4 but had loaned more than one million $ to a Canadian group with the help of contributions from shareholders.

3. **Investment Manager (IM)**

Incorporated in Mauritius with shareholdings of 73% by American company, 22% Indian Financial Services Co. (IFS) and 5% by Asian Development Bank (ADB). Activities comprise investing funds of the Trust (Contributory Trust - C. T) formed in India so as to maximize capital gains and returns.

4. **Indian Financial Services Company (IFS)**

One of the authors of the Trust with initial contribution, having expertise on Indian Markets.

5. **Indian Trustee Company**

Subsidiary of IFS and in the independent business of managing trusts as trustee independently; with good track record.

6. **Indian Trust**

Contributory Trust (C.T) formed by IC and IFS with earmarked amounts of contributions.

c) **Method Adopted**

i) Specific Trust created (C. T) in India as per Indian Trusts Act to receive contributions from contributors present and future upto the earmarked amount. Types of contributories specified and shall include institutional investors. Shares of contributories determinable at any point of time based on contributions.

ii) I.C. collects amount from various investors and gives them to trustees of the Trust for investment as per advice of IM. IM has advisors, experts to advise. Final decision by IM.

iii) Trust funds to be invested as per IM's advice.

iv) IM's Board meetings to be held anywhere except in India and U.S.

v) Capital gains and dividends and other income to be distributed after meeting expenses; as per section 161 of the Income Tax Act. (Specific Trust - Assessment direct on beneficiaries in like manner and to the same extent through the Trustees) as provided under section 161 of the Income Tax Act.

vi) To avail of DTAA with Mauritius, transparent entities were created and transparent method based business considerations followed.

d) **Objections Raised and Dealt With**

Several of the objections raised and the way in which they were dealt with are summarised below:

1. The provisions in the Trust Deed were agreed to be modified so that there was no absolute discretion to the Trustees as

regards the choice of beneficiaries. The power of trustees was restricted by (a) over all limit of the fund (b) only to admit institutional investors to the fund and (c) admit only those institutional investors who agree to subscribe to the Contribution Agreement.

2. Dept. raised preliminary objection on the maintainability of the Application by IC. Contending that the Application seeks ruling on the taxability of CT (the resident Indian Trustee) as to whether CT would be assessed u/s 161(1) or u/s 161(lA) of the Act. AAR ruled that IC being beneficiary of CT (Indian Trust) the assessment of *CT* had a direct bearing on it. Hence the applicant by IC would be maintainable.

3. The second objection on the maintainability of the Application was based on the fact that the investments were routed by the American Insurance Group (AIG) through the subsidiaries in Mauritius (IC & IM) though there was DTAA between India and U.S.A. under which the American Company would not have been entitled to concessional rate of tax on dividend and interest and exemption from tax on capital gains. The present arrangement was therefore a device to secure concessional tax advantages available under the Indo-Mauritian Treaty. Strong reliance was placed on the decision of NATWEST case decided by the AAR. It was urged before the AAR to reject the Application on similar ground of avoiding tax by taking shelter under DTAA between India and Mauritius though there existed DTAA between India and USA. The AAR examined the track record of the Applicant, in investing in infrastructure and infrastructure related activity in China and Asia and the long term nature of investment, the investment via the

special purpose vehicle in Mauritius and the choice of location at Mauritius as an acceptable and cost effective financial centre. The AAR felt convinced that pooling of resources by IC from the world over and investing in India through CT (a trust) would obviate the need to take the permission from FIPB and other regulatory Authorities from India now and then, in respect of each investment by each of its investors. The commercial considerations justified the arrangement. Besides these, Mauritius also offered tax advantages. On the aforesaid basis the AAR came to the conclusion that the ruling could not be denied on the ground that the transaction was designed for avoidance of Indian income tax.

4. The argument of the Dept. was that the operations of the CT (a trust) amounted to business of investment of funds (portfolio investment in equity shares and other instruments). AAR ruled that the depending on the facts and circumstances of the case, it is for the A.O. to determine whether the nature of activities of CT - would be 'investment' or 'business activities'. However at this stage it appeared that the activities contemplated only investment and not business operations. Under the circumstances section 161(lA) would not be attracted (Taxing the trust at marginal rate on account of its business activities)

5. Dept. further contended that the shares of the beneficiaries of CT (Trust) are indeterminate as the trustees had the discretion especially regarding 'special distribution' by the trustees. In order to overcome the above objection the A.R. agreed to modify the Trust Deed suitably wherein the 'special distribution' would also be made in the proportion of the contribution by the contributories.

6. The Dept. pointed out that the shares of the beneficiaries were not determinate as they were not specifically stated in the Trust Deed on the date of the Trust Deed. As a result the Trust would become discretionary trust and attract provisions of section 164 of the Act (maximum marginal rate). The Authority held that the shares of the contributories in the income of the trust fund according to the terms and conditions set out in Contribution Agreement. Hence, there was no ambiguity as regards the contributories (beneficiaries) and their precise share. Hence Section 164 did not apply, as there was no discretion left with any body to manipulate the beneficiaries or their shares.

7. The Dept. urged that the IC and IM could not access, the treaty, as they were not resident of Mauritius as they were not liable to tax in Mauritius. The AAR relied on its decision in the case of M.A. Rafik and over ruled the contention of the Dept.

8. The Dept. pointed out that IM had a P.E. in India through its advisors and engagement of professionally skilled and experienced personnel.

It was contented by the 'AR' that what was envisaged was merely the appointment of professionally skilled persons to assist the 'IM' in the discharge of its functions. In order to satisfy the DR, AR gave an undertaking that the company did not intend to have fixed place of business in India, open place of business in India, appointed in India any agent or broker with authority to conclude contracts in the name of the company.

The agreement was also suitably re-worded to ensure that there would be no 'PE' in India.

Thus the series of objections raised by the Dept. were appropriately

dealt with by the AAR.

7. **Issues arising from the above vis-a-vis NATWEST'S case.**

a) In Natwest case, a single U.K. Bank had created two 100% subsidiaries in Mauritius which in turn invested in the equity capital of HDFC Bank in India. They had sought the views of the AAR on the question of applicability of DTAA and exemption from capital gains and concessional tax treatment of dividend in view of Articles 10 and 13 of DTAA with Mauritius.

The AAR had considered the questions on the applicability of DTAA and had confirmed that though the two companies were residents of Mauritius but were not the beneficial owners of the dividend as the real beneficiary was the U.K. holding company. The AAR held that the capital gains would qualify for tax exemption under Article 13 of the DTAA but the dividend could not qualify for the concessional tax treatment under Article 10, as the shares were not beneficially held by the Mauritian companies. (This was the prime requirement of Article 10 of DTAA).

Moreover, the transaction seemed to be prima facie designed to avoid tax through Treaty Shopping as India and U.K have signed DTAA, which is not as tax efficient as the one signed between India and Mauritius. Hence, under section 245R, the AAR had rejected the application on the above ground.

The decision had created lot of apprehension in the minds of Non Resident Investors investing in India through the Mauritius route.

b) The transactions designed in this case tried to over-come the

deficiencies/ misgivings in the NATWEST's case.

There was abundant business justification for investment into the infrastructure and the core sector in India by pooling of resources from the world over at one place Le. Mauritius into I.C., which in turn would invest them in India through the C.T. (Contributory Trust). This would avoid seeking permission from FIPB now and then and large pool of resources could be mobilised for investment in India at one point. Structure was the one usually designed on the models for International Investments for Long Term Investments. Motives looked genuine and the American group had proven track record of investments in infrastructure and core sector in Asian countries.

Moreover, the Authorized Representative (AR) agreed to consider suitable changes suggested by the AAR and implemented them on the lines suggested by the AAR. At some point of time, AAR allowed the AR to make suitable changes.

This was a departure from the usual run of hearings. If such large investments were routed this way, it would increase FDI inflows into India.

The AAR allowed the application though India and US have DTAA but there is no concessional treatment for capital gains, interest and dividend. This was mainly because the IC held shares beneficially for large number of investors the world over and invested through the CT (Contributory Trust) The preliminary objection of the NATWEST case was thus effectively overcome CT was a specific trust with shares of

contributories specific.

8. The issues raised and the ruling by the authorities are summarized as below

**Questions raised before the AAR and the ruling thereon:**

i) **Application of IM**

Q.1. Whether under the Treaty IM has PE in India based on facts and circumstances of the case?

A.1 On the basis of documents placed and undertakings given by the parties, no PE is envisaged.

Answer depends on how activities of applicant are actually carried on.

Q.2. Whether IM is liable to tax in India on management fees received from C.T. in India?

Q.3. Will IM be liable to tax in India in respect of "carried" interest received from CT?

Q.4. If Answers to Questions 2, 3 and 4 are in the affirmative, whether tax is to be deducted at source?

A.2,3 & 4. Answer depends on Answer to Question 1, if no PE - no tax on management fees and carried interest and no TDS.

If PE - the profits attributable to PE will be taxable in India (on Management fees, carried interest and liable to TDS obligation).

ii) **Application of IC**

Q.1. Based on facts and circumstances whether applicant should be assessed on proportionate share of income earned by the Contributory Trust (in India) as per Section 161 of the Act?

Q.2. Whether CT would be regarded as see-through/ transparent entity vis-a-vis the applicant?

A.1.&

2. Applicant can be assessed directly or through CT only on its proportionate share of income derived from CT.

Q.3. Whether power vested in the Trustees to add to the list of existing beneficiaries keep the Trust as specific Trust and assessment to be done u/s 161? If such power is deleted, would it make matters better?

A.3. Trustees' power to add to the list of beneficiaries - not detrimental to application of S-161; if this power is deleted case for S-161 becomes stronger.

Q.4. If it is held that the shares of the additional beneficiaries are indeterminate whether capital gains of the Trust taxed @ 20% (u/s 112) or at maximum rate (S -164).

A.4. The word 'additional" appears superfluous, as beneficiaries are not indeterminate - view not expressed.

Q.5. Will the investee companies need to deduct tax at source on income distributed to C.T?

A.5. Investee Cos. in India have to withhold taxes on payment to CT at rates applicable in the case payment made by Indian Cos. CT can apply to A.G. for Non Deduction of tax - at lower rate on behalf of IC in view of section 161 and till) DTAA.

Q.6. Whether character of proportionate share in income of the Contributory Trust will be the same as in the hands of the Contributory Trust (CT)?

A.6. Answer is in the affirmative

Q.7. Whether applicant's proportionate share in dividend earned the contributory trust will be chargeable to tax and if so at what rate?

A.7. Yes - Rate of Tax @ 15% - under Article 10 of DTAA.

Q.8. Will applicant's share in interest earned by the Contributory Trust be chargeable to tax at 20%?

A.8. Applicant's share of interest earned by CT chargeable to tax at normal rates.

Q.9. Whether the applicant's share in the capital gains earned by the Contributory Trust be chargeable to tax?

A.9. Capital Gains embedded in the applicant's share of distributions made by the CT will be exempt from tax under Article 13.

Q.10. Is there any T.D.S. liability on CT in respect of distribution made to the applicant?

A.10. The CT would be liable to withhold tax from the distribution made to the applicant in so far as such distributions are attributable to dividend and interest income earned by the Trust.

Q.11. Whether applicant's proportionate share in the surplus arising from the realization of the investments made by the Contributory Trust would constitute capital gains?

A.11. Generally, surplus on sale of Investment would be capital gains. It could also be income from profits and gains of business based on facts and circumstances. The Assessment Officer has to determine its nature based on facts and circumstances of the case placed before him.

Q.12. Whether in case the answer to Question No.11 is in the negative, the proportionate share of the applicant in such surplus will be chargeable to income tax in India in the applicant's hands?

A.12. Article 7 of DTAA would come into operation (If there is income from business) as there is no PE at present, such profits are not taxable.

*NOTE:* The Authority also held that the publishing of Advance Ruling would be in public interest (Section 245Q of Income Tax Act)

**Comments:**

This is a clear-cut case of tax avoision through a foolproof mechanism of "Treaty Shopping". The assessees have learnt from the experience of NATWEST's case why and how the tax avoision mechanism proposed therein was shot down by AAR. Therefore, a consortium of shareholders having interest in many tax havens routed its operation through Mauritius and made 'proper use' of the then prevailing red-tapism in the Indian context. Thus the ingenious device of a corporate entity has been successfully launched through the medium of "Treaty Shopping".

## 6.4 ADVANCE RULING NO.315 1997
## DLJMB MAURITIUS INVESTMENT CO. VS. CIT (33)

### A. Facts

1. The Applicant DLJMB Mauritius Investment Company was incorporated as limited liability Company in Mauritius as an offshore ordinary company and regulated by the Mauritius Offshore Business Activities Authority (the MOBAA).

It had obtained Tax Residency Certificate from the Tax Authorities of Mauritius.

2. It belongs to DLJ Group (DLJ Inc.) a leading Investment and Merchant Bank in USA, with a vast net work of clients comprising high net worth individuals, large institutions, corporations and Governments both within USA and outside.

3. It is a holding company with several subsidiaries to conduct its diverse business operations.

4. It also manages number of companies, partnerships and other entities in the USA and Netherlands Antilles (A Protectorate of Netherlands but situated in the Caribbeans) in which investors from all over the world (including the U.S. investors) have invested their monies.

5. The Applicant company was a special purpose vehicle to pool the resources of the investors, and the entities managed by it, in order to invest in India - in shares of Indian Companies, Debentures, Debt. Instruments, Units of Mutual Funds in India to the extent of U.S. $ 100 million.

b. **Question raised before the Authority**

1. Whether the Applicant will be entitled to the benefits of Indo-Mauritius Treaty?

2. Whether interest received by the -Applicant pursuant to a Loan agreement in respect of Debentures, and or any Debt Claims issued pursuant to the approval of the RBI/Govt. will be exempt from tax under Article 11 of the Treaty?

3. Whether the applicant is liable to capital gains tax in India on transfer of securities in Indian companies?

4. Whether any other income earned by the Applicant, namely income from Unites of a Mutual Fund in India will be taxable only in Mauritius (and not in India)

C. **Decision of the AAR**

**Issues considered and the process of arriving at the decision**

1. The Dept. raised preliminary objection stating (a) that the Application was not maintainable in terms of clause (iii) of the proviso to Sub-section (2) of Sec. 245R, as the transaction has been designed, prima facie, for the avoidance of tax in India, through a nominee company in Mauritius to use the Indo-Mauritius Treaty (to avoid tax on capital gains etc) (b) that the Treaty benefits are available to a 'resident' as defined in Article 4 of the Treaty. In the instant case, the Applicant was not resident in Mauritius as the effective management was riot in Mauritius, but in USA, with DLJ Inc. (holding company). Hence, the Applicant could not access the lndo-Mauritius treaty.

2. The Applicant company justified the formation of Mauritius company as special purpose vehicle to pool resources and channelise investments in India under one umbrella because, investing in India involves cumbersome procedure. It involves taking multiple approvals whenever any foreign entity/investor has to invest in Indian entities (From RBI/FIPB). Mauritius has emerged as a well developed and cost effective offshore financial centre. It has tax treaties with number of countries, including India. The special purpose vehicles have to be domiciled in tax neutral jurisdictions like Mauritius.

Under the circumstances it would make enormous commercial sense to form a company in Mauritius, pool resources of the investors the

world over with a view to invest in India through a single entity. The Authority accepted the arguments of the Applicant in the light of its decision in the AIG's case(32) and held the Application to be maintainable.

3. **Residential Status**

As regards the Residential status of the Applicant, it was reiterated that its effective management and control was only in Mauritius, since it had obtained Tax Residency Certificate after fulfilling the stringent conditions of the Mauritian tax authorities. The day to day management was in Mauritius and the Board Meetings were also held in Mauritius. DLJ Inc. USA did not interfere with the management and administration of the Mauritian subsidiary. Based on the facts and this reasoning the second preliminary objection of the Dept. was also rejected.

4. **Taxability of Interest**

Interest arising to Applicant in India, would be exempt in India because no investment of monies in debentures or debt instruments in India by foreign nationals is permissible without the approval of RBI or FIPB. These bodies grant approval only if the conditions / stipulations laid down by the Govt. are fulfilled.

The Dept. argued that the specific approval was required in respect of each loan, debt claim in terms of para 4 of Article 11 of the Treaty. The Authority ruled that the RBI/FIPB were the wings of the Govt. for the purposes of Article 11 of the Treaty. Both under the constitution of India and on general principles, the RBI is a Govt. agency completely owned by the Govt. of India and the FIPB is only a committee of Govt. of India, and can be appropriately termed as

'Govt.' for the purpose of Article 11 of the Treaty. As a result, interest receivable by the Applicant in respect of transactions where RBI/FIPB approval was granted, would not be taxable under Article 11(4) of the Treaty.

5. Capital Gains (Long Term & Short Term) arising on transfer of securities held in Indian companies were not taxable in terms of Article 13 of the Treaty.

6. **Other Income**

The Authority held that in terms of Article 22, the other income would be liable to tax in the state of residence. Hence, income of units of Mutual Funds arising to the Applicant would be liable to tax only Mauritius. The same would not be liable to tax in India.

D. **Ruling on Questions Raised**

1. Yes. The applicant would be entitled to the benefits of the Treaty.
2. Yes. Interest received pursuant to a loan agreement approved by RBI/FIPB would not be taxable in India.
3. Capital Gains on transfer of securities of Indian companies would not be liable to tax.
4. Income from other sources (income of Units of Mutual Funds) would be liable to tax only in Mauritius.

**Comments:**

This case is also a classic illustration of "Treaty Shopping" by an Investment Company-cum-Merchant Bank of USA making use of Indo-Mauritius DTAA for tax avoision.

General Comments:

The Annual Report of Reserve Bank of India in the financial year 2002-03 includes study of foreign investments. Table No.6.10 at page-111 of the said report is on the subject 'Foreign Direct Investment "Country-wise" inflows'. In all the three financial years of 2000-01, 2001-02 and 2002-03, the inflow through Mauritius has been the maximum amount compared to investment from any other country. The table reads as under:-

**Table 6.10 : Foreign Direct Investment: Country-wise and Industry-wise inflows***

(US $ million)

| Source | 2002-03(P) | 2001-02 | 2001-01 |
|---|---|---|---|
| 1 | 2 | 3 | 4 |
| Total | 1,658 | 2,988 | 1,910 |
| **Country-wise Inflows** | | | |
| Mauritius | 534 | 1,863 | 843 |
| USA | 268 | 364 | 320 |
| UK | 224 | 45 | 61 |
| Germany | 103 | 74 | 113 |
| Netherlands | 94 | 68 | 76 |
| Japan | 66 | 143 | 156 |
| France | 53 | 88 | 93 |
| Singapore | 39 | 54 | 22 |
| Switzerland | 35 | 6 | 8 |
| South Korea | 15 | 3 | 24 |
| Others | 227 | 280 | 194 |

P Provisional

* Data in this table exclude FDI inflows under the NRI direct investment route through the Reserve Bank and inflows due to acquisition of shares under Section 5 of FEMA, 1999.

This table indicates the extent of 'Treaty Shopping' being resorted to by foreign investors.

## 6.5 ARR No. 296 of 1996 – TVM Ltd v. CIT(34)

### 1. Facts

1.1 The applicant company TVM Limited ("TVM") was incorporated in Mauritius on 23-5-1996. It has been contended that the effective place of management of the company is in Mauritius. Hence, the applicant is a non resident under section 6 and eligible to approach the AAR for an Advance Ruling on transaction/s proposed to be entered into by it.

1.2 The applicant has five shareholders which are companies (corporates as shareholders) and each one of them has relevant experience in contributing to making of presentation of programmes produced for broadcast. e.g. one of the companies (Hindustan Times) has experience in making presentation of programmes produced by it on the Indian T.V. net work - the Doordarshan. Another shareholder is stated to be primarily a financing company, another company (shareholder) is a subsidiary of U.K., T.V.B, Broadcast Ltd. running two T.V. Channels in Hong Kong. The fourth company (shareholder), is said to belong to Carlton group, which in turn has a number of joint ventures in Singapore and the fifth company (shareholder) is a subsidiary of Pears on Plc of U.K. which owns T.V. channels in the U.K. and Latin American Countries.

1.3 A Company by name T.V. India Ltd. ("TVI") had been incorporated in India with the same set of shareholders on 6-3-95, with identical proportion of Shareholding as TVM Ltd. The directors of the two companies are different. TVM has only one Indian Director while TVI has five of them. There are no common directors. It is therefore claimed that the management of TVI is entirely independent of that of TVM.

1.4 TVM is engaged, inter-alia, in the business of development, operation, marketing, sale & distribution of Television Programmes and broadcasting of Television Channels. TV! is engaged in the production of software programmes to operate the Channels. It has developed a logo for its programmes namely 'Home T.V.'. TVI proposes to licence the software produced by it in its own studios as well as by other producers to TVM. TVI would permit TVM to use its logo 'Home T.V.' in the telecast made by TVM. The software programmes acquired by TVM from TVI as well as other groups like Pears on, Carltons, BBC, etc. are to be broadcast by it through a transponder taken on lease by Carltons and sub leased to TVM. The transponder is linked to an earth station owned by another Hong Kong Company. It is attached to Satellite with a broadcasting coverage which covers 68 countries and in turn, transmits its signals which are received by dish antennae located in these countries, which are tuned in to the particular satellites. These signals are then transformed into sound and picture and become available for viewing through television sets in these countries.

1.5 TVM earns revenue by way of advertisement from advertisers. The Hindi software programmes and other programmes broadcast by TVI are viewed by millions of viewers from all over the world. Therefore, the advertisers from all these 67 countries as well as from India would find it useful to advertise their wares on the TVM channel. TVM desires to sell air time on its channel to parties in India. It therefore proposes to enter into solicitation agreement for such sale with TVI where under TVI would only solicit orders from the purchasers of air time and pass on those orders to TVM for its scrutiny and acceptance. TVI would also be responsible for remitting the advertisement revenue so collected to TVM and be entitled to a commission for the services rendered by it in this regard. TVI has no

authority to conclude the contracts. TVM directly enters into contracts with the parties in India.

1.6 TVI shall be entitled to collect from relevant purchasers a commission at a rate mutually agreed between TVI and TVM but not exceeding 10% of the amount of invoice issued to the purchaser by TVM. TVI and TVM have made it clear that they are entering in to this agreement as independent contractors and that TVI is not the dependent agent of TVM, and that TVM and TVI are not joint venture partners.

1.7 TVI has successfully prepared software programmes. In particular it has prepared programmes for channel labelled "Home T.V." and entered into separate agreements with TVM. TVM has been licensed to telecast these programmes and also use the label "Home T.V.". From the facts it appears that TVI had so far produced the programmes which are to be exclusively utilised by TVM for telecast on the "Home TV." Channel. But it does not seem to have produced other programmes. But these and other agreements between TVI and TVM are distinct and separate from the solicitation agreement.

1.8 The point at issue is, under the above arrangement, whether the profits earned by TVM by sale of air time on the television channel broadcast in, inter alia, India, would be liable to tax in India?

2. **Issues and questions raised before the authority**

2.1 Whether the business profits earned by the applicant from sale of air time on the television channel broadcast in, inter alia, India, would be liable to tax in India?

2.2 Whether the agent appointed by the applicant to solicit orders from the purchasers of air time and to pass on those orders to the applicant for acceptance, could be construed as a Permanent Establishment of the applicant in India?

2.3. If the answer to question No.2 is in the negative, whether any part of the business profits earned by the applicant could still be deemed to accrue or arise in India and, therefore, liable to tax in India?

3. **Issues considered and the process of arriving at the decision**

3.1 The Main questions to be considered is, whether the profits of TVM which is a Mauritius Enterprise are taxable in India. TVM being a Mauritius Enterprises its profit are prima facie taxable in Mauritius.

3.2 Under Article 7(1) of the DTAA between India and Mauritius, the business profits of TVM can be taxed in India only if it has Permanent Establishment (P.E.) in India and that also only to the extent its profit are attributable to that establishment. The main issue is whether TVM can be said to have a P.E. in India. The answer to the question depends on Article 5 of the DTAA between India and Mauritius.

3.3 Apparently TVM has no fixed place in India. Even if the presence of TVM is taken for granted; in terms of Para 3(c) of Article 5 possibility of its being considered as a P.E. is excluded (mere maintenance of stock of goods etc. does not make one a P.E.).

3.4 The next question is whether the common shareholding of TVM and TVI can be a good ground to hold that TVI is a P.E. of TVM. The AAR clearly stated that the two are separate legal entities. More over TVM does not exercise control over the activities of TVI. Though the shareholders may be common, directors are not. Though there may be close relationship between the two companies and even the possibility of TVM being able to exercise control over TVI, it may not be enough to constitute TVI as the P.E. of TVM under Para (6) of Article 5. Para (6) of Article 5 goes to the extent of saying that even if TVI had been a subsidiary of TVM or fully

owned by it, it cannot be described as a P.E. of TVM because under the DTAA the general principle is that a corporate cannot be treated as P.E. of another company simply because the latter owns, controls or is associated with it. Therefore mere fact that the shareholding groups of TVI and TVM are common, does not make TVI P .E. of TVM.

3.5 The relationship between TVI and TVM is that TVI is just an agent for the collection of advertisements for TVM to be broadcast on its (TVM) channels. This is governed by para 5 of Article 5. A broker or commission agent of an independent status cannot be termed as a P.E. where such person is carrying on his own business and is dealing with the enterprise only as one of his many clients and dealings between the two are on a commercial basis.

3.6 In order that an agent can be treated as having an independent status the following two conditions muse be fulfilled.

a. Such agent must be acting in the ordinary course of his business
   The activities of such agent should not be devoted exclusively or almost exclusively on behalf of that enterprise.

b. The AAR wanted to satisfy itself whether these two conditions were satisfied in the present case.

3.7. **Contention of the Counsel**

Contention of the Counsel of TVM was that the activities of TVI are of an independent nature and though it has developed the programme for TVM at present and permitting the latter to use the logo "Home TV" developed by it, it is also negotiating with other parties namely Raj TV, Star Plus and Mauritius Broadcasting Corporation similar for arrangement. He also pointed out that TVI was tied up With TVM by various types of mutual agreements which make TVI's prosperity dependent on the success of its programme especially those beamed on the 'Home TV'.

3.8 It was contended that the canvassing for advertisement was done by TVI in the ordinary course of its business. Therefore the business of TVI was not confined or devoted exclusively or almost exclusively to TVM. TVI should, therefore, be considered to be, an agent of independent status within the meaning of clause (5) of Article 5 of the DTAA.

4. **The response of the Authority**

4.1 The Authority pointed out that it was difficult to accept the contention of the counsel because clauses (4) and (5) of Article 5 deal with the activities carried on by an enterprise of one contracting state in another state through the medium of an agent. As per the said clauses, the agent will be considered to be of independent status if he carries on the activities on behalf of the non resident in the ordinary course of its business and if those agency activities are not, substantially speaking, confined to a single principal namely the foreign enterprise. One should therefore, examine, firstly whether in carrying on the profit earning activities namely the sale of advertisements and collection of advertisement revenue - TVI is acting in the ordinary course of its business. The Authority stated that no material was placed by the applicant to enable the Authority to answer this question in the affirmative. In the instant case the only one company was handled by TVI Le. TVM. Presently TVI has been canvassing only on behalf of TVM. Whatever may be the position at a later date, in the event of TVI expanding the list of broadcasters for its software and extending the scope of its advertisement canvassing; presently, however, the activities of advertisement of TVI are confined only to TVM under the proposed solicitation agreement. Though the counsel mentioned that the solicitation agreement between TVI and TVM is pending approval with the Government of India; another agreement entered into with a firm known as CM Airtime Promotion Ltd., had been accorded approval by the

Government though its application was made later. But so far as TVI is concerned its activities are proposed to relate to a single principal and no more, though TVM has appointed another advertising agent in addition to TVI. On this ground under clause 5 of Article 5 of DTAA, the Authority could not consider TVI as agent of independent status.

5. **Response of the Counsel**

5.1 To meet the point made out by the Authority, the Counsel for the applicant stated that one should also take recourse to clause 4 of Article 5. This clause refers to a person in one state acting for and on behalf of an enterprise in another state Le. an agent of such enterprise and says that he shall be deemed to be a P.E. for the enterprise if he has and habitually exercises in that mentioned State, an authority to conclude contracts in the name of the enterprise.

5.2 The counsel pointed out that under the solicitation agreement, TVI cannot conclude the agreement on behalf of the foreign enterprise (TVM) and hence, the existence of P .E. can be read in 'if and only if ' the agent exercises independent power to conclude contracts on behalf of the enterprise. Therefore TVI cannot be a dependent agent of TVM. Hence, cannot to be said to have a P.E in India on behalf of TVM.

6. **Stand of the Authority and the reasoning**

The Authority concurred with this limb of the argument of the counsel. Clauses 4 and 5 of Article 5 are interwoven (hence, read together). Para 4 clearly states that if the agent does not have the authority to conclude contract, the entity will not be said to have P.E. in India, under clause 5 of Article 5 Clauses 4 and 5 are to be read together. Clause 5 should not be read in isolation. As per the solicitation agreement, TVI is not the final arbiter in the matter of telecast of the advertisements procured by it. It does not have any authority to conclude the contracts. On this

reasoning TVI is an independent agent and, hence not P.E. of TVM. '.

## 7. Objections raised by the Department

The department objected on the ground that the clauses of the agreement relied upon merely embody a legal formula, repeating the words employed in the DTAA, just to bring the case under clause (i) of para 4 of Article 5. Therefore, the determination of important question as the existence of a P.E. should not be allowed to depend on the use of self serving phraseology in the relevant document.

## 8. Counsel's Response

To this, the counsel submitted that the use in para 4 of the words 'has and exercises authority' shows that the emphasis is on the specific conferment of authority on the agent in this regard and the exercise thereof in terms of such authorisation. It should not be looked upon with suspicion merely because the two companies have same shareholders. It was pointed out that there was a practical necessity on the part of TVM to retain the final word on the acceptance of advertisements. The channels are broadcast not only in India but over a large number of countries in East and Far East and these countries have different types of regulations and controls on the matter to be broadcast. It is only TVM that can fully appreciate and regulate the beaming of advertisements and control it from Mauritius in such a way as not to offend the susceptibilities and regulations of the several countries concerned. TVI, though comprised of the same controlling shareholders, operates primarily in production of software' in India and may not be fully aware of limitations of TVM in this regard. That is why, *the final acceptance of the advertisement is made to rest with TVM and the payment therefore is made only after the broadcast takes place.* Therefore, it was

submitted that the agreement gives expression to a practical necessity and does not merely voice an empty or non-genuine declaration.

9. **Stand of the Authority**

9.1 The Authority saw force in the argument on behalf of the applicant. But felt that the argument had to be accepted with a note of reservation. Para 4 of Article 5 uses two expressions "has" and "habitually exercises" an authority to conclude contracts on behalf of the enterprise in question. The expression 'has' may have reference to the legal existence of such authority on the terms of the contract between the principal and agent, the expression 'habitually exercises' has certainly reference to a systematic cause of conduct on the part of the agent.[t. *despite the specific provision of the soliciting agreement. it is found.* as a *matter of fact. that TVI is habitually concluding contracts on behalf of TVM without any* protest or dissent. then *it could be presumed either that the relevant provisions of the agency contract are* a *dead letter ignored by the parties or that the principal has agreed implicitly to TVI exercising such Dowers notwithstanding the terms of the contract. If such* a *situation is found to exist, then perhaps it could be said that 1VI constitutes* a *P.E for* 1VM *despite the clauses of the contract relied upon.* The solicitation agreement has not been approved or acted upon and, having regard to the identity of the groups of shareholding in both the companies, it is difficult to speculate how the transaction will be finally put through. The department can certainly investigate the actual state of affairs and draw appropriate conclusions. But the mere contention that its identity of shareholders and close business connection with TVM and its representing TVM in its Indian transactions for collection of advertisements and revenue, cannot be held to make TVI a P.E. of TVM.

9.2 The Authority relied on the commentary on the OECD Model of Double Tax Conventions. It also referred to the relevant portion of

Commentary by Klaus Vogel in this respect, reproduced below:

*"The question whether such* a *person has an authority to conclude contracts within the meaning of treaty law must be decided not only with reference to private law but must also takes into consideration the actual behaviour of the contracting parties. An approach relying solely on aspect of private law (the law of contracts) would make it easily possible to prevent an agent being deemed* a *permanent establishment (and, therefore, to prevent the enterprise from being taxed by the State in question) even where he is engaged most intensively in the enterprise's business; he would be allowed only to negotiate contracts upto the point when they were finalised and ready to be signed, but the final signature, to satisfy the proprieties, would be reserved* to *someone from the enterprise's headquarters in the other contracting State. Such* a *formal split-up of business responsibilities on the one hand and legal authority on the other, is considered by Strobl / Kellmann to constitute* a *case of 'tax circumvention' (see supra Introduction at m.no.114) where substance should prevail over form;* a *permanent establishment should, therefore, be deemed to exist irrespective of what the formal arrangements were (Strobl, J. / Kellmann,* C. 15 *A WD 406, 408* (1969). *It is submitted that the solution is even simpler, since the agent in question had in fact an authority to conclude contracts, even if not under private law (the law of contracts) but at all events within the meaning underlying Article* 5. *Corresponding clarification is already to be found in some DTCs (cf., e.g. Germany's DTC with Malaysia, para 3(b) Prot. re Article* 6).

*The question* as *to whether the behaviour of the contracting parties is such* as to *support the opinion that an authority* to *conclude contracts exist should be decided against the background of the economic situation. If there are sound reasons for the enterprise represented* to *reserve its right*

to *conclude the contract itself - say, where major contracts are involved - the agent may not be considered* to *have an authority to conclude contracts. If, on the other hand, mass contract made out on standard forms are merely signed by someone* at *headquarters without showing signs of having been scrutinized by the signatory himself, the agent can be assumed to have taken the ultimate decision and, in other words, to have had an authority to conclude such contracts".*

*9.3* After considering the above observations and the facts obtaining in present case, the Authority felt that TVM had no P.E. in India. Hence, none of its business profits arising as a result of its activities in India through TVI can be brought to tax in India.

10. **Department's View - CBDT Circular**

10.1. The department drew the attention of the Authority to the CBDT Circular No.742 dated 2nd May, 1996 which is reproduced below.

*"Subject:* Taxation of foreign telecasting companies - Guidelines for computation of income-tax, etc.

1. A number of representations have been received from foreign telecasting companies regarding their taxability and the extent of income that could be said to accrue or arise to them from their operations in India. A consequent issue raised is the method of computation of profits from their Indian operations, especially in the cases of those companies which do not have any branch office in India or are not maintaining country wise accounts of their operations.

2. The matter has been examined in the Board and the assessment records of some of these companies have also been looked into. Since this is a new area of commercial activity, no uniform basis is being adopted by the assessing officers at different stations for computing the income in the absence of country-wise accounts of the foreign telecasting companies. It

has, therefore, been decided by the Board to prescribe guidelines for the purpose of proper and efficient management work of the assessment of the foreign telecasting companies.

3. It is seen that out of the gross amount of bills raised by a foreign telecasting company, the advertising agent retains commission at 15 per cent or so. Similarly, the Indian agent of the foreign telecasting company retains his service charges at 15 per cent or so of the gross amount. The balance amount of approximately 70 per cent is remitted abroad to the foreign company. So far as the income in India, of advertising agent and the agent of the non-resident telecasting company are concerned, the same is liable to tax as per the accounts maintained by them. As regards the foreign telecasting companies which are not having any branch office or permanent establishment in India, tax has to be deducted and paid at source in accordance with the provisions of section 195 of the Income-tax Act, 1961, by the persons responsible for paying or remitting the amount to them.

4. In the absence of country-wise accounts and keeping in view the substantial capital cost, installation charges and running expenses, etc. in the initial years of operation, it would be fair and reasonable if the taxable income is computed at 10 per cent of the gross receipts (excluding the amount retained by the advertising agent and the Indian agent of the non-resident foreign telecasting company as their commission / charges) meant for remittance abroad. The assessing officers shall accordingly compute the income in the cases of the foreign telecasting companies which are not having any branch office or permanent establishment in India or are not maintaining country-wise accounts by adopting a presumptive profit rate of 10 per cent of the gross receipts meant for remittance abroad or the income returned by such companies, whichever is higher and subject the same to

tax at prescribed rate, i.e. 55 per cent at present.

5. It has also been decided that while assessing the income in the aforesaid manner, penalty proceedings may not be initiated in the cases in which taxes due along with the interest are paid voluntarily within 30 days of the date of issue of this circular.

6. It is clarified that these guidelines would be applicable to all pending cases irrespective of the assessment year involved until 318t march, 1998, after which the position with regard to the reasonableness of the rate of profits of such companies will be reviewed."

11. **Views of the Authority in respect of the Circular**

The Authority was of the view that the Circular only gives general guidelines and it is open to the assessees to accept them if they are beneficial to them. On proper interpretation of the DTAA in the light of the facts in the present case, it was clear that no portion of the profits of TVM is assessable in India. The Authority pointed out that, *to the extent the guidelines purport to extend the applicability of the presumptive rate of profits even to cases where the foreign telecasting company has no permanent establishment in India, it cannot be treated as laying down the correct position of law.*

12. **Fresh Objection by the Department**

The Department raised another point that there was no ostensible need for establishing a company in Mauritius with .the same group of shareholders as TVI except perhaps with a design to avoid tax. Therefore, the Department submitted that the reference should not be answered as the transaction was prima facie designed to avoid tax.

13. **Counsel's Response - Justification for separate entity in Mauritius**

At this, the counsel for the applicant pointed out that the point raised

by the department was not valid. Though TVI was preparing a software and had enough material for feeding a channel, the Indian law does not permit up linking of TV programmes from India and that many TV organizations in India had proceeded to obtain such facilities from Mauritius. The business of TVI could not have been carried on without the creation of an organisation which could obtain such facilities elsewhere. As already explained the other shareholder groups were running several channels and transmitting programmes all over the world. It was with a view to obtain the benefit of their technical expertise, financial capabilities and well-established reputation in this field of entertainment and education that Hindustan Times entered into collaboration with them to form TVI (to prepare software programmes for TV, particularly in Hindi) and TVM (to avail of the transponder on PanAmSat-4 available to TVI through the good offices of the Carlton group and to broadcast the programmes it acquires from various sources including the Pearson, the Carltons and TVI). The solicitation agreement is but one of several of agreements entered into between TVI and TVM to realise the above objectives. TVM had been incorporated with a view to operate a TV Channel. Since it was considered expedient that such a company should be incorporated in a country neutral to all the parties concerned and from where broadcasting was permitted. Mauritius emerged as the best choice as it had the facility and also a number of other advantages commercially.

14. **Views of the Authority**

After considering the contention of both sides, the Authority came to the conclusion that there were satisfactory commercial considerations for the constitution of TVM as a company in Mauritius. The contention of the department that the question raised in this application related to a transaction that is designed to avoid income-tax was not accepted by the

Authority.

**15. Department's objection on the Applicant's Eligibility to access DTAA and the views of the AAR**

15.1. Another important objection raised by the Department was in regard to applicant's eligibility to any benefit at all under Article 7 of the Treaty. The objection was on the ground that the provisions of DTAA would be applicable only if the recipient was resident in Mauritius in terms of the DTAA and was liable to pay tax in that country. Under Article 1, the DTAA permits the benefits of the DTAA to flow to persons who are resident of one or both of the Contracting States and Article 7 talks merely of an enterprise of a Contracting State, the requirement above mentioned is a must before the applicant can claim the benefit of Article 7 because of the definition of the words "person" and "enterprise of a Contracting State" in Article 3 which reads as under :

"ARTICLE 3 - GENERAL DEFINITIONS: (1) For the purposes of this Convention, unless the context otherwise requires:

The term 'person' includes an individual, a company and any other entity, corporate or non-corporate, which is treated as a taxable unit under the taxation laws in force in the respective Contracting States;

The term 'enterprise of a Contracting State' and 'enterprise of the other Contracting State' mean, respectively, an industrial, mining, commercial, plantation or agricultural enterprise or similar undertaking carried on by a resident of a Contracting State and an industrial, 'mining, commercial, plantation or agricultural enterprise or similar undertaking carried on by a resident of the other Contracting State;"

15.2. The reference to tax is the Income-tax in Mauritius vide Article 2(1) read with Article 3( d). The Authority requested the applicant to produce the particulars of income tax law in Mauritius. However, the applicant did

not produce any, except an averment in a letter by counsel confirming that TVM was liable to tax in Mauritius in respect of its global income. However, the Authority on its own gathered the information and found that in respect of International Business Companies (IBC) they can opt for tax rate from 0 to 35% (as off-shore company). TVM being one such company could opt for rate of tax between 0 & 35% in Mauritius. The Authority stated that if TVM asks for Zero rate of tax, it will become ineligible for relief under the DTAA between India and Mauritius as it was not liable tax in Mauritius. But if on the other hand it as an off-shore company which has opted for being subjected to tax and proof of this is produced, relief under Article will have to be granted. The claim of the applicant will depend on the facts actually prevalent.

15.3 Based on the above reasoning the Authority, considering the fact that question number 1 and 3 were virtually the same and answer to them was dependent on the answer to question number 2. The Authority therefore, pronounced the following common ruling on all the three questions raised.

16. **Ruling**

16.1. **Questions**

1. Whether the business profits earned by the applicant from sale of air time on the television channel broadcast in inter alia, India, would be liable to tax in India?

2. Whether the agent appointed by the applicant to solicit orders from the purchasers of air time and to pass on those orders to the applicant for acceptance, could be construed as a permanent establishment of the applicant in India?

3. If the answer to question No.2 is the negative, whether any part of the business profits earned by the applicant could still be deemed to accrue or arise in India and, therefore, liable to tax in India?

16.2. **Answers**

The business profits earned by TVM through TVI are profits deemed to accrue or arise in India under section 9 of the Act. However, they are not taxable in India by virtue of Article 7 of the DTAA,

a) if TVM's liability to pay tax in Mauritius is established; and only TVM and not TVI is shown to exercise generally the power to conclude the advertisement contracts for the sale of air time.

17. The application was allowed and answered in favour of the applicant.

**Comments:**

With the service sector growing globally, DTAA between India and Mauritius has been utilized here by both foreign companies and Indian companies to create a corporate entity in Mauritius and to make tax free income. Yet another case of tax avoision through "Treaty Shopping".

6.6. **XYZ/ABC Equity Fund v/s CIT** (35)

**Issues relating to Taxation of Mauritius based Private Equity Fund in India**

A. **Facts of the Case:**

a) The applicant is a close-ended Private Equity Fund (similar to a Venture Capital Fund). It has allotted a large number of shares on a Private Placement Basis to a limited number of investors spread over Europe, Japan, Hong Kong, Singapore, U.K. and the USA.

b) The applicant explained to the AAR the nature and functioning of the collective investment vehicle (like a mutual funds), a kind commonly used internationally.

c) The applicant explained in detail the Investment Approval Process of the RBI or the FIPB, as the case may be, for making investment by foreign

investors in Portfolio Companies in India and the need to invest in India through a single entity set-up outside India to avoid the necessity of repetitive approvals.

d) The applicant explained to the AAR in detail the restrictive nature of the Guidelines for setting up Venture Capital Funds or Companies in India and therefore, the necessity of organizing such entity outside India.

e) The applicant also explained that if the applicant was organized in India, it would be difficult to invest in companies set-up outside India as such investments would require the prior approval of the RBI and the RBI's regulations for investment abroad are quite stringent.

f) The applicant stated that since investors from different countries would invest in the fund, it was essential for the applicant to be domiciled in a cost effective tax-neutral jurisdiction and therefore, it was decided to organize and set-up its business in Mauritius.

g) The applicant explained in detail the role and activities of the Custodian and the Investment Advisor in India.

B. **Department's Preliminary Objection:**

The Department contended that since there is no tax on capital gains in Mauritius, the benefit of Article 13 of Indo-Mauritius Treaty is not available to the Applicant and in support of this proposition, reliance was placed on the advance ruling in the case of Cyril Eugene Pereira (1999) 105 Taxman 273 (AAR).

The AAR distinguished Cyril Pereira's case and held that in that case there was no law in force in UAE levying income-tax on the income of the individuals corresponding to the Income-tax Act in force in India, and accordingly, Mr. Cyril Pereira was not liable to pay any income-tax in UAE and therefore, could not be treated as a resident of UAE and

accordingly, on the facts of that case, the benefit of Indo-UAE DTAA could not be given to the applicant in that case.

Further, after examining the provisions of sections 4,5, 10 and 51 of the Mauritius Income-tax Act, held as follows:

"The charging section 4 of the Mauritius Income-tax Act is of wide amplitude and imposes a tax on income of every person derived during the preceding year.

The applicant-company which is resident in Mauritius has to pay tax by virtue of the charging section 4.

By virtue of section 5(10(b) of the said Act, the income received by a person at a point of time when he was resident in Mauritius will be deemed to be derived by him even if the income was actually derived elsewhere. That means the applicant-company being a resident of Mauritius will be liable to pay tax on the income which was derived in India.

A company has to pay tax on its "gross income derived from any business" and also on "any other income derived from any other source". The phrase "any other income derived from any other source" is of widest amplitude. Ti cannot be confined to' "income from other sources' as enumerated in sections 56 to 59 under Chapter IV -F of the Income-tax Act. Any income other than income derived from business will come under the scope of this phrase. For example, if a company apart from business income has income from house property which is taxable under section 22 of the Income-tax Act and which comes under Chapter IV-C of the Income-tax Act, this income will be taxable as any other income derived from any other source apart from the business income. It is clear that a company will have to pay a tax on its business income and also income from any other source which has not been specifically enumerated. It is difficult to construe section 10 so as to exclude "capital gains" from the purview of the charging section of

Mauritius Income-tax Act.

There is another aspect of this. Section 90 of the Indian Income-tax Act empowers of the Central Government to enter into a Treaty for avoidance of double taxation under the Indian Income-tax Act and the corresponding law in force in another country. It does not mean that the tax law of the foreign country must be identical to the Indian tax laws in every respect. If the foreign tax law is substantially similar to the Indian Income-tax Act, the Central Government will be entitled to enter into a Double Taxation Agreement with the foreign country to relieve the tax payer from the burden of payment of tax twice over on the same income. It is true that every section of the Indian Income-tax Act has not been reproduced in the Mauritius Act, but that will not advance the case of the revenue in any way. The American and- British tax laws are not identical with the tax laws of India. That will not prevent the Central Government from entering into an Agreement with the foreign countries for granting relief to the tax payers. **We are of the view that the Mauritius Income-tax Act is substantially similar to the Indian Income-tax Act and the Agreement entered into by the Central Government with Mauritius is not *dehors* the powers given by section 90".**

**D. AAR's Observations & Rulings on the Issues raised by the Applicant:**

i) ***Re: Residential status of the applicant:***

Without much discussion, the AAR held that the Applicant is entitled to be treated as "Resident" of Mauritius as defined in Indo Mauritius DTAA

ii) ***Re: Nature of Gains on transfer of securities held in Portfolio Companies:***

After considering the Object Clause of the Memorandum of Association of

the applicant company and the arrangements between the applicant and the Custodian and the Investment Advisor, the AAR came to the conclusion that the gain on transfer of the securities held by the applicant in the Indian Investee Companies is business profits. The AAR observed and held as follows:

"There cannot be any doubt that frequency of sale is an important aspect for deciding the question whether a transaction in shares is a business transaction or not. But then again it is well settled that frequency of shares though a relevant factor, is not decisive. It is well settled that a single plunge may amount to a business venture if the surrounding circumstances so indicate".

***"Having regard*** **to** ***the objects clauses of the memorandum, there is little doubt that the purchase of shares of the Company in India was part of the company's business operations.*** The business of the applicant-company is "to carry on business as an investment company and acquire, invest in and hold securities of all kinds and from time to time to sell, deal in, vary or dispose of any of the foregoing". Therefore, the Company has been formed with the object of carrying on the business of acquiring and investing in and holding securities of all kinds and ultimately selling them at a profit. For this purpose, the Company has raised share capital and acquired money from other sources with which it has acquired very large blocks of shares in fledgling Indian Companies. ***This indicates*** **a** ***large systematic activity for making profits. The entire object is to sell these shares*** **at** ***profit when the value of the shares appreciates in the market. The gain from such transactions is business profits. Even if*** **a** ***loss is suffered that will be business loss.*** **It** ***is difficult*** **to see** ***how transactions of this magnitude in furtherance of the avowed object stated in the Memorandum of Association can be anything other than business".***

"Whether the company's activities will amount to trading is basically a question of fact. ***In the instant case, very intricate and complicate system of investment has been devised by the petitioner-company*** in collaboration with the other company including an Indian company. The elaborate provisions have been made as to how the investment will be done? How the advisers will decide upon the investments to be made, the sale proceeds of the shares if and when shares are-sold will be kept in the custody of the Custodian who will have to receive and maintain an account on behalf of the Mauritius Company. There are various other facets of this elaborate system which cannot be simply regarded as investment. ***The scheme devised appears*** **to** ***be elaborate business scheme*** **to** ***invest money from Mauritius in India. Such activity cannot be treated*** **as** ***investment activity. These activities reveal an elaborate business set up for trading in shares in India.*** Having regard to these facts and also the stated objects in the memorandum of association of the Company, it is clear that the company has purchased very large quantities of shares with the sole object of making profits by selling these shares at an appropriate time. The gains from the sale of shares will have to be treated as trading profits as and when the shares are sold."

In coming to the above conclusion, the AAR referred to and relied upon many English decisions:

***iii) Re: Taxability of applicant's business profits in India: Does the applicant have*** **a** ***Permanent Establishment in India?***

The AAR examined the provisions of Articles 5 and 7 of the Indo-Mauritius Treaty and observed and held as under:

"The next question is taxability of trading profits arising out of sale of shares. Under the tax treaty between India and Mauritius business profits made by an enterprise of a Contracting State is taxable only in that State.

This is the basic law laid down in article 7, Paragraph 1 of the Treaty. The exception is that if the enterprise of a Contracting State carries on business through a Permanent Establishment in the other State, in such a situation the profits of the enterprise carrying on the business in the other Contracting State may be taxed only to the extent as the profits is attributable to that Permanent Establishment. Paragraphs 2, 3, 4, 5 and 6 contain the rules for calculating the profits which will be attributable to the Permanent Establishment. These are machinery provisions which do not create any liability to pay".

"The question therefore is, does the Company have a permanent establishment in India?"

"The petitioner-company does not have a place of management or branch or office or a factory or a workshop in India. On behalf of the respondent, it has been argued that the shares which are purchased in India are also stored in India. Therefore, the petitioner-company must be treated as having a storage facility as a warehouse for storing its goods. This will bring the case of the petitioner within the mischief of sub-clause (f) of clause (2). Now, clause (f) deals with a warehouse in relation to a person providing storage facilities for others. If a non-resident person is providing storage facility for others, he may be said to have a "permanent establishment in India. But in the instant case, the petitioner is not providing storage facilities. At the most, it can be said that it is availing of or using storage facilities provided by others. *Therefore, the petitioner's case will not come within the mischief of sub-clause {f} of clause* {2}."

*"Therefore, the Petitioner Company cannot be treated as having a "Permanent Establishment" in India because of the provisions of Clause*

**2.** Clause 3 deals with certain negative features which will not be treated as amounting to having a permanent establishment. Clause 4 is a deeming

provision by which it is deemed that a person acting in a Contracting State on behalf of another enterprise of the other Contracting State shall be treated as Permanent Establishment of the non-resident enterprise in certain situations. One of the situations mentioned in sub-clause (i) of Clause 4 is that if a person residing in one state has and habitually exercises in that state authority to conclude contracts in the name of the non-resident enterprise unless its activities are limited to purchase of goods or merchandise for the enterprise. Now, in the instant case, the activities of the Indian Company are not confined to the purchase of goods or merchandise for the Mauritius Company but it has been authorized to sell the shares purchased by it and also to store the sale proceeds in a bank in the name of the Mauritius company and await for the directions of the Mauritius company about the disposal of the sale proceeds. Similarly, under sub-clause (ii) of clause 4 if a person habitually maintains a stock of goods or merchandise belonging to the foreign company from which he ordinarily fulfills orders on behalf of the foreign company then he will also be deemed to be a "permanent establishment" of the Mauritius company in India."

***"However, Sub-clause 5 has made an exception to Sub-clause 4. It lays down that carrying on business through a broker, general commission agent or any other agent of an independent status will not be treated as permanent establishment of a non-resident where such persons are acting in ordinary course of their business.*** This rule further clarifies that when the activities of such an agent are devoted exclusively or almost exclusively on behalf of a foreign enterprise he will not be considered as an agent of an independent status".

"The petitioner company has stated in its application that the agent in the instant case is not working exclusively on behalf of the Mauritius

Company. It has given the list of nearly 20 companies for whom the Indian company is rendering same or similar services. It has further been argued that the Indian Company, in this case, is acting in the ordinary course of business in rendering agency service to the Mauritius company. It is not a special business done exclusively for the petitioner company only".

"These allegations of facts have not been controverted effectively by the respondent. ***Under these circumstances, it must be held that the Mauritius company, the petitioner here, did not have a "permanent establishment" in India. Therefore, the profits made by this company if and when made will have to be taxed as business profits in Mauritius and not in India in view of the provisions of Article 7 of the Treaty between India and Mauritius".***

iv) **Re: Necessity of filing of Income-tax Return by the applicant in India:**

The applicant argued that if it does not have any taxable income in India, it need not file a Return of Income in India. The AAR did not accept the applicant's contention and observed that, "if the income received by or on behalf of the Non Resident exceeds the maximum amount which is not chargeable to income-tax, a Return of Income has to be filed. It may be that in the final computation after all deductions and exemptions are allowed, it will turn out that the assessee will be not liable to pay any tax. The exemptions and deductions cannot be taken by the assessee on his own. He is obliged to file his return showing his income and claiming the deductions and exemptions. It is for the assessing officer to decide whether such deductions and exemptions are permissible or allowable. The assessee cannot be allowed to prejudge the issues and decide for himself not to file the Return if he is of the view that he will not have any taxable income at

all".

*v) Other Questions:*

The AAR declined to answer other questions holding the same to be hypothetical questions and accordingly, the AAR did not discuss the issues raised by the Applicant.

D. Questions raised before the AAR and the AAR's answers to various questions may be summarized as follows:

In the light of the above essential facts, the applicant raised following 16 questions for the ruling of the Authority:

1. Whether, on the facts and in the circumstances of the case, XYZ/ ABC Equity Fund, ("Applicant") will be a resident in Mauritius and, hence, entitled to the benefits of the Convention between the Government of the Republic of India and the Government of Mauritius for Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect of Taxes on Income and Capital Gains and for Encouragement of Mutual Trade and Investment, as notified on 6-12-1983 ("Treaty")?

Ans. In the affirmative and in favour of the Applicant.

2. Whether, on the facts and circumstances of the case based on the provisions of Article 13 of the Treaty, the Applicant will not be taxable in India on capital gains (whether long-term or short-term) arising from the transfer of securities it holds in companies incorporated in India ("Portfolio Companies")?

Ans: Proceeds of sale of shares in India will amount to business receipts and not capital gains.

3. Whether, on the facts and circumstances of the case, the activities of the Investment Adviser will not constitute a permanent establishment of the applicant in India?

Ans: Having regard the facts as stated by the applicant, it may be held that the activities done by the Investment Advisor cannot be converted into "permanent establishment" of the Applicant in India.

4. Whether, on the facts and in the circumstances of the case, the activities of the Custodian will not constitute a permanent establishment of the applicant in India?

Ans: The activities of the Custodian cannot be treated to constitute the Applicant's permanent establishment in India.

5. Whether, on the facts and circumstances of the case, would the employees of the Investment Adviser appointed as "Nominee Directors" on the Board of Directors of the Portfolio Companies on behalf of the applicant constitute the permanent establishment of the applicant in India?

Ans: The AAR declined to answer the question by observing that the role and functions of the Nominee Director will have to be examined in depth.

6. Whether, on the facts and circumstances of the case, if for any reason the activities of the applicant were to constitute a permanent establishment in India, even then, since the securities held by it in India would not form part of the business property of its permanent establishment, the applicant would not be subject to tax on capital gains (whether long term or short term) arising from the transfer of securities it holds in India?

Ans: The AAR declined to answer the question in the absence of full details and observed that it required detailed investigation.

7. Whether, on the facts and circumstances of the case, will the income earned by the applicant from units of an Indian mutual fund set up in the form of a trust not being specifically covered by any other article of the Treaty, fall within the purview of article 22 of the Treaty and be taxable in Mauritius only and not in India?

Ans: The AAR declined to answer the question and observed that the role and capacity of the Nominee Director requires detailed investigation. (Authors' Note: The question really related to taxability of income from units of a Indian Mutual Fund set-up in the form of a trust, under Article 22 of the Treaty)

8. Whether, on the facts and circumstances of the case, will the interest including penal interest received by the applicant pursuant to a loan agreement in respect of debentures and any other debt claims issued pursuant to the approval of the Reserve Bank of India ("RBI") / Government of India be exempt from tax under article 11 of the Treaty?

Ans: The interest and penal interest should be taxed in accordance with Article 11 of the Treaty as the applicant is not carrying on any business of money lending through any Permanent Establishment in India.

9. Whether, on the facts and circumstances of the case, will interest or capital gains earned by the applicant from the securities it holds in portfolio companies be regarded as its "business income"?

10. Whether, on the facts and in the circumstances of the case, even if interest or capital gains earned by the applicant from the securities it holds in Portfolio Companies were regarded as "business income" based on the provisions of article 7 of the Treaty, they will not be taxable in India as the applicant does not have a permanent establishment in India?

Ans. 9 & 10: Need not be specifically answered in view of answers given to Q. Nos. 4, 5 & 6.

11. Whether, on the facts and circumstances of the case, "Front End Fees" ('Deference Fees') received on a discretionary basis by the applicant from Portfolio Companies, not being specifically covered by any other article of the Treaty, will fall within the purview of article 22 of the Treaty"?

Ans: If the basic character of the Deference Fees is in the nature of compensation for loss of possible Investment, the taxability of such fees will fall within the purview of Article 22. of the Treaty.

12. Whether, on the facts and in the circumstances of the case, would the premium on redemption of debentures receivable by the applicant from the Portfolio Companies be treated as capital gains and be tax exempt in India as per the provisions of article 13 of the Treaty?

Ans: As the applicant is not carrying on business of lending money, the Front End Fees received on discretionary basis from the portfolio companies and the Premium on redemption of debentures will fall within the ambit of Article 13 of the Treaty.

13. Whether, on the facts and circumstances of the case, the applicant will be absolved from filing a tax return in India, under the provisions of section 139 of the Indian Income-tax Act, 1961 if the entire income is subject to tax only in Mauritius?

Ans: 13. The applicant will have to file a Return of Income in India under the provisions of Section 139 of the Indian Income-tax Act.

14. Whether, on the facts and in the circumstances of the case, the applicant will be absolved from filing a tax return in India, under the provisions of section 139(1) of the ITA, if the entire tax payable by it is withheld in India under the Treaty provisions and as per the rates prescribed in the Treaty?

Ans: Need not be separately answered in view of answer to question No.13

15. Whether, on the facts and in the circumstances of the case, would there be any penal consequences under the ITA if the applicant fails to file a tax return, provided the entire tax payable by it has been withheld at

source?

Ans: If the applicant is liable to pay income-tax in India, he is under an obligation to file a return of Income. Non filing of the Return will attract penal provisions of section 271(1) (b).

16. Whether, on the facts and in the circumstances of the case, if for any reason, the applicant is found to have a permanent establishment in India, will the profits attributable to such permanent establishment be taxable at the rate of 35 per cent instead of 45 per cent, based on the provisions of article 24 of the Treaty?"

Ans: The matter is already concluded by the principles laid down by the AAR in case of Society General, France, dated 4/4/1998 (236 ITR 103) The AAR held that mere charging of a higher rate of tax does not constitute discrimination between a domestic and a non-domestic company.

**Comments:**

This is yet another case of 'Treaty Shopping' made use of by Foreign Institutional Investors in the financial sector. The route has been through Mauritius. Apparent reason given is the cumbersome process of investing in companies set-up outside India by a company organized in India, as such investments would require prior approval of the RBI whose regulations are quite stringent. As noted earlier in the Chapter IV on "Interpretation of DTAAs", the Supreme Court held that 'Treaty Shopping" is not illegal (23). Therefore this equity fund also passes muster.

## CHAPTER-VII

## CASE STUDIES ON ABSENCE OF P.E.

### 7.1 ADVANCE RULING P-11 OF 1995 (36)

**Facts**

The applicant is a company incorporated in Singapore; hence a resident of Singapore. During the year ended 31-3-1995, it entered into two contracts, namely, X pipeline project and Y trunk pipeline project with ABC for providing services related to burial of pipelines off shore in India. The work executed by the applicant was in the nature of a turnkey sub-contract since the main contract from the ONGC was obtained by XYZ. This contract among other things envisaged installation of pipeline crossing free span rectification works, sub sea welding, submarine cables, pipeline rigging, testing, drying and so on. The task also included mobilization and demobilization, pre-trenching survey.

Part of the job was sub contracted by XYZ to ABC. ABC in turn further subcontracted the job of burial of pipeline to the applicant. As the contract with the applicant was in the nature of turnkey sub-contract, all marine vessels, personnel and equipments were provided by the applicant.

The duration of the two contracts was for 7 days and 39 days respectively. The activities under the contract were performed in Indian territory.

Issues and questions raised before the Authority:

1. Whether the revenues earned by the applicant (tax resident of Singapore) from the contracts entered into with ABC during the previous year ended 31-3-1995 were liable to tax in India in view of the DTAA between India and Singapore.

2. Whether the specific provisions of the DTAA override the general

provisions of the Income-Tax Act 1961

**Issues considered and the process of arriving at the decision**

Coming to the second question first, the Authority held that the specific provisions of the DTAA override the general provisions of the Income-Tax Act 1961 because by now it is a settled law. Moreover, the department also did not raise any objections to the aforesaid contention.

Coming to the issue of taxability of revenues earned by the applicant in India the department contended that the applicant had a permanent establishment in India in terms of clause (f) of para 2 of article 5 of the DT AA which reads as "a mine, an oil well, a quarry or any other place of extraction of natural resources". It maintained that the installation work was in fact carried out by the ABC and the applicant was awarded only a part of the work by the ABC. Hence, it cannot be said that the installation work was carried out by the applicant. According to the department, oil as well as gas, has specifically been covered by the DTAA in clause (f) para 2 of Article 5.

The Authority did not accept the contention of the department on the following grounds.

1. The applicant had merely worked on the oil or gas well and the oil well in question was not owned or operated by the applicant.
2. The applicant was engaged in an installation and assembly project which pertained to the burial of pipelines in the seabed. Such activities are covered by para 3 of the Article 5 of the DTAA which reads as "A building site or construction, installation or assembly project constitutes a permanent establishment only if it continues for a period of more than 183 days in any fiscal year". Hence, para 3 permits such project to be treated as permanent

establishment only if the duration of the project exceeds 183 days in any fiscal year. In the instant case, the applicant worked on the project only for 7 days and 39 days respectively.

Article 7 of the DTAA dealing with profits of enterprise, permits the taxation of resident of Singapore on the profits attributable to a permanent establishment in India. In the present case, in view of the DTAA and the absence of permanent establishment, the applicant is not liable to tax in India although the applicant earned profits on the projects carried out in the Indian territory.

**Ruling:**

The revenues earned by the applicant from the contracts entered into with ABC, Singapore, during the previous year ended on March 31 1995 would not be liable to tax in India, as it had no permanent establishment in India.

**Comments:**

This Singapore company could escape from taxation in India, as its establishment in India was not having a PE in terms of DTAA between India and Singapore.

## 7.2 AUTHORITY FOR ADVANCE RULING P.NO.13 OF 1995 (37)

1. **Facts**

ABC Company of France having worldwide affiliates posed as many as 13 questions for the ruling of the AAR. ABC provides services to its clients on turnkey basis and on specific assignment basis in the diverse fields covering

a) transfer of licensed technology, b) basic engineering designs, c) detailed engineering designs, d) project and construction management services, e) buying services, f) start-up technical

assistance and g) operational services.

ABC would be responsible for all the services to X and Y (Indian companies) on a single point responsibility basis though it might be required to procure the services from third parties. ABC would be operating from its Head Office in France as also from its project offices in India. It expects to employ 200 to 400 employees in India and about 800 employees outside India. The work to be done by ABC for X and Y is covered by the following seven separate agreements:

a) Umbrella Services Agreement (USA)

b) Licence and Basic Engineering Agreement (LBEA)

c) Engineering Services Agreement (ESA)

d) Equipment Supply Agreement (SA)

e) Buying Services Agreement (BSA)

f) Site Services and Assistance Agreement (SSA)

g) Project Management Services Agreement (MSA)

ABC may get part of the work done on sub-contract basis through their affiliate offices/third parties keeping the overall responsibility with them. Some activities will be done in India and some others will be performed outside India.

DTAA between India and France came into force on August 1, 1994. A protocol entered into between the two countries, at the time of appending signatures to the convention, added further provisions forming part of the convention and relied upon by the applicants.

2. **Issues - (Questions raised), Analysis in brief and the Ruling of the Authority**

Q.1 Whether ABC is a person resident in France under DTAA?

A. Yes. *ABC* is a foreign company and the control and management of its affairs was not 'wholly situated in India. Hence "Non Resident" entitled to make application to AAR.

Q.2 Whether project office and site office of ABC in India will constitute a permanent establishment under DTAA?

A. Yes. It is so, in view of the long duration of the contract (28 to 30 Months) for the purpose of taxation of income from the contract.

Q.3 Whether the payments under the agreements are in the nature of "royalty" and "fees for technical services" under the DTAA?

A. Of the seven contracts five, provided for payments to ABC as a consideration for use of patenting trademarks, designs, models, etc (belonging to ABC or acquired by it) or for information concerning industrial, commercial or scientific experience or consideration for managerial, technical consultancy services. They are in the nature of royalty/fees for technical services under Article 13.3 and 13.4. They also answer to the description "business profits" assessable under Article 7.

In the words of the A.A.R. "There is no incompatibility between recognising the receipts as royalties and fees for technical services - which they are under the Agreements - and looking upon them also as the profits of business assessable under Article 7".

Q.4. Whether the royalties and technical fees received by ABC under the contract in respect of its activities outside India is effectively connected with the P.E. in India?

A. Yes. Such activities were meant for installation of the manufacturing plant and industrial complex in India, integrally connected with the project of X & Y.

The Authority observed, "All the outside activities are directed

towards the installation of the manufacturing plant and industrial complex in India. Though carried out elsewhere, they are integrally connected with the project in India. The designs, basic engineering services and other services are based OD information collected in India and the use of the process and technologies have to be adapted to the needs of, and prove workable in, Indian conditions. The P.K in India has an undoubted 'voice over the outside activities as well...".

Q5. Whether the ABC is the beneficial owner of licence technology and basic engineering procured by it from its affiliates and/or third parties?

A. Yes. ABC utilises its own existing expertise, sharpens it by its own in-house resources or by acquiring it from its affiliates / third parties. It modifies, synthesises and blends them to suit the requirements of X & Y under Indian conditions. It does not act as a mere post office nor as a mere go-between; but supplies/applies them in the performance of contract as its own under a single source and is responsible for the performance.

Q.6 Whether ABC is the beneficial owner under DTAA in respect of engineering services and buying services sub-contracted by it to its affiliates/third parties?

A. Yes. For the reason adduced above.

Q.7 Whether payments under agreements are liable to tax as "royalties and fees for technical services" under the DTAA or under the head "business profits"? and

Q.8. Whether in terms of article 7.1 and 7.2 (business profits) read with paragraph 3 of the Protocol to DTAA, the profits attributable to activities inside India alone will be liable to tax in India?

A.7

& 8. The said payments are taxable under Article 7 read with Article 13(b) of the DTAA. In view of the Protocol signed with France, Article 13(6) lifts out of the purview of Article 13 and transposes to Article 7 (profits attributable to PE) all payments received as royalties or fees for technical services which are effectively connected with PE.

What is assessable under Article 7, is not the whole of such royalties / technical fees, but only the profits attributable to the PE. Clause 3 of the Protocol then steps in to clarify that profits attributable to PE can only mean those attributable to the "activities in India" and none others. As a result, royalty and technical fees received for activities outside India though effectively connected with the PE would not be covered, thanks to the Protocol.

Q.9. Whether, while computing the profits of the permanent establishment in India, the restrictions imposed by article 7.3(a) of the DTAA would extend to only section 44C of the Act or to any other provision of the Act?

A. The words "in accordance with the provisions of and subject to the limitations of the taxation laws of the Contracting State" used in Article 7.3 (a) of the DTAA, would attract, in the computation of the profits under Article 7, the limitations and restrictions not merely of section 44C of the Act but also of all other provisions contained in the Act as well.

Q.10

& 11. Whether the payments made to head office for technology and basic engineering services, buying services are reimbursement of expenses and deductible for computing profits of P.E.?

A.10

& 11. The technology acquired by ABC may be modified / refined over a period of time. The payments made by X and Y to ABC are for technology perfected by ABC to suit Indian conditions for X and Y. Hence, such payments are not reimbursement of payments to ABC - but to ABC in its own right. In view of Article 7(3) (b) payments by PE to Head Office will not be deductible in computing the profits of PE in India.

Q.12. Whether head office of ABC would be liable to withhold taxes under the Income Tax Act of India in respect of payments made to the foreign suppliers (including its affiliates)?

A.12 The Authority considered the issue at length and also after considering the provisions of Section 9(1)(vi) & (vii) of the Income Tax Act, held that such payments cannot be deemed to accrue or arise in India. ABC may use the), technology so acquired anywhere in the world. Hence, ABC would not be liable to withhold taxes under the Income Tax Act in respect of payments in question.

Q.13. Whether the profits of the P.E. will be computed under the head "profits and gains of the business" as per the Income Tax Act and at the rate as applicable to foreign company or the gross receipts shall be taxed at the rates prescribed under section 115A of the Act?

A.13. Taxability would depend upon the facts

a) If approval of Government is not received u/s 115 A, the profits of the PE would be computed in a normal manner and tax levied as applicable to a foreign company.

b) If contracts / agreements are approved by the Government of India u/s 115A, relating to royalties and fees for technical services, they would be taxed @ 30% on gross and for the balance at the rate as applicable to a foreign company.

c) Payments to ABC in consideration of services relating to construction, assembly or like projects the same would not be covered by section 44D / 115A; and only net receipts after deducting expenses under section 28 to 44C or 57 of the Act will be assessable to tax as applicable to a foreign company. This is so because" site services and assistance agreement" as well. as the "project management services agreement" relate to the assembly and construction of the manufacturing plant and the industrial complex to be set up by ABC for X and Y. The consideration stipulated for these agreements will, therefore, fall outside the purview of the definition of "fees for the technical services" under Explanation 2 to section 9(1) (vii) which is also in tune with the DTAA read with the Protocol.

**3. Conclusion:**

The above ruling of the Authority is significant, for it clarifies the taxability of income under appropriate head (Article) of the DTAA, read with Protocol, liability to deduct tax at source, as also income attributable *to* operations in the host country (i.e. India)

Comments:

In this case the income is taxable as business profit because the duration of the contract was 28 to 30 months and the French company did have a P.E. But the interesting feature in the DTAA between India and France is paragraph-3 of Article-7 which reads as under :-

"3.(a) In determining the profits of a permanent establishment,

there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere in accordance with the provisions of and subject to the limitations of the taxation laws of that Contracting State. Provided that where the law of the contracting State in which the permanent establishment is situated imposes a restriction on the amount of the executive and general administrative expenses which may be allowed, **and that restriction is relaxed or overridden by any Convention, Agreement or Protocol signed after 1st January, 1990, between that Contracting State and a third State which is a member of the OECD, the competent authority of that Contracting State shall notify the competent authority of the other Contracting State of the terms of the corresponding paragraph in the Convention, Agreement or Protocol with that third State immediately after the entry into force of that Convention, Agreement or Protocol and, if the competent authority of the other Contracting State so requests, the provisions of that paragraph shall apply under this Convention from that entry into force.**

The highlighted portions in the above paragraph are quite interesting. The DTAA between India and France was notified on 7th September, 1994.

But the highlighted portion refers to any relaxation of the restrictions by any convention or agreement or protocol signed after 1st January, 1990. This enables the French company to derive benefit out of any other DTAA entered into between India and a third country. Further even income derived by way of royalty and fees for technical services and dividend and interest would be liable to tax on net basis – i.e. net of expenses including head office expenditure and administrative expenditure – instead of gross basis, in the absence of a PE. Thus TNCs are willing to have a PE only when they are able to reduce their tax liability.

## 7.3 ADVANCE RULING NO.274 OF 1996(38)

1. **Facts**

a) The applicant, a US Company, is engaged in the International Courier business.

b) The applicant entered into a Service Agreement with an Indian Company, engaged in Domestic Courier business.

c) The US Company Provides necessary software (Belonging to US Company) to be used by Indian Company for electronic communication with the help of own facilities and equipments.

d) Each of the companies was to provide necessary services to each other at mutually agreed schedule of rates and send invoices to each other. The net remittance to be sent by either of them to the other depending on their respective billings. Invariably the US Company was receiving amount from Indian Company (after netting out).

e) Both the Indian and the US Company were independent in doing their business and the arrangement did not constitute partnership, agency,

or employment relationship between the two.

2. **Issues and the Questions raised before the Authority**

Whether the applicant company (US Co.) is liable to tax in India in respect of the amounts received by the US Company in respect of services provided by it to the Indian Company?

3. **Department's Preliminary Objection on the maintainability of the Application**

The application of the applicant was pending for consideration before the Hon. Tribunal (ITAT) on the question of deductibility of TDS on payments to the applicant. In view of this and Clause (a) to the proviso to Section 245 R (2) of the Act, the Department contended that the application was not maintainable.

The Authority rejected the contention of the Department on the ground that the question raised before the Authority was not the same as the one raised before the IT AT. As the question raised before the AAR was different (the same question) from that raised before the IT AT, the issue raised before the AAR was not pending before any Tax Authority or court (ITAT in this case).

While so doing the AAR relied on its earlier ruling on AAR No.269 of 1996 (unreported)

4. **Department's Contentions:**

The way bill issued in India bears the name of the U.S. Company and that way bill is "not negotiable". This indicates privity of contract between the consignor in India and the US Company.

On the basis of the continuous dealing between US Company (applicants) and the Indian Company, it was contended that the US Company has business connection in India. Hence, profits and gains accruing to the US Company through and from such business connection are liable to tax in

India.

5. **Submissions of the Applicant**

a) The applicant submitted that both the US Company and the Indian Company are independent and the dealings are 'at arms length'.

The share of US Company's business handled by the Indian Company is a small portion of its total business. Indian Company is a listed public company and the US Company has no interest in the management of Indian Company.

b) US Company does not carry on any business operations in India. Hence, the question of part of its profits being taxable in India does not arise.

c) As regards 'way bills' bearing the name of the US Company, it was clarified that in International Courier business, it has become the practice to use way bills bearing the name of the international courier or the foreign collaborators, as a matter of routine. The way bills are got printed in serial order, so that there is no duplication, and it contains electronics bar coding system to trace the consignment and ascertain their stage of transit at any point of time, under the system. It is not advisable for each (independent) agent to print and use its own way bills.

The way bills merely reflect the freight charged direct by Indian company to its customers and does not reflect the amount charged by the US Company to Indian Company / amount paid by Indian Company to US Company.

And finally in case of loss of consignment in mid way the consignor will have recourse against the Indian Company and not the US Company.

6. **AAR's Observations and Ruling**

a) In the first place the transactions between the parties (US Company and Indian Company) are governed by the Indo-US DTAA which override

the provisions of the Income Tax Act. Therefore there is no need to go into the issue of the applicability of the provisions relating to business connection contained in Section 9(1)(1) of the Income Tax Act. The appropriate question would be "whether under the DTAA the profits arising to the applicant through its Indian activities, are chargeable to tax in India".

b) **Nature of activity of US Company in India**

Based on the agreement / arrangement, the Authority concluded that the US Company, which has authorized the Indian Company, to issue such way bills and permitted such representations is carrying on business of courier in India through its agent namely Indian Company.

c) **Whether US Company has PE in India**

The Authority considered the provisions of Clause (c) of Article 5 of the Indo US DTAA and observed that carrying of a business in India through an independent agent in India, by the US Company would not constitute the 'PE' of the US Company.

In the instant case the Indian Company was an independent agent because,

i) the activities of the agent were not wholly or substantially wholly devoted to the US Company (Non-resident enterprise) and

ii) the transactions between the US Company and the Indian Company (agent) were 'at an arm's length'

Based on the above findings the Authority ruled as under

*"On the facts stated and placed before the Authority, the US Company is not liable to tax* on *the amount received by it in respect of services provided by it to Indian Company".*

**Comments:**

This American courier company escapes liability to tax by showing that the

activities in India carried on through a constituted agent did not amount to having a PE. The decision of AAR was based on Indo-US DTAA.

## 7.4. ADVANCE RULING P. NO.18 OF 1995 (39)

### 1. Facts

i) 'A' private limited company and 'B' private limited company are two companies incorporated in Australia. They formed an association known as "A and B" for pursuing and carrying out various kinds of projects in India.

ii) The Australian association along with three Indian associates (namely Development Consultants Ltd., Calcutta, STUP Consultants Ltd., Calcutta, and A-B India Pvt., Ltd.) formed consortiums and entered into an agreement with Port Trust of India, on 30th April, 1994.

iii) The consortium is "to provide consultancy services" necessary for the effective implementation of a project, drawn up by the Port Trust with financial assistance from the Asian Development Bank (ADB).

iv) The consultancy services were in respect of the certain of mechanised coal handling facilities at the Indian Port for handling thermal coal.

### 2. Questions raised before the AAR

Four questions were raised before the AAR. Out of the four questions, Question No. 1 was found incorrect at a later date, hence the same was modified with the permission of the AAR. The questions raised were as follows:

i) Whether, on the facts and circumstances of the case more particularly set out in the explanatory computation below, this would not be a fit case for a ruling that no tax should be deducted at source on payments

amounting to Rs.....that are being made to the applicant in terms of the agreement dated.....entered into between the applicant on the one hand and Indian Port Trust on the other and further that if deduction has already been made by Paradip Port Trust and paid by them to the Income-tax Department should be refunded to the applicant.

ii) Whether, on the facts and circumstances of the case (where the applicant joint venture has business operations only in relation to India) the deduction of a head 'Office expenditure' would be subject to limits laid down in section 44C of the Income-tax Act, 1961 ?

iii) Whether the entire business income of the applicant accruing or arising from this contract would be assessable in India or only that part of it which is reasonably to operations in India?

iv) Whether and to what extent services rendered outside India by the applicant to the Indian Port Trust would fall under the definition 'royalties' so as to attract tax in India of such payments under paragraph 2 of article 12 of the DTAA ?

3. **Issues considered and the process of arriving at the decision**

**Applicant's Contentions**

3.1 Applicant submitted its arguments in four parts. The arguments in brief were as mentioned below:

a) Since the applicant has a P.E. in India only that portion of its profits can be brought to tax as is attributable to the P.E.. Expenses incurred for the purpose of the P.E. including executive and administrative expenses at the head office in Australia have to be deducted in ascertaining the taxable profits.

b) The consultancy services provided outside India cannot be said to be effectively connected with the permanent establishment and payments, therefore, can be taxed only if they can be described as "royalties".

However, no part of the payments made to the applicant for services rendered outside India can be termed as "royalties" as the contract involved no element of supply, conveyance or transfer of any technical know-how.

c) If the profits attributable to operations carried out in India are to be taken note of, the receipts of the applicant being practically by way of reimbursement of the expenses incurred by it on the employees by way of travel and remuneration, the margin of profits embedded therein was practically negligible.

d) In any event, since the activities of the applicant were entirely confined to India, the applicant is entitled, in the computation of its business profits, to deduct the entire expenditure incurred by it including head office expenditure incurred in Australia, without any disallowance under section 44C : Vide, the decision of the Calcutta High Court in Rupenjuli Tea Co. Ltd. V.CIT [1990] 186 ITR 301. It is argued that if this is done, the net profit of the operations of the applicant in this regard would be negligible.

**3.2 Department's contention**

Ms. Ameeta Saini represented the Department. She raised following arguments:

i) Applicant's case is covered by article 7 of the DTAA and entire profits would be taxable as business profits.

ii) The payments made to the applicant whether in Australian dollars or in Indian rupees constitute income arising from services provided in India and will be fully taxable.

iii) The rate of deduction should actually have been @ 55 per cent applicable to business profits and not just 20 per cent.

iv) The applicant is really not affected by the tax incidence as the Paradip Port Trust (PPT) has paid taxes to the Government on behalf of the

applicant in respect of payments made in Australian dollars.

v) The margin of profits has been grossly understated.

### 3.3. AAR's Observations

AAR expressed difficulties and the practical ineffectiveness of answering question number (iii) to (iv) as they would require detailed scrutiny and assessment. The learned counsel for the applicant agreed to it and requested ruling for question No.(i) only. Further applicant did not seek any ruling for deduction of tax @ 20 per cent from payments made to the applicant in Australian dollars. Obviously the applicant was not much concerned about this as this liability was born by the PPT. The applicant was concerned about deduction of tax @ 20% as payment made in Indian rupees as profit margin (which mainly represented reimbursement of expenses) was negligible.

Applicant submitted three different workings to show how its profits would not exceed 10 per cent of the gross receipt under any circumstances. Applicant also cited various section of the Income Tax Act viz 44AD, 44AE, 44B, 44BB, 44BBA and 44BBB all dealing with presumptive taxation and wherein maximum rate of profit is 10 per cent.

AAR observed that there is substance in the applicant's contention of the 10 per cent profits of gross receipts. Profit element embedded in the payments made in Indian currency was estimated. The tax liability @ 55 per cent on such profits was also estimated and that work out to about 4.5.% of the gross receipt.

**Ruling by the AAR**

Considering all arguments and different workings the AAR held that "Tax deduction should be made at the rate of 4.5 per cent on all payments made under the contract to the applicant in Indian rupees on or after April, 1995, instead of @ 20 per cent.

**Comments:**

This is a typical illustration of the Australian company taking shelter under the Income-tax Act, 1961 and getting its tax liability reduced from 20% of withholding tax on the gross receipts to 4.5% of the gross receipts. Thus it is a case of 'heads-I-win, tails-you-lose'.

7.5 **Al Nisr Publishing – No.358 of 1997**(40)

1. **Facts:**

1.1 The applicant Al Nisr Publishing is a partnership registered in the UAE.

1.2. It is engaged in the business of publishing, printing and distributing news papers or other publications. It publishes a daily English language Newspaper called "Gulf News".

1.3. In order to solicit orders for advertisements, it has entered into agency agreements with advertisement representatives in several countries namely India, Pakistan, U.K., Philippines and Japan.

1.4 In respect of India, Bennet Coleman Co. Ltd. (BCL) was appointed as the sole advertisement representative for the applicant in the republic of India.

1.5 Term's of the agreement inter alia provided as under

a) BCL was the exclusive agent for soliciting advertisements from recognized advertising agencies and national advertisers in India for the applicant's publications.

b) BCL to inform all the advertisers that it would not enter into any contract or accept any order on behalf of the applicant or act on behalf of

the applicant or attempt to bind the applicant in any way.

c) BCL to inform all advertisers that the applicant to accept orders on its standard terms and conditions.

d) The applicant is empowered to accept orders for advertisement and reserved to the applicant the right at its absolute discretion, to refuse to accept any order but the notification of such refusal and the reasons therefore had to be given forthwith.

e) BCL is entitled to 30% commission to be deducted out of charges collected by it before remittance to the applicant.

f) BCL is free to act as advertising agent in India for other overseas newspapers, magazines and publications.

1.6 BCL obtained permission from Reserve Bank of India to act as collecting agents for advertisement received on account of the applicant.

2. **Issues:**

The applicant filed an application before the AAR requesting the ruling on the following questions:

"a) Whether, in the fats and circumstances of the case, any business profits or income accrues or arises in India in the hands of the applicant out of advertising revenue received / receivable from its agent(s) in India?

b) Whether such advertising revenues remitted out of India by the agent(s) of the applicant is subject to deduction of tax at source under Section 195 or any other provision of the Income Tax Act, 1961, and, if *so,* what would be the amount on which the tax would be deducted at source?"

3. **Submissions before the AAR :**

**3.1** ***Submissions by the Department:***

a) The applicant has business connection in India and therefore any income which accrues or arises to it in India from the advertisements should be deemed to accrue or arise in India under Section 9(1)(i) of the

Act.

b) The advertisements are canvassed in India, with the authority to conclude contracts on behalf of the applicant. Hence BCL should be considered as the applicants Permanent Establishment.

c) The right of refusal to accept advertisements booked by BCL was ineffective and meaningless. The advertisements were received and charges collected in advance by BCL. There was no reason or ground for the applicant to refuse to accept any advertisement that had been booked by BCL so long 'as rates and other standard conditions had been fulfilled. Therefore BCL was not an independent agent and the case fell within the ambit of para 4 of the Article 5 of the DTAA.

d) The applicant has failed to give even a single instance where the advertisement solicited by it was rejected by the applicant. There is not a single instance where the charge collected for the advertisement had been returned to the advertisers for whatever reason, was not and could not be published. Therefore the case fell within the realm of paragraph 4 of Article 5 of the DTAA and the advertisement revenue of the applicant should be taxed in India.

**3.2 Submissions by the Applicant**

a) The objects clause of the Memorandum of Association of BCL is very wide and permitted it to carry on various types of business.

b) There was a special authorisation in clause (b) of paragraph 3 of the Memorandum which authorised it to carry on business in India as advertising agents.

c) The agreement between BCL and the applicant was a non exclusive arrangement and that BCL was at liberty to, and in fact does act as advertisement agent in India for several newspapers. At the relevant time it was acting as advertisement representative for as many as 19 foreign

publications published in different countries in the world. To this effect a certificate was furnished by the BCL.

d) Number of applications (AAR Nos. 368 to 370 and 375 to 378 of 1997) had been filed before the AAR in which similar questions have been raised by certain other foreign newspapers which have BCL as their advertisement agent in India.

e) The applicant also filed correspondence to indicate that the applicant was directly dealing with some of the advertisers as there were many reasons why advertisements submitted for publication could not be accepted straight away, as some of them could be violative of the laws of the UAE or otherwise not acceptable.

f) In the light of these facts, any reference to paragraph 4 of the Article 5 which reads as under became redundant

"Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of independent status to whom paragraph 5 applies - is acting on behalf of an enterprise and has, and habitually exercises in a Contracting State, an authority to conclude contracts on behalf of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to the purchase of goods or merchandise for the enterprise.

g) Therefore in terms of paragraph 5 of Article 5, which reads as under

"An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of any independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on

behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of his paragraph".

BCL should be held to be an agent of independent status of the applicant and therefore not a Permanent Establishment of the applicant.

h) Under Article 7 of the Treaty no business of the profits of a non-resident can be brought to tax within the meaning of Article 5.

i) The dealings of the applicant through BCL cannot be said to constitute "Business Connection" within the meaning of Section 9 of the Act, since the applicant has no Permanent Establishment in India it is not liable to any tax on the advertisement collections received form India.

4. **Analysis of the Submission**

Based on the aforesaid submission the authority came to the following findings

a) Paragraph 4 is applicable only to a case where a person who acts as agent for the non-resident is not an agent of independent status within the meaning of paragraph 5.

b) BCL is an agent for receiving advertisements and collecting advertisement revenues on behalf of the applicant in India. But the agency is not exclusive. The Memorandum of Association of BCL permits it to carry on business as advertising agents and in exercise of this power. BCL has entered into contracts with several foreign newspapers to act as their representative to collect advertisements in India.

c) Though the principal business of the BCL is the publication of newspapers in India, but BCL is also carrying on business in that{ collection of advertisement for foreign newspapers and it is the course of such business that it has entered into contracts with various foreign newspapers.

d) The applicant and BCL are in no way associated with each other and

the terms of the contract between them are at an arms length.

e) The question whether the terms of the contract authorise BCL to conclude contracts on its own, and whether the applicant was habitually exercising authority for accepting the advertisements so as to bring within the scope of paragraph 4 of Article 5 is otiose in the present circumstances as spelt out above.

f) The case clearly falls under the terms of paragraph 5 of article 5 of the DTAA and BCL though an agent; is an agent of independent status within the paragraph 5.

g) In view of this question of applicability of section 9(1)(i) does not arise as under the DTAA there is no Permanent Establishment

5. **Ruling**

For the reasons stated above, the Authority held that the applicant has no permanent establishment in India within the meaning of article 7 read with article 5 of the DTAA. That being so, the following ruling was given on the questions raised by the applicant:

a) Whether, in the facts and circumstances of the case, any business profits or income accrues or arises in India in the hands of the applicant out of advertising revenue received / receivable from its agent(s) in India?

*Ans.* It is unnecessary to answer question No.1 raised by the applicant in view of the' ruling given on the second question.

b) Whether such advertising revenues remitted out of India by the agent(s) of the applicant is subject to deduction of tax at source under Section 195 or any other provisions of the Income Tax Act, 1961, and, if so, what would be the amount on which the tax would be deducted at source?

*Ans.* No. The advertising revenues received by the applicant in India are not taxable in the hands of the applicant in view of Article 7 read with

Article 5 of the DTAA. There is, therefore, no obligation to deduct tax at source from the remittances made to the applicant by BCL.

**Comments:**

Carrying on business through an independent agent does not constitute having a PE. This decision is entirely based on the interpretation of DTAA between India and UAE, another 'Tax Haven'.

### 7.6 Advance Ruling No.24 of 1996 (41)

**1. Facts of the Case:**

a) The two applicants, M/s.B and M/s. H, are Companies incorporated and resident in The Netherlands. Since their applications raised similar questions, they have been disposed of by the AAR by a common order.

b) An Indian Public Sector Undertaking (PSU) entered into a contract with a Korean Company *("K"),* which contemplated designing, engineering, procurement, fabrication, transportation, laying/installation, burial, testing and commissioning, etc. of a Trunk Pipeline Project within the territorial waters of India.

c) K, in turn, entered into sub-contracts with an Indian Company, M/s. B in respect of some of the items of work to be performed by K under the main contract.

d) The Indian Company, in turn, entered into a sub-contract with M/s. H.

e) Thus, Band H, the two applicants are subcontractors executing portions of the work originally entrusted by the Indian PSU to a Korean Company and the subcontracts related to pipelines under the sea.

f) H's responsibilities were" primarily in the nature of a works contactor performing various physical activities on and in relation to the pipeline constructed for extraction, production and transportation of mineral oil from oil fields located offshore India.

g) B's responsibility was to mobilize from abroad a vessel equipped with a diving plant and other necessary equipment and undertake remedial construction works at the laterals (a lateral being an offset to the main pipeline and equipped with valves to be used later, if required, to connect a new pipeline in the future).

h) The project undertaken by H was completed within a period of 68 days and that undertaken by B was completed within 27 days.

**2. Questions before the AAR :**

In the light of the above facts, the applicants sought advance ruling of the authority on the following questions (suitably rephrased).

i) **In H's case:**

"Whether income derived by H from its contract with the Indian Company is taxable in India?"

ii) **In B's Case:**

"Whether the revenue earned by B from its contract with the Korean Company is taxable in India in terms of Article 5 of DTAA between India and The Netherlands?"

**3. Applicants' Contention and submission:**

a) The applicants submitted that though the income under the said Contracts can be said to arise in India as they arise from activities carried out in Indian territory, they cannot be taxed in India in respect of such income because of the provisions of the DTAA read with Section 90(2) of the Act. The applicants placed reliance on a Circular [No.333, dated 2-4-1982] of the Central Board of Direct Taxes and the decision of the Andhra

Pradesh High Court in CIT vs. Visakhapatnam Port Trust, [1983] 144 ITR 146, for the proposition that the specific provisions of the DTAA will prevail over the general provisions of the Act.

b) The applicants further pointed out that the contracts are being carried out by them as part of their regular business activities and the income derived from these activities is in the nature of Business Income. Article 7 of the DTAA regulates the taxability of income from business carried on by a resident of one of the States in the other State. Relevant portion of Article 7 reads as follows:

"Business Profits - (1) the profits of an enterprise of one of the States shall be taxable only in the State unless the enterprise carries on business in the other State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment"

c) In brief, the contention of the applicants is that their profits from their activities in question are not taxable in India as they have no 'permanent establishment' in India.

**4. AAR's observations and ruling:**

The AAR observed that the answer to the questions raised has to be given on the basis of the definition of the expression 'Permanent Establishment' 'contained in Article 5 of the DTAA, relevant portions whereof are reproduced below:

**5. Permanent establishment:**

**a)** i) For the purposes of the Convention, the term 'permanent establishment' means a fixed place of business through which the business of the enterprise is wholly or partly carried on.

ii) The term 'permanent establishment' includes especially:

a) a place of management

b) a branch.

c) an office

d) a factory

e) a workshop

f) a mine, an oil or gas well, as quarry or any other place of extraction of natural resources

g) a warehouse in relation to a person providing storage facilities for others

h) a premises used as sales outlet

i) an installation or structure used for the exploration of natural resources provided that the activities continue for more than 183 days.

iii) A building site or construction, installation or assembly project constitutes a permanent establishment only where such site or project continues for a period of more than 6 months".

b) The AAR observed that the expression 'permanent' is used only in contradistinction to something fleeting, transitory, temporary or casual. The context in which the expression is used amply makes this clear. The language of paragraph (2) [in particular of clause (i)] and that paragraph (3) of Article 5 also indicates that the duration of the establishment need not be for years and may be of months only the words 'permanent' and 'establishment', when read with the language of paragraph (1) of Article 5, connote the existence of a substantial element of an enduring or permanent nature which can be attributed to a fixed place of business in that country but the issue whether the nexus can be said to be 'substantial' or 'enduring' would depend entirely on the facts and the circumstances of each case.

c) The term' a place of business' covers both premises and other tangible assets used by the enterprise. In the present case, the diving vessels fully equipped with all the equipment necessary to execute the contracts satisfy the definition.

d) The Authority also considered the question whether the ship or vessel will cease to be a fixed place of business because in the course of execution of the contract it may have to move from place to place on the ocean and expressed the view that the expression 'fixed place' envisages the possibility of locating identifying or pointing out to a definite place as the place from which a business carried on and does not import a requirement that the place of business should be stationary and not moving. The diving offshore vessel located and functioning within a defined area can well be described as a fixed place of business from which the applicants are carrying out their business transactions.

e) However, in order to decide whether a foreign enterprise has a permanent establishment or not, all the paragraphs of Article 5 which define the expression have to be read together. The scheme of Article 5 is - paragraph (1) set out a general definition; paragraph (2) gives an inclusive definition; paragraph (3) prescribe a limitation; paragraph (4) outlines a number of exclusions and paragraphs (5) to (7) deal with special cases where the foreign enterprise functions not directly but through some other agency. The AAR confining their attention to paragraphs (1) to (3) noticed that while the general definition and clauses (a) to (h) of paragraph (2) make no reference to any minimum period for which the permanent establishment should be in existence within the State, clause (i) of paragraph (2) make no reference to any minimum period for which the permanent establishment should be in existence within the State, clause (i) of paragraph (2) does. Such a qualification with reference to time is also

found in paragraph (3).

f) The AAR considered Article 5(3) of US Model, OECD Model and UN Model and thereupon observed that a 'construction, installation or assembly project' cannot be treated as a permanent establishment unless it continues for a period of more than 6 months even though it might otherwise fulfill the definition contained in paragraphs (1) and (2) and held that as neither of the contracts under consideration, not even both of them put together, exceed that period in duration, the applicant cannot be said to have had a permanent establishment in India.

g) The AAR accordingly held that the applicant are not taxable in India on the income received by them under the sub-contracts under consideration and thus, disposed of the applications in favour of the applicants.

**Comments:**

This decision is based on the interpretation of DTAA between India and Netherlands. Here also AAR held that there was no PE because combined duration of the works contracts fell short of 183 days period prescribed in Article-5 of DTAA between India and Netherlands.

ii) Whether in computing the profits attributable to the Permanent Establishment of the applicant which is tax resident of the Netherlands, can recourse be had to the provisions of Section 115JA ?

3. **Applicant's submissions**

- The provisions of Section 115JA cannot be applied to a foreign company similar to the applicant who is having its headquarters in the Netherlands. The control and management over the Indian business of the applicant are exercised from there.
- All its financial records and books of account are maintained in the Netherlands. However, to comply with various statutory requirements, the applicant prepares and maintains its accounts relating to the Indian projects at its project office.
- For income-tax purposes, the applicant prepares its financial statements in the form of Statement of Assets and Liabilities and Statement of Revenue and Expenses.
- However, for the purposes of filing the financial statements with the Exchange Control Authorities and the Registrar of Companies, the applicant prepares its accounts in accordance with Parts II & III of Schedule VI to the Companies Act, only in respect of the income and expenditure incurred out of Bank Accounts in India. Expenditure incurred by the Head Office is not included.
- In the Financial Statements filed with the Register of Companies, the applicant claims depreciation allowance at the rates provided in the Companies Act.
- The applicant argued that if the wordings of Section 115JA are closely examined, it will be found that the provisions of the Section are not strictly applicable to a foreign company carrying on business in India.
- Section 210 of the Companies Act does not apply to a foreign

company (like the applicant). Further, the applicant is not required to hold Annual General Meeting u/s 166 of the Companies Act.

- In short, the applicant argued that the fact that there are so many integral and important provisions of Section 115JA which cannot apply to a foreign company and it would go to show that the foreign company is not covered by the provisions of Section 115JA.

4. **Authority's observations and rulings:**

The Authority (AAR) answered both the questions in the affirmative and against the applicant. The AAR observed and ruled as follows:

- AAR referred to the Finance Minister's Budget Speech and the Memorandum explaining the provisions of the Finance Bill to ascertain the purpose of introduction of Section 115JA viz. to tax zero-tax companies. Referring to large number of decisions cited by the applicant relating to well-known rules of construction of a taxing statute, AAR stated:

"What is important to bear in mind is the object of introduction of Section *115JA*. ..... There is no reason to confine this Section to Indian Companies alone. If a foreign company is avoiding tax lawfully by similar devices, this Section will be applicable also to such companies. This' Section has been made applicable to companies generally and not to Indian companies or domestic companies only".

- Relying on the case of Commissioner of Inland Revenue V. Rossminister Ltd., 52 TC 160,209 wherein it was observed "however, the *Court* may deprecate an Act, it must apply it. It cannot by torturing its language or by any other means construe it so as to give a meaning which the Parliament did not clearly intend it to bear", AAR held that when Section *115JA* speaks of a company, there is -no reason to restrict the meaning of a company to a domestic company.

- Applicability of Section *115JA* will not depend on whether a

company, Indian or foreign, has been given depreciation allowance or not, nor will non-payment of dividend make any difference. It is not necessary that each and every provision for calculation of book profit as given in the Explanation to Section *115JA* must apply. Some of the provisions may not apply even to an Indian Company. Book Profit will have to be calculated by adding back all or any of the amounts referred to in Clauses (a) to (f) provided that such amounts were deducted from the Profit & Loss Account.

- It may be that some of the provisions of Section *115JA* will not apply in toto to a foreign company but that is not the reason why the foreign company will be exempted altogether from the purview of Section *115JA.*

- There are many provisions in the Act specially applicable to foreign companies only e.g. Section 44B (special provision for computing profits and gains of shipping business in the case of non-residents), Section 44BB (Special provision for computing profits and gains in connection with business of exploration etc., of mineral oils), Section 44BBA (special provision for computing profits and gains of the business of operation of aircraft in the case of non-residents) Section 44BBB (special provision for computing profits and gains fa foreign companies engaged in the business of civil construction, etc., in certain turnkey power projects). Section 44C (deduction of head office expenses in the case of non-residents), Section 44D (special provision for computing income byway of royalties, etc. in the case of foreign companies). There are also special exemptions available to a foreign company u/s 10(6A) and u/s 10(6B). Section 115A contains special provisions for tax on dividend, interest, royalty and technical service fees in the case of foreign companies.

Similarly, there are many provisions which apply to Indian companies and domestic companies only, e.g. S - 80HHB, S - 80HHC, S - 80HHD, S - 80

HHE, S - 80M, S - 80-0, S - 115-0 to S - 115-Q containing special provisions relating to tax on distributed profits of domestic companies.

There is no indication in Section 115JA that its application should be confined to domestic companies or Indian companies only. The only inference that can be drawn from the absence of any words of limitation is that the provisions of Section 115JA will apply to any company which comes within the definition of a company as provided by Clause (17) of Section 2. There is no reason to presume that the legislature did not intend the provisions of Section 115JA to apply to an assessee which is a foreign company.

- AAR referred to provisions of Section 594 of the Companies Act providing for preparation and submission of the Balance Sheet and Profit & Loss Account by a foreign company, notifications issued by the Government of India and the commentary on the same in 'Guide to the Companies Act' by A. Ramaiyya, 12th edition and held that it did not see any difficulty why the profit or loss made by a foreign company in its Indian business cannot be found out or determined by the Assessing Officer in India.

- With regard to the second provision posed before it, AAR referred to Article 7 (Business Profit) of DTAA between India and the Netherlands and held that under Article 7 :

"the applicant company is liable to be taxed on so much of its business profits as is attributable to its Permanent Establishment in India. If that be so, whatever tax has to be paid by any other company in India has to be paid by any other company in India has to be paid by the applicant company. The effect of Article 7 is to limit the quantum of the taxable income of the applicant company but it does not absolve the applicant company form paying any tax which is payable by a resident company the

well settled principle is that once the charge is clearly established, the machinery sections should be construed in a way to effectuate the charge and not to nullify the charge".

- AAR further held that the Profit & Loss Account of the Indian business has to be prepared separately by the foreign company as required by Section 594 of the Companies Act. Therefore, there should not be any difficulty in calculating the book profit and tax payable u/s 115JA. Moreover, it is well settled that an inconvenient is not a ground for not applying a taxing provision.

It may be noted that the AAR has reiterated its view in the unreported Ruling in the case of Niko Resources Ltd., Canada in AAR No.391 of 1997.

**Comments:**

It has already been noted in Chapter-IV (supra) on Interpretation of DTAAs that in India the DTAAs prevail over domestic law. This is a rare case where apparently stringent charging section 115JA, levying Minimum Alternate Tax (MAT, for short) has been made applicable by AAR on this Netherlands' company. For this purpose the AAR also drew strength from section 594 of the Companies Act which obliges foreign companies to prepare profit and loss account of the Indian business in terms of that section.

## 8.2 NIKO RESOURCES LIMITED V. COMMISSIONER OF INCOME TAX (43)

**1. Facts:**

The applicant company is a foreign company incorporated in Alberta, Canada. It is engaged in the business of exploration and development of oil and gas fields.

1.1 It has entered into a collaboration agreement with Gujarat State Petrochemical Corporation Ltd.

1.2.1. Thereafter both have jointly entered into a contract with the Central Government, for exploration and development of oil and gas fields at various place .

1.2.2. The applicant contends that its activities come within the scope of Section 42 of the Act. Hence Section 115JA cannot be made applicable to the applicant.

**2. Issues:**

2.1 Whether the applicant is entitled to special benefits allowed under specific Section 42 of the Income Tax Act, 1961 (regarding the special provisions for deduction in case of business of prospecting, etc., of mineral oil), before calculating the book profit as per Section 115JA ?

**3. Submission by the applicant:**

3.1.1. Section 42 contains special provisions for deduction from total income in case of business of prospecting of mineral oil.

3.1.2. Mineral oil is defined under the said section to include petroleum and natural gas.

shall be calculated on the same method and rates which have been adopted for calculating the depreciation for the purpose of preparing the profit and loss account laid before the company at its annual general meeting in accordance with the provisions of Section 210 of the Companies Act, 1956 (1 of 1956) :

Provided further that where a company has adopted or adopts the financial year under the Companies Act, 1956 (1 of 1956), which is different from the previous year under the Act, the method and rates for calculation of depreciation shall correspond to the method and rates which have been adopted for calculating the depreciation for such financial year or part of such financial year falling within the relevant previous year.

4.2.1. In order to compute the total income of the assessee for any particular assessment year, it is necessary to classify and assess income under each appropriate head. If an assessee is engaged in the business of prospecting for or extraction or production of mineral oil, his income will be assessed under the business head. If he fulfils the conditions laid down in that section, he will get the benefit of Section 42 in the computation of his business income. But this is only a step in the computation of total income. In the process of computation of total income, if any relief has been given to an assessee under any other section that too will have to be allowed. Section 42, however, cannot override Section 115JA which introduces a legal fiction by which thirty per cent of the book profit of an assessee is deemed to be his total income. Section 115JA does not seek to levy tax on the business income on an assessee, but on his total income.

Section 42 will be applicable only when computation of profit and loss of the business of prospecting for or extraction or production of mineral oil is taken up.

4.2.2. Section 293A has nothing to do with computation of total income. It

lays down that the Central government may by notifications grant exemption or reduction in rate of tax or other modifications in respect of income tax in favour of certain classes of assesses.

4.2.3. The two Notifications dated 31-3-1983 and 6-7-1987, cited by the Applicant refer to the rates of tax payable by foreign companies under certain circumstances are not relevant to the present facts.

4.2.4. Section 115JA stands on an independent footing. It provides a rough and ready formula for payment of minimum amount of tax payable by the assessee on the basis of its book profits if its total income as computed under relevant section is less than 30% of book profits. This is a legal fiction.

4.2.5. The Section 115JA applies "notwithstanding any thing contained in any other provisions of the Act".

5. **Decision:**

5.1 The applicant cannot claim any special benefit under Section 42 in calculation of its book profit by resorting to Section 115JA.

5.2 Section 42 of the Act cannot override the provisions of Section 115JA.

5.3 The provisions of Section 115JA applies to the applicant company.

**Comments:**

In this case also the AAR virtually allowed Treaty Override by holding that the domestic law would prevail over the DTAA between India and Canada, mainly because the DTAA is silent in this regard.

## CHAPTER-IX

## CASE STUDIES ON BUSINESS PROFITS

### 9.1. P-6 OF 1995 (44)

1. **Facts:**

Z - The applicant company, incorporated in the U.K. entered into three agreements with X (an oil company in India) for rendering consultancy services for gas flaring reduction project.

The applicant company did not have 'PE' in India and none of the services provided by it to X were utilised in India. The work allotted to the applicant was carried out in England using its own staff and consultants, who were subject to tax in the U.K. On this basis it was contended that the provisions of Section 9(I)(vii)(b) did not apply to it and no tax should be levied in regard to contract with X. This was so stated in the application to the AAR.

The applicant had entered into three separate agreements with 'X' on the following dates in respect of the assignments stated against them.

| S.*No.* | *Date* | *Assignment* |
|---|---|---|
| Agreement-I | 23-1-93 | Agreement for in-depth reservoir Management Study of the Offshore field on behalf of X and included. |

a) reservoir simulation studies,

b) history matching, Reservoir performance Production and Reservoir Management,

c) review of 'X' Plans,

d) independent assessment of recoverable reserves by generating reservoir simulation models and carrying out well wise history

matching and provide future production for profit etc.,

e) assessment and recommendations for Oil Zones and Wells,

f) recommendations regarding reservoir management system, and

g) making development work programme for three reservoirs of offshore oil field.

Work to be done by applicant at his home office comprised.

a) Simulation studies,

b) Barometric estimates,

c) Fair cost of future oil and gas production profile,

d) Evaluation of reservoir performance, etc.,

e) Submit comprehensive reports to 'X' covering cost of these aspects, and

f) Handover the data generated during the study to 'X' on Computer Media.

The study was to be completed in 4 months and was to be reviewed in three stages. The first review to be completed in India, Second review meeting in applicant's home office and the third review meeting in India. Out of Lump sum cost for the work in terms of U.S. $ 1% was to be paid in Indian currency. Taxes were to be borne by the applicant but the cost of work in association with officers of the applicant namely air fare, lodging, & boarding were to be borne by X.

| S.*No.* | *Date* | *Assignment* |
|---|---|---|
| Agreement II | 1-5-1994 | a)review of Hydro Carbon reserves, analysis and review of data, maps, reserves, etc. This agreement was only to regularise the work already completed. (Agreement - I) Payment in US $ was to be made in four installments. Tax & duties borne by the applicant. The work relating to the review of oil fields under the contract was to be done in India, payment partly in US $ and partly in Indian Rupees. The |

Third (III) Agreement was drawn in June 1994, to assist and advise X on methodology of evaluation of the tenders, giving commercial and legal advice in evaluation and accepting tenders by X. This work done in India with consultation with officers of X. Package U.S. $ + cost of airfare and accommodation to be provided by X. Copy of the Application to the AAR, was sent to the concerned Commissioner of Income Tax for his views on the Application. It was pointed out by him that 'X' had rightly deducted tax @ 30% of gross amount as provided u/s. 115A r/w section 44D. The payments were for royalties and technical fees within the meaning of Section 9(1)(vi) & (vii) and covered by Section 115A read with Section 44D of the Act.

4. **Issues and questions raised before the authority:**

1. Whether on the facts and circumstances of the case any part of the consideration receivable under the Agreements (I, II, III) entered into between the applicant and 'X' (an Indian oil company) is chargeable to tax under the Income Tax Act, 1961?

2. If any part of income is taxable at what rate it would be taxable?

**5. Issues considered and the process of arriving at the decision Tax leviable at best at 10% of payment to Non Resident (Section 44BB)**

5.2.1. Applicant's contention was that it was engaged in the business of rendering services outside India in connection with the prospecting of mineral oil and its case was covered by section 44BB. Hence, neither Section 9(1)(vi) or (vii) nor Sections 42, *44p,* 115A and 293A would apply. Therefore at best the income of the applicant would be assessed at 10% of the gross payment to Non Resident on deemed basis and the effective tax at 10% on such income was to be applied which at usual rate of 55% would be 5.5.% of the gross payment to the N.R. applicant.

Moreover, at the time of payment of first instalment, of the consideration under the agreement of December 1993 the rate of tax on the foreign company was 65 per cent and the tax was deducted by 'X' at 6.5 per cent of the gross payment of the basis of Section 44BB. But now the rate at which tax deducted by 'X' was at 30% of the gross payment and the same rate of deduction was proposed to be continued in respect of all future payments under the Agreements. Thus the counsel for the applicant contended was erroneous.

**No tax leviable**

5.1 The applicant had stated in his application that the company, was based in U.K. having no branch office or local presence (i.e. P.E.) in India, and none of the services provided by the applicant to X had been utilised in India (so far). All work was carried out in England, using the applicant's own staff and consultants. Both the company and its staff were subject to U.K. tax. As a result the provisions of Section 9(1)(vii)(b) of the Act did not apply. Therefore, no tax should be levied on the applicant with regard to its contract with X. The applicant contended that the payment made to the applicant falls in the same set of exceptions provided in sub-clause (b) of clause (vii) of Section 9(1) of the Act. Moreover, Explanation (2) to clause (vii) also excludes such payment from taxation as fees for technical services which reads under:

*"Explanation* 2 - For the purposes of this clause, 'fees for technical services' means any; consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but 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'".

5.2.2. The counsel pointed out that the case of this applicant does not fall within the proviso to sub-section (1) of Section 44BB, because, none of the Sections 42 or 44D or 115A or 293A apply because, in this case the Central Government has not entered into an agreement and that agreement has not been laid on the table of the Parliament. Section 44D would not apply because payment would not be covered by the terms "royalty and fees for technical services". Section 115A would not apply as it is dependent on Section 44D and Section 293A did not apply because no notification was issued by the Central Govt. covering the class of persons specified in sub-section (2) of that section.

5.2.3. Under the circumstances at best the provisions of section 44BB would apply considering only 10 percent of payment to non resident as deemed income .In this connection the decision in the matter of Dy.CIT v. Schlumberger Seaco Inc.[1994} 50 ITD 348, (SSI for short) was cited. In that case 'SSI' had also provided personnel to wire logging equipment (conducting wire line services/ wire logging) used in extraction of mineral oil. Since the services of the applicant were also in the business of rendering technical services in the area of mining of mineral oils to be undertaken by X the consideration received for this business is taxable only under section 44BB as it is not excluded from the operation of the proviso to that section, which reads as under "Provided that this sub-section shall not apply in a case where the provisions of section 42 or section 44D or Section 115A or section 293A apply for the purpose of computing profits or gains or any other income referred to in those sections"

### 5.3. Payment taxable as "Business Profits" under Article 7

The counsel also submitted that the applicant can claim the benefit of

DTAA with U.K. by virtue of the provisions of sub-section {2} of section 90 of the Act. As the applicant did not have a permanent establishment {PE} in India {Article 5}, 'Business Profits' embedded in the payments made by X would not be taxable in India under Article 7 of the DTAA, in the absence of PE in India. Even assuming the business profits are taxed, it would be after deducting the expenses incurred for the business including general executive and administration expenses. The incidence of tax would be much lower than the deemed rate of 30 percent on gross payment as provided under section 115A read with section 44D.

5.4. **Article on Non Discrimination (ART - 26) to apply:**

5.4.1. The counsel took up Article on Non Discrimination and cited the decision in the case of Standard Chartered Bank v IAC (1991) 39 ITD 57. The Hon. Tribunal had allowed deduction under section 36(1)(viia) of the Act read with article 23 of the earlier DTAA between UK and India. The bank was a national of UK but incorporated in India, therefore it could not be subjected to a higher burden of tax than a scheduled commercial bank in India by virtue of Article 23 of DTAA. On this basis it was argued that the applicant should not be subjected to a higher burden of tax than a national in India. According to the counsel if section 44BB was not applicable to the applicant, it would mean discrimination within the meaning of article 26 of the present DTAA between India and UK.

**5.5. Alternatively, the Provisions of DTAA to be applicable**

The counsel reiterated that the payment made by 'X' to the applicant was not covered by the definition of royalties and fees for technical services under article 13 of the DTAA because it was not a payment for use of any copyright, etc, or use of any industrial, commercial or scientific equipment. The payment could have been classified under paragraph 4(c} of article 13

if it had not been the business of the applicant to render services for imparting technical knowledge, experience, knowhow, etc. He however argued that even if the payment was to be covered by article 13, the DTAA would override the provisions of the Act, especially section 44D read with section 115A, and in that case the tax would only be 20 percent for fees for technical services and not at 30 percent as claimed by the department.

5.4.2. The counsel also relied upon paragraph (1) of the article 26 of the DTAA which provides non-discrimination between the nationals of the two Contracting States in respect of taxation or any requirement connected therewith which is more burdensome than the taxation and connected requirements to which the nationals of the other State in the same circumstances may be subjected. If the applicant was subjected to taxation at the rate of 30 percent under the Act or 20 per cent under the DTAA on the gross payments it would amount to discrimination between the applicant and a similarly placed national of India providing such services, as the latter would be taxed after deduction of expenses incurred for the business on net income at normal rate of tax, which would be much lower than the deemed rate of 30 percent or 20 percent on the gross payment. The applicant should be given the option of being taxed under subsection (2) of section 90 at the normal rate after allowing the eligible expenses incurred for the business.

## 6. Submissions of the departmental representative (DR) are Summarised below:

### 6.1 Agreements Analysed:

Applicant had rendered technical services to "X" which included {a}survey of 23 areas in India demarcated by "X" for estimation of reserves and generation of production profiles after collecting essential data in close

collaboration with "X".(b} preparation of simulation studies and a comprehensive report on the forecast of oil and gas production upto the year 2015 and hand over data so generated to X on computer media.(c) assistance and advice to "X" on methodology of tenders invited on the basis of the report prepared by the applicant and suitable modification of the model contract including commercial and legal aspects.

6.2.1. Justification for application of Section 9(1)(vii) r/w 44D and 115A :

Though three separate agreements have been entered into between the applicant and "X" these were closely connected and inter-dependent agreements for rendering technical services to "X" for a consideration which was clearly "fees for technical services" received from "X" an Indian concern in pursuance of an agreement and therefore the payment is fully covered by the provisions of section 44D. Hence, the case of the applicant falls under the proviso to section 44BB which excludes the applicant from the operation of that section. The attempt by the counsel to make a fine distinction between "fees for technical services" and "income from business of providing technical services" is not helpful because section 44D is a special, provision for computing income from royalties and fees for technical services in the case of foreign companies by excluding sections 28 to 44C of the Act. This means that but for these special provisions fees for technical services would have been assessable under the head "income from business or profession"

6.2.2. It was further submitted that the applicant's case was fully covered by section 9{1}{vii} because the applicant was receiving income by way of fees for technical services payable by "X", a resident person, in respect of services utilised by "X" in India. He refuted the contention of the counsel that the case of the applicant was covered by the Explanation {2) to section 9{1}{vii}. As a result the rate of 30 percent provided under section 115A

would be applicable to the applicant.

6.3. **On Provisions of DTAA overriding the Provisions of Act**

As regards the provisions of the DTAA overriding the provisions of the Act the DR concurred. However, even under the DTAA, he urged that article 13 would be applicable to the payments received as fees for technical services and that the learned counsel was not correct in arguing that the case of the applicant would be covered under article 7. {business profits} It was urged that the provisions of article 13 are special provisions for taxation of royalties and fees for technical services, therefore, if an income is covered by these special provisions, there is no question of considering the applicability of article 7 meant for assessing business profits of an enterprise through a PE. The applicant does not have a PE in India, therefore article 7 would not be applicable even otherwise. The attention to paragraph 4{c} of article 13 was drawn which reads as under

"{ 4} For the purpose of paragraph {2} of this article, and subject to paragraph {5} of this Article, "fees for technical services" means payment of any kind to any person in consideration for the rendering of any technical or consultancy services (including the provision of services of technical or other personnel) which:

{a} .....or

{b} .....or

{c} makes available technical knowledge, experience, skill. know-how or processes or consist of the development and transfer of a technical plan or technical design"....

6.3.2. Therefore, the case of the applicant was fully covered by sub-para (c) because he has made available technical knowledge, experience, skill and know-how which is also to be transferred to 'X' on computer media in terms of the agreement. Therefore, the payment received by the applicant is

liable to be taxed at the rate of 20 per cent of the gross amount under paragraph 2(a)(I)(bb) of article 13 for the first 5 years for which the DTAA has effect.

6.4. **On applicability of article on Non Discrimination**

6.4.1. As regards the non-discrimination clause of the DTAA, the 'DR' pointed out that paragraph (2) of article 26 was not applicable because the applicant did not have a P.E. in India. As regards paragraph (1), he submitted that nondiscrimination was to be judged by comparing two classes of persons similarly placed and not two individuals or two companies. Under the Indian Income Tax Act, income of every person arising in India is to be taxed under the procedures and rates provided under the Act. But for the DTAA, the applicant would also have been subjected to tax under the Act, but it had claimed privilege under section 90(2) and wants to be assessed in accordance with the DTAA. Article 13 of DTAA provides a rate of only 20 per cent of the total payment as against the rate of 30 per cent leviable for similar payments covered under section 44D, read with section 115A. Thus, discrimination, if any, is in favour of the applicant by virtue of the provisions of DTAA.

6.4.2. As regards the claim of the applicant that his income should be assessed under section *44BB,* the 'DR' submitted that section *44BB* does provide a lower rate but by virtue of the proviso to that section, the case of the applicant is not covered at all under section *44BB.* Hence, that section cannot be applied artificially in violation of the proviso to the section. He further submitted that even if the income of the applicant is to be assessed as business income by applying the provisions of sections 28 to 44C, the net profit may perhaps work out to 80 per cent (because all expenses in India have been borne by 'X') which would be taxable at the rate of 46% (including surcharge) in the case of a domestic company which means an

average tax rate of 36.8 per cent on the gross payments which is 16.8 per cent higher than the rate applicable to the applicant by virtue of the provisions of article 13. Even if the net profit is assumed at 45 per cent of the payments, the average tax payable by a domestic company would be 20.7 per cent on such payments. On this ground also, he argued that there was no discrimination.

### 6.5 Why income accrued or arose in India :

A perusal of the facts stated in para 2 of this order would make it clear that the main contract was regarding identification of the oil reservoir which was dependent upon a thorough survey on Onshore and Offshore areas in India. Therefore, the main contract of December 1993, which also covers the major payment received by the applicant, was carried out in India. The work relating to the second agreement was partly in India and partly in U.K. The work relating to the third agreement was also mainly performed in India. Therefore, the source of income arising to the applicant as a result of these three interrelated contracts was in India. On this basis, the 'DR' urged that all these three agreements should be treated as one and the income arising to the applicant out of these agreements should be taxed in India.

7. 7.1. **Views of the AAR**

Based on the submissions of the counsel for the applicant as well as the 'DR'

the AAR was of the following views.

**Application of section 9(1)(vii) r/w section 44D, 115A**

According to explanation 2 to section 9(1)(vii) 'Fees for technical services' means any consideration for the rendering of any technical or consultancy services, etc. The explanation does not have any scope for making a

distinction between 'fees for technical services' and 'income from business of providing technical services', insofar as the taxability under sections 44D is concerned. If special provision like section *44BB* and 44D had not been included in the Act, such rendering of technical services would have been taxable only as business income under the provisions of sections 28 to 44C.

7.2. There is, wide range of income falling under section *44BB* which will not fall within section 44D. The exclusion of royalty and fees for technical services from the scope of section *44BB* will not, therefore, render section *44BB* otiose or redundant, as suggested. On the other hand the proviso in section *44BB* will be meaningless if royalty and technical service fees arising out of a business cannot at all fall within the purview of section 44D.

7.3 The entire scheme of the Act, section 9(1)(vi) and (vii), section 44D, section 115A clearly shows that the underlying idea is to give special tax treatment to income by way of royalties and fees by way of technical services of foreign companies in two ways; by prescribing a flat rate lower than the general rate of tax on the other income by taxing the gross amount of receipt of this nature without providing for any deduction therefrom and a mode of taxation evolved after a good deal of thought and discussion between nations where double taxation is involved. The mode of taxation and relief provided in the DTAA, also shows that royalties and fees for technical services are taxed on a basis different from business except where they arise in the course of a business with a permanent establishment in India. Section *44BB* and section 44D have, thus, both to be given effect to and the only way of doing it is by restricting section *44BB* to income that does not fall within the scope of section 44D; it is this that is made clear by the proviso to section 44BB(1) which specifically excludes any profits and gains of business or other falling under section 44D from the purview of

section 44BB.

7.4. **Why the decision in the case of SSI does not apply?**

The decision in the case of SSI cited by the counsel does not apply to the present case, because, SSI had conducted wire-logging services to 'X' with the help of wire-logging equipments and tools and had also provided personnel to operate the same. The income of SSI consisted of a monthly rental charges for the equipments and tools and monthly charges for the crew. Since the payments there did not, thus, fall within Explanation 2 to section 9(1)(vii), section 44D had no application and the provision of section 44BB were, consequently, attracted.

7.5.1 **Correct Mode of taxing income of the Applicant:**

By virtue of the proviso to section 44BB, the case of the applicant gets covered by provisions of section 44D and section 115A. However, since fees for technical services are covered under article 13 and the rate of tax prescribed in the DTAA is 20 per cent as against 30 per cent prescribed under section 115A, the applicant is entitled to the option available to him under sub-section (2) of section 90 as the provisions of the DTAA between India and UK are beneficial to it.

7.5.2. **Special provisions taking precedence over general provisions:**

Applicant's case is not covered by article 7 because that article is applicable only in the case of profits of an enterprise which carries on business through a P.E. in India. In the present case, article 13 makes special provision for taxation of royalties and fees for technical services. It is an accepted norm in interpretation of DTAA as indeed of all documents, that special provisions take precedence over general provisions like that of article 7 unless specifically excluded and therefore, the payments received are taxable in accordance with article 13.

7.6. **Non Discrimination - why there is no discrimination:**

7.6.1. The object of article 26 is to ensure that no discrimination enures as between nationals of two countries which have entered into a DTAA. The case of the Standard Chartered Bank, cited by the counsel has no application, as the facts of that case were different. In that case, Indian branch of the bank was a P.E. in India, within the meaning of article 5 of the DTAA and this brought into operation, para 2 of article 26. The question whether the bank was a national which could avail of the benefit of para 1 of article 26, was not very material. As the applicant does not have a PE, in this case, the provisions of para 2, would not be applicable, and the applicant has to restrict to para 1 of article 26.

7.6.2. Para 1 of article 26, provides for non discrimination between nationals of two contracting states. Question is whether the applicant can be called a 'national', though reference to it is made in paragraphs 2(c) and 2(d) of article 4 dealing with fiscal domicile and these relate only to individuals.

7.6.3 The applicant is a company incorporated in the U.K. It would be a person resident in the UK and its business would be an enterprise of the UK carried on by a resident of the UK. Such a person can invoke article 26 only if it has a PE in India. But, as stated earlier, since the applicant does not have a PE in India, it cannot claim to come under paragraph 2 of article 26 which is the only relevant provision against non-discrimination for a 'person', who is not an individual.

7.6.4. Argument that there is discrimination under the Act, against the applicant, because of nationality, u/s 44D or 115A is not correct. The system of taxation in India does not make a distinction between nationalities of tax payers. Both foreign national as well as Indian nationals are taxed on the basis of their residence under the Act. Even it the applicant had been a company formed by Indian nationals and registered outside

India, the provisions of section 44D and 115A(2) would operate in the same manner. Even on this count, there is no discrimination under paragraph 1 of article 26.

7.6.5. Even the applicant's charge of discrimination that the applicant has been taxed at 30 per cent under section 44D and 115A, as applicable to foreign national, or at 20 per cent, as provided under DTAA, are not 'correct. In fact applicant has been taxed at lower rate, compared to the normal rate of tax of 55% on net income. In resect of royalties, it is difficult to predict the proportion of deductible expenses. In reality, it could form a very negligible amount to substantial amounts. While dealing with DTAA, there is allegation, at least in some cases where technology is supplied by developed countries, that the expenditure they have incurred for acquiring technology already stands recouped. Though this may not be true in all cases, the percentage of deduction could vary from person to person. The margin of profit in the area of 'oil exploration' could be very high. If it is 80 per cent of total receipts the effective rate of tax would be 36.8 per cent if taxed at 46% (the present rate) much higher than 20 per cent applied to the applicant,. Even if the net profit is assumed at 45 per cent, the effective rate of tax would still be 20.7 per cent (more than 20%). Hence, it could not be said there is discrimination per se against non national.

7.6.6 Thus, there is no discrimination against the applicant with regard to taxation of the fees for technical services received from 'X', if the same is taxed under article 13. In fact, in the circumstances of this case, only article 13 is applicable and no other provision of the DTAA can be invoked.

**8. Ruling of the AAR**

1. On the facts and in the circumstances of the case, the consideration receivable under the agreements entered into between the applicant

India, the provisions of section 44D and 115A(2) would operate in the same manner. Even on this count, there is no discrimination under paragraph 1 of article 26.

7.6.5. Even the applicant's charge of discrimination that the applicant has been taxed at 30 per cent under section 44D and 115A, as applicable to foreign national, or at 20 per cent, as provided under DTAA, are not 'correct. In fact applicant has been taxed at lower rate, compared to the normal rate of tax of 55% on net income. In resect of royalties, it is difficult to predict the proportion of deductible expenses. In reality, it could form a very negligible amount to substantial amounts. While dealing with DTAA, there is allegation, at least in some cases where technology is supplied by developed countries, that the expenditure they have incurred for acquiring technology already stands recouped. Though this may not be true in all cases, the percentage of deduction could vary from person to person. The margin of profit in the area of 'oil exploration' could be very high. If it is 80 per cent of total receipts the effective rate of tax would be 36.8 per cent if taxed at 46% (the present rate) much higher than 20 per cent applied to the applicant,. Even if the net profit is assumed at 45 per cent, the effective rate of tax would still be 20.7 per cent (more than 20%). Hence, it could not be said there is discrimination per se against non national.

7.6.6 Thus, there is no discrimination against the applicant with regard to taxation of the fees for technical services received from 'X', if the same is taxed under article 13. In fact, in the circumstances of this case, only article 13 is applicable and no other provision of the DTAA can be invoked.

**8. Ruling of the AAR**

1. On the facts and in the circumstances of the case, the consideration receivable under the agreements entered into between the applicant

and 'X' is chargeable to tax under the Income Tax Act, 1961.

2. The considerations receivable under the aforesaid agreements are taxable as fees for technical services under article 13 of the DTAA with United Kingdom of Great Britain at the rate of twenty percent of the gross amount of such fees for technical services for the assessment years 1994-95 and 1995-96. If the considerations are received in subsequent years as well, then these also would be taxable at the rate of twenty per cent up to the assessment year 1998 - 99.

**Comments:**

This case was a vain attempt by the British Company to claim some advantage under the Article-26 on non-discrimination. AAR ruled against the assessee by holding on facts that there was no discrimination where none existed. This is how very ingenious arguments are invented to indulge in tax avoision. Arguments advanced on behalf of the British Company wherefrom ingenious but devoid of merit. Hence the rejection of the same.

9.2 **AAR NO.353 OF 1997** (45)

**BROWN & ROOT INC v CIT -**

1. **Facts :**

1.1 Mazagaon Dock Ltd. (MDL) (an Indian Company) was awarded contract by ONGC for the installation of sub-sea gas pipeline, offshore India. MDL, in turn sub-contracted part of the installation work to Hyundai Heavy Industries Co. Ltd. (HHI) (a Korean Company). HHI is turn subcontracted part of work subcontracted to it, to Brown & Root Inc (BRI) a Company incorporated in the USA.

1.2. During the accounting year ending on 31-3-1997, (previous year) BRI had entered into a contract with HHI in relation installation of the pipeline, offshore India, by mobilizing 8-point mooring vessel 'Subtec I' and the test support vessel

'Captain BO'. The work was completed in 39 days from the date of commencement ie. From 30-11-96 to 7-1-97.

1.3 The point at issue is whether the revenues earned by the applicant (BRI) from the contract with HHI and performed in India would be liable to tax in India, in view of the DTAA between India and USA.

2. **Issues and the questions raised before the Authority**

Taxability of revenues earned by BRI, (in India) a tax resident of the USA, from its contract with HHI Co. Ltd., a company incorporated and existing under the Laws of the Republic of Korea, [in terms of Article 7 read with Article 5 of the DTAA between India and the USA].

3. **Issues considered and the Process of arriving at the decision**

3.1 **Submissions of the Applicant:**

3.1.1. An agreement for Avoidance of Double Taxation exists between

India and the USA. In its statement containing interpretation of law and facts, it is contended by the applicant that the provisions of DTAA will prevail over those contained in the domestic laws of both the countries, if the provisions of the DTAA are more favourable to the assessee.

3.1.2. In this connection the reliance was placed on the judgement of the Andhra Pradesh High Court in CIT V. Visakhapatnam Port Trust (29) as also on section 90(2) of the Income Tax Act, 1961, inserted by the Finance Act 1991 which reads as under:

"Where the Central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or, as the case may be, 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".

3 .1.3. In view of this the applicant contended that since it is a tax resident of USA, the issue of tax liability should be determined in accordance with the provisions of the DTAA.

3.2. The applicant submits that the work was mainly carried out at various depths of sea requiring mobilisation and demobilisation of diving personnel/equipment including the 8-point mooring vessel "Subtec I" and also test support vessel 'Captain BO' which were used by BRI to execute the work under the contract with HHI. Its work being in the nature of work contractor, it does not require to maintain any office or fixed palce of business in, India or any establishment of the nature mentioned in article 5 of the DTAA between India and USA, for performing the contract. As a result the revenue earned by it, under the contract does not fall within the scope of business profit as dealt with in Article 7 of the DTAA.

3.2.1. Under article 7 read with article 5 of DTAA between India and USA, business profit arising to a US tax resident in India are taxable in India,

only if the US tax resident carried on business in India, through a permanent establishment (PE) and to the extent profits are attributable to the permanent establishment of such US resident.

3.3 BRI would have been construed to have a permanent establishment in India as per clause 2(k) of article 5, of DTAA provided its activities in India including those in relation to projects or sites, had continued for a period of more than 120 days in any twelve month period. In the instant case, the total duration of the (only) contract executed by the BRI was of 39 days (From Nov. 30, 1996 to Jan 7, 1997). In view of this, the revenues earned by it, are not taxable in India.

## 4. Contentions of the Department

4.1 BRI executed only a job work, the project being that of MDL and that BRI under subcontract with HHI had preformed only a part of the installation work of the pipe line project of MDL. Therefore BRI is not covered under article 5(2)(k), but under article 5(2)(a) Le., "place of management" and 5(2)(f) Le. "a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources". Under these clauses (a and f) no time limit is prescribed for existence of permanent establishment. Hence BRI has a 'PE' in India.

4.1.1. Moreover, sub-contract was managed and conducted by BRI from vessels 'Subtec 1" and 'Captain BO' at seabed in the Indian territory which would constitute permanent establishment (PE) within the meaning of article 5(2)(a).

4.1.2. Another view put forth by the Department was that the pipeline laid by BRI under the sub-contract was connected with the gas well, and hence the pipeline were a place of extraction of natural resources and constituted PE under article 5(2)(f) of the DTAA.

4.2 Vessels were not used merely for transportation of personnel, but were also used for radio and communication, sending telex and fax etc., and as such were fit to be used as office premises and for the purpose of management of the work, to be covered as PE.

4.2.1. The sub-contract was signed on behalf of the applicant by the applicant's manager (India) who was receiving instructions at the vessels from BRI to function as per their advice. Vessels therefore constituted fixed base (workshop/ office premises) for the purposes of management of their part of the project.

4.2.2. Definition of the term 'site' in article 1.7 of the contract was referred to by the Dept. contending that the applicant had some 'site' from where it could supervise the work, suggesting 'site' as 'PE'.

4.3. BRI may be acting as an agent or in benami capacity and that the real company behind the transaction may be having a PE, thereby revenues could be brought to tax in India, even under DTAA.

4.4 Alternatively it was argued that the case of the applicant could be brought under article 12(3)(b) of the DTAA, namely, "royalties" towards "payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial or scientific equipment" since, according to department it was contract to provide commercial equipment. It being a case covered by article 12(3)(b), where the period or duration of the work was not relevant.

5. **Response of the Applicant**

5.1 The learned counsel clarified that the applicant was not involved in any other work or installation and that without the work entrusted to it (BRI), the installation work would neither be complete nor safe. The work

instant case since article 5(3) and 7 of the DTAA between India and Singapore are pari materia with article 5(2)(k) and article 7 of the DTAA between India and the D.S.A. In that case P-11, [1997] 228 ITR 55, this Authority held as under (page 60).

"From a perusal of the scope of the work carried on by the applicant, it is clear that the applicant was engaged in an installation and assembly project which pertained to the burial of pipelines in the seabed. Such activities are covered by para. 3 of article 5 of the Agreement for Avoidance of Double Taxation and not by clause (f) of para 2 of article 5 as claimed by the Department. But para 3 permits such project to be treated as a permanent establishment only if the duration of the project exceeds 183 days in any fiscal year, which is not the case here. It, therefore, follows that the applicant has no permanent establishment in India within the meaning of article 5 and since article 7 of the DTAA permits the taxation, in the hands of a resident of Singapore, only of the profits attributable to a permanent establishment in India, no part of the profits earned by the applicant from its activities under the contract can be charged to Indian income-tax even though such activities took place within Indian territory and the profits therefrom would have been chargeable to tax in India but for the DTAA."

6. **Observations of the Authority**

6.1 After hearing the submissions of both the applicant and the department, the Authority observed as under:

We do not find much force in the argument of the Department that the activity of installation of the pipeline could be brought under other clauses of the DTAA such as clause (a), (e) or (f) of article 5(2) or under article 12(3)(b) of the DTAA. In our opinion, to hold that installation of the gas pipeline clearly falls within the scope of other clauses such as (a) would militate against the well-established principles that a specific provision will

override a general one and that the assessee/subject is entitled to invoke the provisions of a treaty or statute. Since the activity falls short of 120 days, the applicant could not be said to have a permanent establishment in India. The element of permanence in relation to an establishment, if any, would be attracted under article 5(2)(k) only if the installation project continues for a period of more than 120 days and that condition is not satisfied here. It is not disputed that earnings from the work performed by BRI constitute business profits. However, in the absence of permanent establishment, article 7 of the DTAA would not be attracted. As such, there is no tax liability on BRI for the business profits earned by it. In the circumstances, the ruling of the authority in the Singapore case [1997] 228 ITR 55 (AAR), referred to earlier is equally applicable in the facts of the present case.

In the light of the above discussion, the Authority pronounced the following ruling on the question raised in the application before it.

7. **The Ruling**

The revenue earned by the applicant from the contracts with Hyundai Heavy Industries Co. Ltd., U/san, Korea, and performed offshore India, during the previous year ended on March 31, 1997, will not be liable to tax in India, as it had no permanent establishment in India.

**Comments:**

In this American company escaped liability to tax on its business profits because there was no PE in India with reference to its activities performed offshore India. This is still an arguable issue because under the IT Act as well as DTAAs, territory of India includes the continental shelf and the Exclusive Economic Zone. But the services rendered were of supervisory character. Hence the ruling in favour of the assessee company.

**9.3 P. No. 28 of 1999, In re.** (46)

1. **Facts:**

a) AB is a 50 : 50 Joint Venture Company in India between A (an Indian Co.) and B (an American Car Co.) for manufacture and marketing of cars and automotive components. AB entered into a technical collaboration agreement with a German Company to produce motor vehicles under a technology licence agreement. In addition 'AB' the Joint Venture Company had a project management service contract with XYZ, a subsidiary of B (the said American Co.) XYZ is a specialist organisation to provide management and consulting services to 'B's subsidiaries or affiliates worldwide. XYZ was to provide to AB, managerial services for the establishment, development and operation of its business in the manufacture and sale of cars under the Joint Venture agreement. The entire Joint Venture as well as the management services agreement was approved by the Ministry of Industry.

b) Under the Management Services Agreement XYZ was to provide the said services on cost to cost basis by deputing maximum of five of its executives to 'AB' for up to three years for providing management and technical service to the Joint Venture. XYZ would also train the personnel of the Joint Venture so that the services of the employees of the foreign collaborators would be eventually replaced by Indian personnel.

c) Personnel to be provided by XYZ to AB (JV) are:

a) President and Managing Director - (CEO)

b) Vice President (Marketing)

c) Vice President (Finance)

d) Vice President (Manufacturing & Engineering)

e) Vice President (Supplier Development &Material Management)

In short the key management of AB - would rest with the deputed personnel who would manage AB and train Indian personnel eventually to be replaced by Indian personnel.

d) AB is required to pay to XYZ, fee, equivalent to the annual costs incurred by XYZ on its employees. e.g. Salaries, Provision for home, leave, bonus, retirement, insurance and other fringe benefits and all other incidental expenses. They also include any Indian taxes payable by XYZ in connection with the furnishing of executives' personnel.

e) XYZ is the applicant to the AAR. XYZ submitted invoices to AB for reimbursement of expenses (with out any profit element) for the deputation of personnel under the Agreement.

f) While making payment of invoices to XYZ, AB, deducted 20 percent as with holding tax (TDS) and issued certificate to XYZ to that effect.

g) In terms of Agreement, AB was to withhold the taxes due from XYZ as per the law in India.

The question arises why tax is to be deducted at source when there is no element of profit on invoices raised.

2. **Questions raised before the Authority:**

1. Is any part of the amount invoiced by "XYZ" to "AB" in terms of the management provision agreement liable to tax in India?

2. Is any part of the amount paid on behalf of the employees towards Indian taxes liable to tax in India?

3. Can "XYZ" claim that the amounts invoiced are in the nature of reimbursement of expenses and that, therefore, the question of any amount being taxable does not arise?

4. As "XYZ" has not filed any return of income, can it claim a refund of the taxes withheld by "AB"?

5. Would "XYZ" be entitled to interest in respect of the refund referred to in question (4) above?

6. Is "XYZ" justified in its belief that it is not required to file a return of income, apart from the reason of having to claim a refund of taxes withheld by "AB"?

After discussion and in the course of submission only the first question was pressed.

3. **Submissions before the** AAR :

***Submissions by the Applicant:***

a) There is no income generated in the hands of applicant under the contract because what was received was mere reimbursement.

b) The fees paid to the applicant are not taxable in India under Article 7 of the DTAA between India and the USA because the applicant has no Permanent Establishment (PE) in India but has only a liaison office which does not constitute PE in terms of Article 5(3)(d) of the DTAA.

c) Alternatively, the fees received by the applicant can -be taxed only if they are fees for "included services" within the meaning of Article 12 of the DTAA, which is not so in this case.

***Submission by the Department:***

Service agreement is a part of a package entered into between "AB" and "XYZ" which has to be looked at as whole. The terms of letter- of approval of the Government of India, as well as the recitals in the agreement leave no doubt that the employees were to render technical services. As to the argument based on sub-clause (b) of the proviso, it is said that "XYZ" was rendering services to "AB" by placing the services of its employees at the disposal of "AB" for carrying on its manufacturing business and that clauses 7, 9 and 18(c) of the agreement make it clear beyond all doubt that information, ideas, and technical knowledge were being made available to

"AB" by these employees, bringing the case within the ambit of sub-clause (b) of paragraph 4 of Article 12 of the DTAA between India and the USA (included services).

4. ***Issues considered and the decision of the AAR :***

AAR made a reference to paragraph (6) of Article 12 which reads under "The provisions of paragraphs 1 and 2 - under which the tax of 20 per cent is being sought to be imposed - shall not apply if the beneficial owner of the royalties or fees for included services, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties or fees for included services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties or fees for included services are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (business profits) or article 15 independent personal services, as the case may be, shall apply." In view of this paragraph if fees for included services are paid to "XYZ" in India in the course of its business through a PE in India, they have to be taxed under Article 7 and not Article 12. Even if fees received by "XYZ" from "AB" do not constitute "fees for included services" they have to be charged to tax under Article 7 as the profits attributable to a permanent establishment in India. In other words, in the case of business carried on through a permanent establishment in India, it is Article 7 and not Article 12, that would be operative to bring to tax all receipts, even fees from included services, arising in the course of its business.

A conjoint reading of Article 5(2)(1) and Article 12(6) leads to the following result. If "XYZ" furnishes services to "AB" and those services do not qualify for being treated as "included services", the furnishing of those services within the parameters of sub-clauses (i) and (ii) of clause (1) of

paragraph 5(2) will itself constitute a permanent establishment in India and the profits attributable to these services will be chargeable to tax in India under Article 5. The contention of the applicant that "XYZ" is furnishing no services at all to "AB" is not acceptable. The submission of the applicant that "XYZ" is just like an employment agency and its role comes to end with the nomination of the five personnel referred to in the agreement and that they become full-fledged employees of "AB" is not correct.

The case of Carborundum Co. V. CIT (1977) 108 ITR 335 (SC) is distinguishable both on the facts and in law. The court in that case had to interpret the meaning of the expressions "business connection" in section 9( 1) of the Act and "operations" of the business of a non-resident in that connection. The services rendered by "XYZ" fall squarely within the definition of PE and subject to their being found to be "technical or consultancy" services, of the expression "included services" in the DTAA. "AB" is in need of services, call them managerial or technical or anything else, and it finds that "XYZ" is carrying on a business in the provision of such services to all "B" affiliates. It enters into an agreement with "XYZ" for those services. "XYZ" being a company, can render such services only through human agency and it does so through its own employees. In the case of Carborundum, the foreign company provided the personnel who became the employees of Indian company and were paid by it. In this case "AB" dose not pay any remuneration to the employees. The responsibility of "XYZ" is much more than that of a mere employment agency; it continues to have its nominees on its own pay roll and, though they may be serving "AB" and its board in their day-today work, they continue to be "XYZ" employees and they are paid by "XYZ". The mode of remuneration paid to "XYZ" is also significant. It is paid as remuneration every quarter,

being the remuneration payable to the designated employees. In other words, "XYZ" is being paid for the services rendered by it to "AB" through its employees.

The AAR concludes its findings as under:

"The question whether the services rendered by the five nominees of "XYZ" can be said to be "technical or consultancy services", however, is not free from difficulty. We have only the terms of the management provision agreement to go by. The agreement sets out the duties of these employees which seems to cover (except probably in one case, viz., the vice president of manufacturing engineering) only duties of management of various kinds - overall, sales, finances and purchases. It is true that four out of five of the deputationists are engineers. But these are days in which even engineers have to qualify in management skills. The authority has no information or material on record to indicate that the employees were rendering services of a nature falling beyond the terms of the agreement. In the circumstances, the authority has no option but to conclude that the services of the nominees of "XYZ" are "managerial" and not "technical or consultancy" services within the meaning of Article 12.

In the result, the Authority finds, on the facts available to it, that the services of the five nominees. of "XYZ" are not covered by the expression "included services" in Article 12. The consideration received by "XYZ" for these services is, therefore, assessable not under a Article 12 but as business profits under Article 7 read with Article 5(2)(1) of the DTAA".

**Decision of the AAR**

| | *Question* | *Ruling* |
|---|---|---|
| 1. | Is any part of the amount invoiced by "XYZ" to "AB" in terms of the management provision agreement liable to tax in India? | The amount is assessable as business profit under Article 7 of DTAA |

**Comments:**

In this case business profits were claimed as reimbursement of expenses by the American Company. The AAR held that the amount received by the American company was of the nature of business profits in terms of Article-7 of DTAA between India and USA.

## CHAPTER-X

## CASE STUDIES ON

## RE-CLASSIFICATION OF REMITTANCES

### 10.1 ERICSSON TELEPHONE CORPORATION INDIA AB CASE - Advance ruling No.269 of 1996(47)

**Re.: Rate of tax to be deducted at source on receipts from Indian companies on contracts for introduction of cellular system of telecommunication in India. Article 7,13, of DTAA read with Explanation 2 to clause (vii) of S-9(1), S-44D and S-115A considered.**

**Facts:**

A Swedish company entered into contracts with Indian companies for introduction of Cellular System of Telecommunication in India. The Indian Companies informed the Swedish company that they would withhold 55% as prescribed under the Finance Act 1995 from the gross amount. The Swedish company contends that its net profit from Indian operations would not exceed 10% of the gross receipts. Therefore, tax deduction should not exceed 5.5% of the gross payments made to it.

One of the Indian companies with whom the Swedish company had entered into a contract has filed an application under section 195(2) of the Income Tax Act before the Deputy Commissioner of Income Tax seeking determination of the rate of tax to be deducted at source.

**The question raised before the Authority**

"Whether the tax withholding by the Indian companies on amounts payable to the foreign company should be at the rate of 55% as provided under the First Schedule, Part II(2)(b)(ix) of the Finance Act, 1995, or at the estimated net profits from the local operations of the foreign company. This is in view of the fact that the foreign' company estimates that the net profits from the Indian operations will not be more than 10% of the amount received on installation of cellular systems from the Indian companies".

**Issues considered and the process of arriving at the decision**

1. One of the Indian companies with whom the applicant had entered into contract had filed the application before the Deputy Commissioner of Income Tax regarding rate of deduction at source. The Authority considered the question whether it was bound to reject the application under section 245Q because the application was already pending in the applicant's case before the Income Tax Authority, Tribunal or any Court. The Authority held that in the present case the Indian company had raised the question not on behalf of the applicant but only to safeguard its own interest regarding its duty to deduct tax at source on payments made to Swedish company (Non resident). However, in the case of the applicant no question is pending before any Income Tax Authority; therefore it would not be proper to reject the application relying on clause (a) of the proviso to sub section (2) of section 245R.
2. a) Prima facie, the nature of the payments fell within the ambit of clause (vii), paragraph 2(b) of Part II of the First Schedule to the Finance Act 1995.

b) The applicant was receiving fees for technical services which related to a matter included in the industrial policy for the time being in force of the Government of India. In the present case, the agreements have not been approved by the Government of India but relate to a matter included in the 1991 Industrial Policy of the Government of India viz. item (V) under the head "Electrical Equipments in Annexure III". Prima facie, tax deduction has to be effected @ 30% of payments made.

c) The contentions posed on behalf of the applicant and the response of the AAR thereto.

i) Payments made to the applicant were in the nature of "fees for technical services" and were governed by Article 13 of the DTAA between India and Sweden and that they ought to be taxed @ 20% of gross amount of royalties and fees for technical services, as the Swedish company was the beneficial owner of such payments.

ii) The receipts in question in the present case arise to the company in the course of a business carried on by it as it has a permanent establishment in India. Hence, such payments would be governed by Article 7 of the DTAA, and only so much of the profits as are attributable to the P.E. would be taxable.

Under the circumstances, only the profits are to be arrived at after allowing all deductions which worked out to only 2.3% of receipts based on the unaudited accounts for year ended 31-12-95 ought to be taxed. It was therefore submitted that, even making a very liberal estimate that profits be estimated @ 10% of receipts and tax be deducted @ 5.5% of gross receipts as specified in paragraph 2(IX) of the First Schedule to the Finance Act, 1995.

iii) To the above contention, the AAR observed that, if this contention was accepted, under para 3 of Article 7 of the Treaty, the expenses allowable would be subject to the provisions of the domestic tax law (Indian). In that case, special provisions of section 44D of the Act would automatically apply while computing income by way of royalties etc. in the case of foreign companies. This would be so because it would not be merely a contract for assembly of the hardware but involved installation of new system requiring high degree of technical skill and experience. As a result, the above contract would not fit into Explanation 2 to clause (vii) of section 9(1) of the Income Tax Act and hence would not entitle the foreign company to deduct any expenses under the provisions of sections 28 to 44C as contracts were entered into after 31-3-1976 and it is also hit by section 44D. Hence, all receipts of foreign company would be liable to tax @ 55% of the gross fees received.

iv) However, the AAR proceeded observing that there is a silver lining. The Act itself provides for special relief in respect of foreign companies u/s 115A and proceeds on the same lines as paragraph 2(b)(vii) of Part II of First Schedule to the Finance Act 1995 in respect of contracts entered into after 31-3-1976 where fees for technical services are received and which fulfill conditions laid down therein, the tax would be chargeable at 30% on fees for technical services and not at 55%.

v) The attempt to contend that the receipts of the applicant would not constitute fees for technical services within the meaning of Explanation (2) to clause (vii) of section 9(1); was not accepted by the AAR. This was so because as the definition which is also applicable to section 44D and section 115A excludes "consideration

for any construction, assembly, mining or like project undertaken by the recipient". The said contention that the applicant just did the assembly of hardware (Screw driver technology) and software belonging to Indian companies did not find favour with AAR. On facts, AAR held that the installation of new system, would go far beyond merely assembly work, hence would be outside the purview of the Explanation.

vi) The Authority did not express any final opinion on this issue as it felt that the work of the applicant involved something much more beyond the realm of mere assembly of hardware under knocked down condition. It would need a lot of expertise as it was installation of new system and was to be custom built. The word "installation" does not find place in explanation 2 u/s (vii) of 9(1) is also one of the factors noted by the AAR.

vii) The Authority did not entertain the question of "non discrimination" under Article 26 as this was not the question raised before the Authority. The question raised before the Authority was one relating to rate of tax to be deducted on the amount received by the applicant. The applicant was free to raise all the other issues before the Assessing Authority based on factual data.

3. Based on the above facts the AAR gave the following ruling.

**Ruling of the AAR**

The Indian companies shall not withhold tax on amounts payable to the applicant company at the rate of 55 per cent. They should deduct tax only at the rate of 30 per cent being the rate applicable to such payments under paragraph 2(b)(vii) of Part 11 of the First Schedule to the Finance Act, 1995. The Authority does not express any opinion about the net profits of the applicant company

from the local operations and leaves the question open to be agitated by the applicant in appropriate proceedings.

**Comments:**

This is a case where the assessee-company tried to classify its receipts as 'fees for technical services' to be taxed @20% in terms of Article-13 of the DTAA between India and Sweden. As the nature of work executed by the assessee involved installation of new system requiring high degree of technical skill and experience, the AAR held that it was not just fees for technical services. However, the AAR gave the benefit of tax rate at 30% given under the relevant clause in Finance Act, 1995.

## 10.2 HORIZONTAL DRILLING INTERNATIONAL SA. V. CIT (45)

1. **Facts:**

1. The applicant a French Company was awarded a contract by Gas Authority of India Ltd. (GAIL) for installation of gas pipelines in India for a consideration of $ 9,60,000

2. The contract is dated October 25, 1996, but was effective from 15th October 1996 and the work was to be completed by January 14, 1997. However the work on the contract (rig) actually began on Jan. 20, 1997 and installation completed on February 14, 1997.

3. On installation of the rig 10 per cent of the contract amount had to be paid to the applicant.

4. According to the completion certificate of 8th May 1997 the drilling started on Feb. 6, 1997 and the work under the contract was completed on March 4, 1997.

5. The applicant had given a Sub-contract to Larsen & Toubro (L & T) an Indian Company on Oct. 28th 1996 in respect of the works executed, but

assumed full responsibility for the work.

6. The applicant paid L & T a sum of $ 2,10,000-and L & T was responsible for all local support activities, pipelines works and the design, engineering, procurement and installation of the optical fibre cable as per specifications.

2. **Issues and the Questions raised**

Whether the applicant is liable to tax under Income Tax Act, 1961, for the Assessment year 1997 - 98 on title amount received from GAIL on the aforesaid contract dated October 25, 1996, in the absence of any Permanent Establishment in India, in view of Article 5 and 7 of the Double Taxation Avoidance Agreement between India and France?

3. **Issues considered and the process of arriving at the decision**

1. Department contended that the nature of payment made by GAIL would fall under Fees for technical services [Article 13(4) of DTAA] meaning "payments of any kind to any person" other than payments to an employee of the person making the payments and to any individual for independent personal services (Article 15).

2 The Authority drew guidance from the terms of paragraph 6 of Article 13 which application of the rule of taxability outlined in paragraph 1 and 2 of the article to cases where the recipient and beneficial owner of the fees in question carries on business in the state in which they arise through a Permanent Establishment situated therein. This provision indicates that where the payment to the non-resident arises out of the latter's business and may have been made, in a loose sense of the term, in lieu of services rendered in the course of business (including services of technical, managerial or consultancy nature) they should be treated as receipts of business, the chargeability of which would fall under article 7 of DTAA and depend on the existence of a Permanent Establishment of the

non-resident in the source country. To such receipts article 7 and not article 13 would apply. The same would be taxed as business profits if the French company has PE in India.

In the instant case the applicant is carrying out a project for the installation of underground pipelines for the GAlL. If this project had lasted beyond six months, the profits arising to the applicant therefrom would have been chargeable to tax in India by virtue of article 7 as part of business profit. In the present case the project has not lasted that long enough to be considered as its PE in India. Hence, its profits cannot be charged as "business profits" in India.

4. **Ruling**

| *Question* | *Answer* |
|---|---|
| Whether the applicant is liable for tax under the Income Tax Act, 1961, for the Assessment Year 1997-98 on the contract proceeds receivable form. GAIL under the contract agreement dated Oct. 25, 1996, in the absence of any PE in India in view of article 5 and 7 of DTAA between India & France? | NO |

**Comments:**

This is a case where the Income-tax department admitted to tax the receipts as fees for technical services. But the French Company showed the receipts as business profit earned without having a PE because the pipeline project did not last beyond six months and so the French Company escaped taxation in India in terms of DTAA between India and France.

## 10.3 ADVANCE RULING P. NO.22 OF 1996 (48)

**Facts:**

Facts of the case can be easily understood with the help of following diagram.

In the above diagram WOS refers to Wholly Owned Subsidiary.

Original Arrangement

i) A - was the proprietor of trade mark in India

ii) B - acquired property interest in it.

iii) Agreement between Band IC whereby

- IC was given right to use the trade mark in India for the business of refrigerators and other articles.

- IC to make payment of royalties to B.

iv) B - holding 51 % in IC.

New Arrangement

i) An agreement reached between AB and C whereby C purchased all the existing trade marks and trade name licences from 'B' and or 'A' in favour of "IC".

ii) IC was allowed to use trade mark or trade name during the phased out period of 24 months.

iii) B transferred its 51% holding in IC to CM. (a wholly owned subsidiary of C)

iv) C paid to B

a) One time royalty of US $ 52,95,756/

b) US $ 1,05,24,477 towards 20,86,796 Equity shares of IC held by 'B'.

**Question Raised before AAR**

'B' Sought ruling on payment of royalty only and asked following question. "Whether the royalty paid outside India amounting to US $ 52,95,756/- by 'C' to 'B' as a _consideration for granting the licence and

right to 'IC', a company in which 'CM' has 51 per cent equity holding, to use the trade mark in India is liable to Indian tax?"

**Issues considered and the process of arriving at the decision.**

**Applicants' contentions**

i) The payment of royalty in question would be one deemed to accrue or arise in India under article 12(7)(b) of the DTAA, which provides that the royalties paid for the use of, or the right to use, the right or property relate to services performed in India then such royalties shall be deemed to arise in India.

ii) However, definition of royalty under section 9(1)(vi)(c) of the Income Tax Act, 1961 is more beneficial to the applicant and since the type of royalty in question do not fall in that definition it would be exempt from tax. (Applicant wanted to invoke provisions of section 90(2)). Section 9(1)(vi)(c), according to the applicant, would be attracted only if the royalty is payable to a non-resident person, in respect of any right, property or information used for the purposes of a business, profession or vocation carried on by such person in India. Since 'c' made the payment and 'IC' is going to use trade marks in India it can not be said that 'c' made payment to carry on its business activities in India. Therefore such royalty would be out of the purview of Section 9(1)(vi)(c).

**AAR's Observation**

i) As regards coverage of Section 9(1)(vi)(c) the applicant's contention missed the second part of that clause which deems royalty to accrue or arise in India where it is payable in respect of the right, property or information used for the purposes of making or earning any income from any source in India. Here there is no reference to the person who is liable to pay the royalty or a business carried on by him in India. Here it is sufficient that the property in this case the trade mark in respect of which royalty is

payable is used to earn income from any source in India.

ii) There is no dispute about coverage of royalty payment under article 12(7)(b) of the India-USA DTAA. The applicant's representative assumed and even conceded the applicability of the paragraph 7(b) of the Article 12.

**Ruling of the AAR**

In view of the above discussions and/or arguments the AAR held that the royalties in question would be taxable in India.

**Comments:**

This is a case of royalty payment made outside India. Initially it was contended that the payment was not taxable in India. It became taxable in India due to a deeming provision under Article-12 of DTAA between India and USA. Ultimately even the applicant accepted that position.

### 10.4 P. NO.30 OF 1999, IN RE (49)

**Facts:**

The applicant, "Y" is a US Company. It has sub-subsidiary, "XT", which is an Indian Company "XT" obtains voluminous data from its clients in India and in other part of Asia, transmits it to a Central Processing Unit ("CPU") maintained by Y in USA for processed, gets back such proceed data and retransmits the same (i.e. in the processed form) to its clients. The CPU of Y in US in accessed by XT directly, but via a Central Data Network ("CDN") of Y installed in Hong Kong. For allowing the use of CDN and CPU, XT pays to Y certain charges (called CPU charges, CDN access changes, CDN service charges & E-mail charges)

**Questions raised by Y**

On the foregoing essential facts, Y raised following two questions for the ruling of the AAR

i) Whether the payment due to Y from XT is liable to tax in India?

ii) If yes, whether the payment can be taxed as "royalty" under Article 12(3)(a) (which is taxable @ 20%) or under Article 12(3)(b) (which is taxable @ 10%) of the Indo-USA DTAA ?

**Issues considered by the Authority and Ruling**

The AAR has given its ruling in the above question as under:

i) Yes

ii) It is royalty taxable under Article 12(3)(a) on the grounds that :

a) The Indian Company (i.e. XT) accesses the CDN in Hong Kong through which it establishes access to CPU in USA. At both stage XT is "allowed to use the software development and protected by the applicant company" (i.e. Y).

b) As per commentaries on OCED Model conventions, any payment for right to use software is to be regarded as a "right to use ...Scientific work". The commentary shows that payment received in such transaction are for the use of intellectual property and partake the character of royalty.

c) Since the software is customised and secret it is quite clear that the payment has been received on "considerate for use of, or the right to use... design or model, plan, secret formula or process" within the meaning of the term "royalties" in Article 12(3)(a).

d) Use by XT of CDN and CPU is not merely use of equipment as envisaged in Article 12(3)(b). CDN/CPU authorised communication and computations with application of sophisticated information technology requiring constant upkeep and updating so as to meet the challenges of the advance of technology in this area. It is the use of embedded secret

software (an encryption product) developed by Y for the purpose of processing raw data transmitted by XT which clearly falls under Article 12(3)(a).

e) Payment is calculated on the basis of time taken by CPU and it is well known that royalty can be either fixed or variable on certain parameters.

Authority ruled:

(i) That the definition of the expression "royalty" under section 9(1)(vi) of the Income-tax Act, 1961, read with Explanation 2(vi), included rendering of any services in connection with any activities for the use of any patent, invention, secret formula or process, etc. Hence the transmission of information is through encryption as the data related to clients and strict confidentiality is observed. It is for the downloading of the software that the royalty is paid. In this context, the source rule becomes relevant which requires that the royalty is sourced in the State of payer. The royalty is, therefore, taxable in India.

(ii) That according to the agreement between the applicant and the Indian company, the facilities are to be accessed only by XT. The consideration payable is for the specific programme through which XT is able to cater to the needs of the group companies located in Japan, Asia Pacific, Australia and New Zealand. The transaction would relate to a "scientific work" and would partake of the character of intellectual property. The payments received in such transactions are for the use of intellectual property and

partake of the character of royalty. The software is customised and secret. From the facilities provided by the applicant to the Indian company, which are in the nature of online, analytical data processing, it would be clear that the payment is received as "consideration for use of, or the right to use. . . design or model, plan, secret formula or process ..." within the meaning of the term "royalties" in article 12(3)(a). The use by XT of the central processing unit and the consolidated data network of the applicant is not merely "use of or the right to use any industrial, commercial or scientific equipment", as envisaged in Article 12(3)(b) of the DTAA but more than that. From the transactions of the applicant with the Indian company it is quite clear that the central processing unit / consolidated data network of the applicant are modern technological designs or models involving customised communication and computation with application of sophisticated information-technology requiring constant upkeep and updating so as to meet the challenge of the advance of technology in this area. It is the use of embedded secret software (an encryption product) developed by the applicant for the purpose of processing raw data transmitted by XT which would clearly fall within the ambit of article 12(3)(a) of the DTAA between India and the U. S. A.

**Comments:**

More and more such cases are likely to crop-up in the years to come – thanks to the business process outsourcing and the variable rate of tax given in the DTAA.

10.5. **PRO QUIP CORPORATION Vs. CIT** (50)

1. **Facts:**

1.1 The applicant is resident of U.S.A. It was incorporated in the USA.

1.2 There is an Indian company which is engaged in the business of executing the turnkey projects in India, more particularly the chemical process plants. It undertakes the work of executing the projects (jointly with foreign contractors) on behalf of its Indian clients and also help them source for them appropriate technology required for their project and supply the same to them.

1.3 The Indian company received purchase order from its constituent (a company incorporated in India) for supply of Design, Engineering Technical know-how and erection and commissioning of Hydrogen Generation Plant 2200 NM3/HR capacity for a total consideration of Rs.. . .. . . .. Million. As part of the package the said Indian company was required to obtain and supply the Engineering Drawings and Designs for setting up of the said plant.

The said engineering Drawings and Designs were available with the U.S. Company.

1.4 The said Indian company placed a purchase order No. dated with the U.S. company (Applicant) for the purpose of specified Engineering, Drawing and Designs for the construction of Hydrogen Generation Plant for its Indian constituent as per the specifications in accordance with the inquiry documents of Indian constituent. The purchase order was for a total

consideration of US $.....

1.5. In terms of the purchase order the applicant (the U.S. company) supplied various Engineering, Drawings and Designs from time to time. The Indian company made a total payment of US $ .....on.....and US $ .....on.....

1.6 Initially the Indian company made these payments without deduction of tax at source.

1.7. However the Indian company considered the said payments as taxable in India and paid a sum equivalent to US $ 38,981/- to the Central Government.

1.8 The said sum of US $ 38,981 was deducted out of the fourth payment of US $ 1,15,500 due to the applicant (U.S. company) (Net payment US $ 76,519).

1.9 The Indian company made payment to the Central Government in the following manner:

| | |
|---|---|
| Towards TDS | Rs. 16,60,385 |
| Towards Interest for late payment | Rs. 50,140 |
| | Rs. 17,10,525 |

2. However at the time of remittance of the amount after 7th June 1999, in response to the representation made by the applicant (U.S. Co.) the Indian company approached the Income Tax Department, through the ITO, - TDS-1 Baroda, requesting him to issue NOC for remittance of the said amount without deduction of tax at source, giving detailed reasons. The said A.O. issued NOC to the Indian company vide certificate dated 12th August 1999. Hence, the amounts of US $ and US $ were remitted to the applicant without deduction of tax at source.

2.1. Balance amount of US$ was not remitted till the date of application and is proposed to be remitted without deduction of tax at source in accordance with the NOC issued by the Income Tax Department.

3. The applicant (U.S. Co.) submits that it did not have any income from any source in India, other than income described above and other transactions involving sale of machineries or equipments. As a result the applicant (U.S. Co.) was not required to file any return of income in India, as it did not have any taxable income in India.

3.1 **Points at Issue**

The following questions were raised before the AAR

1. Whether the applicant is liable to tax on the amount received from Indian Company towards consideration for the sale of Engineering, Drawings and Designs received under Purchase Order No.....dated.....of Indian Company?

2. Whether the applicant is entitled to the refund of the tax, deducted by Indian Company calculated @ 15% on the part of the total remittance of US $ 2,59,875 together with interest on delayed payment of Tax Deducted at Source and already deposited with bank by the said company aggregating to Rs.17,10,525 ?

**4. The Submissions of the Department**

4.1 The Commissioner contended that the said payments are covered under clause (b) of paragraph 4 of Article 12 of Indo - US DTAA, under the head "Fees for included services".

4.2. Article 12(4) of the Indo - US Treaty reads as under as regards "fees for included services"

"*.... payments of any kind of any person in consideration for the rendering of any technical or consultancy services (including through the provisions of services of technical or other personnel) if such services:*

a) are ancillary and subsidiary to the application or enjoyment of the right, property; or information for which a royalty payment within the meaning of the tax treaty is made, or

b) make available technical knowledge, experience, skill, know-how or processes or consist of the development and transfer of a technical plan or technical design".

4.3 It is clear that paragraph 4 (a) refers to technical or consultancy services that are ancillary; and subsidiary to the application or enjoyment of an intangible asset for which a royalty is received under a licence or sale described in Article 12(3)(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial or scientific equipment for which a royalty is received under Article 12(3)(b). In addition, the predominant purpose for which the service fees is paid, must be ancillary and subsidiary to the application or enjoyment of the right, property or information, which in turn, has to be determined with reference to the facts of the particular situation.

4.4 The Memorandum of Understanding to the Treaty discusses situations where technology could be said to have been made available. The principle which emerges from an analysis of situation illustrated in the memorandum of this *aspect, is that technology would be considered made available when the person acquiring the service is enabled to apply the technology embedded in the services provided to him. The mere fact that the provisions of the service may require technical input by the person providing the service would not per se mean that technology has been made available. Similarly, the use of* a *product, which embodies technology, shall not per se constitute technology being made available.*

4.5. Training services, which envisage transfer of technical know-how or expertise to the recipient of service and enable application of such know-how independently, are therefore covered within the scope of 'make available'

***Development and transfer of a technical plan/design***

Services that involve development of technical plans, designs, drawings (as per deeds of the payer) are covered within this clause and include services such as:

Engineering Services

Architectural Services

Computer Software Development, etc.

4.6. The Department drew the attention of the AAR to example No.(6) of the Memorandum of understanding. In that example an Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed process for refining the cholesterol out of the oil. The Indian Company contracts with the US Company to modify the formulas, which it uses so as to eliminate the cholesterol, and to train the employees of the Indian Company for applying the new formula. Are the fees paid by the Indian Company for included service he fees are for included services. The services are technical, and the technical knowledge is made available to the Indian Company.

4.7. Hence, the Department contended that the present case squarely falls with in Article 12 ( 4)(b) of the Indo - US Treaty and is liable to tax under the said Article.

***5. Analysis of the Issues***

Based on the submission of the applicant, the AAR observed that

5.1. It is a case of out and out sale of engineering drawings and designs by the U.S. Co. (Non Resident American Company) to the Indian Company to enable the Indian Company to execute an order received by it from another Indian Company.

5.2. The payment basically was not made for any service to be rendered by the American Company. This is not a case of a licensing agreement or sale being coupled with a restrictive clause. *The purchaser was entitled to use the engineering designs and drawings* as *it liked. It was entitled to sell or transfer the properties purchased.* The agreed price of the sale C.I.F. Mumbai airport was fixed and not subject to any escalation or variation until complete execution. All costs, taxes and duties were to be borne by the seller. The agreed price included cost of documentation. The total price of the purchase order was to be the sole consideration for supply of goods as described in the purchase order placed by Indian Company and its constituent. U.S. Company agreed to carry out the Engineering according to the general standard of engineering profession to enable Indian Company's constituent to achieve the performance guarantee. In carrying out this engineering U.S. Company had to exercise maximum care and diligence. If there were any deficiencies in engineering, U.S. Company had to correct and / or complete such engineering at its own cost so that the Indian Company's customer could reach the minimum performance guarantee.

5.3 The said payment is not Royalty because payments received for the sale of engineering, design or drawings is not contingent upon any of the things mentioned in clause (3) of paragraph (3) of Article 12 of the Indo - US DTAA.

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5.3 The said payment is not Royalty because payments received for the sale of engineering, design or drawings is not contingent upon any of the things mentioned in clause (3) of paragraph (3) of Article 12 of the Indo - US DTAA.

5.4. The AAR analysed further whether the said payment could be "Fees for included services" and observed that paragraph 4 includes in the definition of 'fees for included service' payments which are received for *making available technical knowledge, skill, know-how or processes or consists of the development and transfer of* a *technical plan or technical design.* It can be argued that the American Company has made available to Indian Company its technical knowledge, experience, skill, know-how, process all have developed and transfer technical design as contemplated in paragraph 4. But paragraph 5 has specifically excluded from the ambit of paragraph 4, amounts paid for services that are ancillary and subsidiary linked to the sale of property other than a sale described in paragraph 3(a). *But if,* as *in this case, there* is *an out and out sale without any contingent clause then even if such sale included rendering* of engineering services, those services cannot be anything other than "services that are ancillary and subsidiary as well as inextricably and essentially linked to the sale of property" in paragraph 5. Therefore, such services will clearly fall within the exclusionary clause of paragraph 5.

5.5. The AAR went on to add that the illustration given in Memorandum of Understanding on which reliance has been placed is not appropriate. In that example (Example No.6 of Memorandum of Understanding which has been set out earlier) there is no sale of property involved. The Indian Company has requested the US Company to modify the formula for refining the cholesterol within the oil and also to train the employees of the Indian Company for the application of the modified formula. The fees are paid for technical services and also technical knowledge made available to the Indian Company but no sale of any design or engineering plan or machinery is involved.

Without the updates, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates, cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer". .

5.7 The example is in two parts. Firstly, it deals with the purchase of a computer from a US Computer manufacturer. The second part relates to updating the operating system and training personnel for the purpose of application of the updated technology over a period of ten years.

5.8 In this case, one is not concerned with any long term contract for up-dating technology. But the first part of the example squarely applies to the facts of this case. In that example an Indian company purchased a computer from a US manufacturing company. In the instant case the drawings and designs have been purchased from the U.S. Company. Engineering service has also been given in connection thereof.

5.9. The fact of this case are very similar to the facts of the first part of Example 8. The engineering services were being rendered as a part of the purchase agreement as a composite whole. This service was essentially linked with the sale of drawings and designs. It is not an agreement for long term service to be rendered after the sale of the machinery.

6. The AAR observed that drawings and designs which constitute know-how and are fundamental to an assessee's manufacturing business are treated as "plant" under Section 32 of the Indian Income Tax Act. The nature of the designs, drawings and patterns has been examined by the Supreme Court in the case of CIT Vs. Elecon Engg. Co., 166 ITR 66. In the case of Nippon Electroincs Ltd. Vs. CIT, 116 ITR 231 it was observed by Venkataramaiah J (as His Lordship then was), *"it* is *not only tangible assets that depreciate but also intangible assets like technical knowledge become obsolete as progress is made with scientific research". There* is *a well*

*known distinction between the out and out sale of property and allowing use of the property or technical know-how. In the former case property, which include person's business transferred unconditionally and becomes property of the purchaser. In the latter case the purchaser only gets the right to use the property. The payment* in *the latter case may be treated as licensing fee or royalty but the payment* in *the first category of cases cannot be treated as royalty unless there* is *a special definition making such payments "royalty". Considering these features the AAR held "the case before us* is *a case of out and out sale of property".*

7. **Ruling**

7.1 In view of this the first question is answered in the negative and in favour of the applicant.

7.2. The second question, however, relates to the refund of tax deducted by Indian Company at source. The applicant will be entitled to claim refund of the tax deducted at source alongwith the amount of interest paid for belated payment of advance tax. Refund is to be availed in the manner laid down in the act and following the prescribed procedure. For this purpose, a return of income will have to be filed claiming refund in accordance with law. It is to be seen whether there is any other source of income of the applicant in India. If the only source of income of the applicant is the consideration for sale of engineering drawings and designs under purchase order No...dated.....then the applicant will not be liable to pay any tax in India under Article 12. In such a situation, it may be entitled to get refund of the amount deducted at source. If the amount has been paid with interest the applicant company may claim that the amount be paid back to it along with that interest and also interest, if any, in accordance with the provisions of Chapter XVII of the Income Tax Act.

**Comments:**

Where an outright sale of engineering drawings etc. takes place FOB outside port India, no profit accrues in India to the non-resident seller in that transaction. This was the ratio laid down by S.C. in the case of ITO v. Sri Ram Bearings Ltd (as quoted in 33) The department tried to classify the payment as fee for technical services. That claim was held to be untenable by the AAR.

## CHAPTER-XI

## ABUSE OF A.A.R.

### 11.1 SOCIETE GENERAL V. C.I.T. (AND OTHER APPEALS) (51)

| | |
|---|---|
| Whether charging of higher rate of tax to Non Resident amounts to Discrimination under Indo French Treaty | Decision of the Authority for Advance Ruling set aside by Supreme Court in the case of Societe General. |

1. **Overview:**

This land mark decision comes close on the heels of few learned decisions of the Hon. Tribunals. The Hon. Court has set aside the ruling of the Authority for Advance Ruling.

2. **Back ground:**

2.1 The question involved was whether the (non resident banking company) French Banking Company could claim the benefit of lesser rate of tax on domestic companies in view of Article 26 of the DTAA between India and France providing for Non-discrimination.

2.2. The assessee had approached the Authority for Advance Rulings for decision on the question involved.

2.3 The Department had raised a preliminary objection that the Authority had no jurisdiction to decide the question in view of the fact that the assessment proceedings in respect of the assessee (appellant) relating to the Assessment year 1996 - 97 were pending when the application before the Authority was filed.

2.4 The attention of the Authority was drawn to Section 245R of the Act, the proviso whereof states that the Authority shall not allow an application

where the question raised is already pending before an Income Tax Authority or the Appellate Tribunal or any Court.

2.5 The Authority was .of the opinion that the objection raised by the Department was of some substance and that it did not have jurisdiction to make a ruling, in view of the proviso to Section 245R of the Act.

2.6 However the Authority did not dispose of the application on the preliminary ground, but went on to dispose of the application on merits.

2.7 The Authority ruled the rate of tax fixed by an Act of Parliament. even if the rate of tax on non domestic companies was higher, cannot be whittled down by reference to the provision of an earlier agreement between France and India, even if such agreement had the force of law. And therefore the rate of tax payable by a non domestic company could not be reduced by relying on Article 26 of DTAA.

**3. The steps taken by the Appellant and the subsequent developments:**

The Appellant filed Special Leave Petition to the Supreme Court to have the said ruling set aside.

3.2. The Special Leave Petition was admitted by the Hon. Court.

3.3 The Revenue raised the same objection as the one raised before the Authority for Advance Rulings.

3.4. The learned counsel for the Appellant applied for leave to withdraw the application before the Authority (AAR).

3.5 The learned counsel submitted that the issue of rate of tax for the Assessment year 1996 - 97 and subsequent years shall be raised by the Appellant before the Tax Authorities.

3.6. It was stated by the Solicitor General before the Hon. Court that this may be done and that no objection shall be raised on behalf of the Revenue to the rates of tax being raised by the Appellant before the Tax Authorities.

3.7 The Learned Solicitor General also stated that the Revenue will not rely on the said decision of the Authority for Advance Ruling before the Tax Authorities

**4. Decision of the Hon. Court:**

4.1 The Hon. Court pronounced the following judgement

*On the application of Mr. Dastur, learned counsel for the appellant, the application before the Authority for Advance Rulings (A.A.R. No.362 of* 1997) *is dismissed* as *withdrawn. Consequently, the impugned judgement and order is set aside.*

*The appellant shall be* at *liberty* to *raise the issue of the rate* at *which it is liable to pay tax before the authorities, the Tribunal and the courts thereafter and they shall come to* a *decision thereon independently of and without reference to the impugned judgement of the Authority.*

*The civil appeals are allowed accordingly."*

**Comments**

This French Company approached the AAR for a ruling on the rate of tax applicable by resorting Article-26 of DTAA between India and France providing for non-discrimination. The ruling of the AAR went against the French Company. In terms of section 245S of the Income-tax Act, 1961, the said ruling was binding on the applicant. In order to circumvent the same, the French Company approached the Supreme Court with a Special Leave Petition and got permission to withdraw its petition before the AAR. This is a typical case of abuse of the institution of AAR.

## 11.2 ADVANCE RULING P NO.19 OF 1995 (52)

### Overview

This advance ruling does not pertain to any specific section or Article of a DTAA the applicant is a UK Company sought ruling on taxability of collection of rent in India for letting of apartments in the U.K.

**Facts**

The applicant is a private limited company incorporated in the UK. It proposed to acquire number of residential apartments in the UK for the purpose of running on apartment letting agency for Indian businessmen and tourists. Instead of collecting rents in sterling ponds it proposed to collect the rents in Indian Rupees in India through its proposed branch office, to be located in India.

**Questions raised before the AAR**

Based on above facts the questions which were raised by the applicant were not very clear or specific. The meaning of these questions could be rephrased as below.

Whether these rupee earnings in India, could be treated as invisible exports from India and be claimed exempt under any of the provisions of the Income Tax Act, 1961?

**Issues considered and the process of arriving at the decision**

i) There was no appearance from the applicant side. Therefore the Authority applied its mind to the facts set out in the application and decided the matter.

ii) The Authority observed that exemptions in respect of export earning are contained in Section 1OB, 8OHHB, 8OHHC, 8OHHD and 8OHH. None of these sections govern the transactions proposed to be undertaken by the applicant and the income arising therefrom.

**Ruling of the AAR**

AAR ruled that "the applicant is not entitled to any exemption in respect of the earnings received in India in terms of rupees for letting out its London properties to Indian parties".

**Comments**

This case was decided exparte by AAR. This British Company put in an application before AAR for a ruling but conveniently abstained from the hearing because the question raised before the AAR was highly imaginary and far fetched from facts.

## 11.3 SUMMARY AND CONCLUSIONS:

(a) Analysis of DTAAs entered into by India with other countries shows that the 'tax haven routes' for TNCs could have been avoided if there had been proper discussion open to public before the conclusion of DTAAs. Under the Constitution of India, the Executive has totalitarian power to enter into any treaty by virtue of Article 73 read with entry 14 of List I of VII Schedule. Consequently, there is no public debate on the pros and cons of a treaty before it is entered into.

(b) DTAAs do help TNCs in tax avoision. All the available models of DTAAs - like the OECD Model, the UN Model and the US Model are weighted against the 'have-nots of technology'. It is like 'heads-I-win-tails-you-lose' situation. In other words, even where some tax would be payable by the TNCs, such tax liability gets invariably shifted to transferee countries. Such shifting of tax liability has been witnessed in all the cases of payments for transfer of technology covered under 'royalties' and 'fees for technical services'. Consequently, the burden of the transferee company gets exacerbated by the provisions of Sec.195A of I.T Act, 1961 by which the 'net of tax' payment gets grossed up for withholding tax. This is the harsh reality in the globalised business.

(c) DTAAs between India and tax havens like Mauritius, Singapore etc have 'inspired' the TNCs to take the 'Mauritius route' to bring in money as FDI and take back the income without suffering tax – as detailed in Chapter VI of the thesis.

(d) Absence of PE enables tax avoision in full, when technically there is no PE in existence beyond 182 days. This is a gaping

loophole. Under domestic law any adventure in the nature of trade, when results in income, the same is taxable as business profits. Then, why should there be a requirement of a PE, when organized business by TNCs is carried out even for less than 183 days? No evaluation of revenue loss through this route has been done so far.

(e) In consonance with the International Judicial view, the Supreme Court of India also has repeatedly laid down the law that domestic law cannot override a treaty, whereas, in the event of a conflict between the two, the treaty would always prevail. This dictum is always made use of by TNCs to demonstrate a conflict even where there is none. Case studies on business profits in Chapter IX illustrate this aspect. Claims of discrimination, where none existed, were rightly negatived by the AAR.

(f) A rare instance of domestic law overriding the treaty,as held by the AAR, in the case of a Holland company where MAT was held to be leviable by virtue of Sec.594 of Companies Act, 1956 is covered in Chapter VIII on Treaty Override.

## CHAPTER-XII

## RECOMMENDATION-1 : WANTED PARLIAMENTARY CHECK ON THE TREATY MAKING POWER OF THE EXECUTIVE

12.1 The treaty making power is sourced form Entry-14 List-1 of Seventh Schedule to the Constitution of India. Entry-10 in List-1 empowers the Parliament to enact laws for implementing any treaty entered into by the Union of India with a foreign country. Article-73 extends the Union executive power to 'such rights', authority and jurisdiction as exercisable by the Central Government under any treaty or agreement. Article-253 empowers Parliament to legislate on even the State List items to implement treaties. As such, under the Constitution of India there is no requirement for parliamentary ratification of any treaty executed by the Government – whether it is a tax treaty or WTO or GATT, etc. Due to this unlimited treaty making power, DTAAs entered into with tax havens like Mauritius (without any debate or discussion on their impact on the economy) are causing great revenue loss in the name of economic development. Re-negotiation of such treaties is not plausible.

In this regard an analysis of Treaty making power , vis-à-vis ratification process, discloses at least 85 Constitutions around the world

providing some check or other. Taking a global view, these countries from Albania to Yugoslavia have provided for parliamentary ratification of treaties and there is no reason why the Indian people should deny themselves the plenary control of ratification when treaties of grave consequences are being entered into affecting their fate. *(53)*

"Let me cite three random instances of Treaty Ratification provisions illustratively.

The Constitution of the United States (1787), even in its brevity, has had the salutary sagacity to circumscribe the President's treaty-making power. By Article II Sec.2 he shall have the Power, by and with the Advice and Consent of the Senate, to make Treaties, *provided two-thirds of the Senators present concur.*

Absent Senate validation, presidentially signed treaties have been casualties. Even many UN instruments slumber without US Senate approbation e.g CTBT signed by President Bill Clinton was not ratified by Senate.

Even a small State like Nepal has a ratificatory imperative for foreign countries. Its Constitution (1990) in Article 126 provides:

"(1) The ratification of, accession to, acceptance of or approval of treaties or agreements to which the Kingdom of Nepal or His

Majesty's Government is to become a party shall be as determined by law.

(2) The laws to be made pursuant to clause (1) shall, inter-alia, require that the ratification or, accession to, acceptance of or approval of treaties or agreements on the following subjects be done by a majority of two-thirds of the members present at a joint sitting of both houses of Parliament".

South Africa made its recent Constitution (1996), after a survey of the world's best Fundamental Laws with eclectic excellence. The wisdom of Section 231 relating to International Agreements flows as follows:

"(1) The negotiating and signing of all international agreements is the responsibility of the national executive.

(2) An international agreement binds the Republic only after it has been approved by resolution in both the National Assembly and the National Council of Provinces, unless it is an agreement referred to in sub-section ."

The case for ratification is too strong to be delayed and dilatory default is too dangerous to be risked what with 'GATT*astrophe'* strangling our economy and WTO's commanding height holding us to recolonisation status." *(54)*

The power to tax is a sovereign power generally vested with the Parliament under the Constitution. Such a power cannot be surrendered to the Executive when entering into tax treaties with other sovereign states. More so, when such treaties override the domestic law and such treaties can only grant exemption from taxes imposed by domestic law and not vice versa. It amounts to surrendering the sovereign right of taxation to other countries through the medium of Executive Power. Hypothetically, if the Executive is weak or succumbs to external pressures like terrorism, whether economic or otherwise, it would be fatal for the country. An amendment to the Constitution of India is imperative in this regard. Such an amendment would go to strengthen the basic structure of the Constitution and the sovereignty of the nation.

Further, the power to tax is a sovereign power. That power includes the power to exempt from tax also. If so, it is submitted that such a power, normally vested with the Parliament, should not be surrendered to the Executive even under the Constitution.

## 12.2 RECOMMONDATION-2 : WANTED RENEGOTIATION OF TREATIES OF DTAAs BETWEEN INDIA AND TAX HAVENS LIKE MAURITIUS.

In the case of Union of India vs. Azadi Bachao Andolan(27) the Supreme Court held ( in the context of DTAA between India and Mauritius) that treaty shopping is not illegal. Many Foreign Direct

Investments (FDI) are being routed through Mauritius into India by OBCs (Overseas Business Corporations). All such offshore companies have an e-residence in Mauritius by virtue of the registration under Mauritius law. The Indo-Mauritius DTAA provides that a person, who by reason of his domicile, residence, place of management or similar criterion is liable to taxation in a State should be considered a resident of that State.

The above provision in the DTAA enables off-shore companies to indulge in treaty shopping with the active support of Mauritius.

The USA generally includes anti-treaty shopping measures in its treaties entered into with other countries for Double Taxation Avoidance. For instance, in the Indo-US DTAA Article-24 provides against treaty shopping in the following manner:

"**Article 24 : Limitation on Benefits:**

1. A person ( other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

(a) More than 60 per cent of the beneficial interest in such person ( or in the case of a company, more than 50 per cent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the

Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the Unites States; and

(b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or citizens of the Unites States.

2. The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).

3. The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognised stock exchange. For purpose of the preceding sentence, the terms "recognized stock exchange" means:

(a) in the case of the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934;

(b) in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contract RegulationAct,1956; and

(c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines."

It is recommended that India also may re-negotiate its treaties with countries like Mauritius and propose to include such reasonable restrictions in the DTAAs. Otherwise, India would become a 'favoured destination' for money laundering activities through countries like Mauritius.

## 12.3 RECOMMENDATION-3 – REQUIREMENT OF A P.E FOR TAXING BUSINESS PROFITS SHOULD BE DONE AWAY WITH.

Why should there be a PE to assess business profits earned within six months?

In Chapter-VII (supra) illustrative cases show one inevitable conclusion that TNCs make business profits but escape taxation of the same in the source country on the ground that there are no PEs. This is based on the requirement of a PE, as generally mandated by all the DTAAs (except ANDEAN Model), for a period of more than six months .

In our domestic law even a single transaction in business can result in profits liable to tax. Similarly, the TNCs enter into international transactions not for charitable purposes but for making money. Indeed, the TNCs admittedly do make profits in their international ventures. When there is no requirement of a PE for earning business profits, it does not stand to reason and logic and equity as to why should there be a requirement of a PE beyond a particular time limit to make such profits liable to tax.

Therefore, it is strongly recommended that the OECD and UN should be persuaded for removing this requirement of a PE beyond a particular time limit for the purpose of levying tax on the business profits earned due to business connection.

## 12.4 RECOMMENDATION-4 EXCHANGE OF INFORMATION TO PREVENT FISCAL EVASION.

All DTAAs provide for exchange of information on the lines of Article 26 of OECD or UN Model Convention. The preamble to the DTAAs includes prevention of fiscal evasion as a declared objective. In practice very rarely this objective has been achieved by any useful exchange of information.

Only under the Narcotics Control Bureau, with a view to preventing drug trafficking, exchange of information does take place between sovereign countries. Similarly, Interpol also enables exchange of information on international culprits/criminals. Economic Offenders are included in this regard, only when the narcotics angle is involved.

In this background it is strongly recommended that under auspices of IFA (International Fiscal Association) or any similar organization, a nodal agency should be created for the following purposes:-

a) Exchange of information on the latest trends of tax avoision in international transactions.

b) Training of both tax gatherers and professionals should be organized to keep pace with the changing circumstances in the areas and methods of tax avoision.

c) In the computerised atmosphere world over, with electronic fund transfer available, tax heavens can be utilised for money laundering activities through countries with which the tax havens have entered into comprehensive DTAAs. Such activities can be controlled and minimised only through multilateral agencies investigating into them.

d) Simultaneously, action should be taken against countries that have introduced regimes constituting harmful tax competition through a network of DTAAs.

## 12.5 RECOMMONDATION-5 THE IMPACT OF TRANSFER PRICING REGULATIONS ON THE TREATY OBLIGATIONS.

In the Indian Income Tax Act, Chapter X deals with Special Provisions relating to avoidance of tax. In this Chapter, Sections 92, 92A to 92F have been substituted by Finance Act, 2001 w.e.f. 1-4-2002. Out of these provisions, Section 92 has again been substituted by Finance Act, 2002 w.e.f. 1-4-2002. These seven provisions deal with the Transfer Pricing Regulations. If there is any shifting of profit from a taxable territory to a non-taxable territory or for a lesser liability of tax through international transactions, such methods of avoidance of tax are dealt with by these Transfer Pricing Regulations.

These regulations, inter alia, include definitions of (a) arm's length price (b) associated enterprises (c) permanent establishment and (d) international transaction. The terms like associated enterprise and permanent establishment are also defined in every DTAA. The concept of arm's length price is otherwise contemplated in every DTAA. But, as per Article 9 of the OECD model convention, taxation of associated enterprise under this Article would arise only when conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises.

Normally, when DTAA is available between two contracting states and the associated enterprises are located in the said two contracting states, then they would be governed by DTAA for their tax liability. To take such associated enterprises out of the DTAA and within the Transfer Pricing Regulations, the Transfer Pricing Officer 'must find that conditions are made or imposed between the two enterprises in their commercial or financial relations'. In the absence of such conditions 'made or imposed', the transfer pricing

regulations are bypassed. To this extent, there is 'a treaty over-ride'. This law is in its nascent stage in India and it would be a Herculean task for the Transfer Pricing Officer to indulge in treaty over-ride. To this extent, the measures brought in for preventing avoidance of tax become ineffective. One has to wait and see the evolution of law in this regard.

## 12.6 RECOMMONDATION-6 GOVERNMENT'S OBLIGATION FOR JUDICIOUS USE OF TAX COLLECTED

It has been noted in Chapter II supra that one would wish that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay the price to buy civilization. In the case of *CWT vs. Arvind Narottam,* Justice Subyashachi Mukharji remarked: *"The question which many ordinary taxpayers very often, in a country of shortages with ostentatious consumption and deprivation for the large masses, ask is, does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless, waste and ostentation in Government's spending are avoided or eschewed, no amount of moral sermons would change people's attitude to tax avoidance*".

The above sentiments bring out the judicial anguish on the attitude of the Government (of the time) perceived by taxpayers in general in spending

the tax collected in an ostentatious and wasteful manner. Such attitude acts as a catalyst in persuading even genuine taxpayers, in their heart of hearts, to indulge in tax avoidance schemes to the detriment of the revenue. In the year 1995, a book has been published in USA under the title 'THE TAX RACKET – GOVERNMENT EXTORTION FROM A TO Z' (54) with the objective "reform the tax system and close the IRS", by Martin L. Gross . In the very first chapter of this book, the author has written *"Nothing in this world can be said to be certain except DEATH AND TAXES," Ben Franklin wrote to a friend in 1789.*

*Were Franklin to return to America today, he would surely change the ancient saw to read "TAXES ARE DEATH," especially for a civilization such as the U.S. of A.*

*The nation is just waking up from twenty-five years of sleepwalking. We had watched mute as America became an endangered society, threatened not by pollution but by excessive taxes at all levels, from a dogged IRS to an insatiable Town Hall.*

*Just a few years ago, the antitax crowd was dismissed as "crackpots." American politicians taxed and spent with a promise of Nirvana tomorrow as long as we handed over our wallets today.*

*Well, tomorrow has arrived, and it turns out that our bloated, wastrel governments at all levels are the true "crackpots," apparently determined to weaken the economy and destroy our independence."*

In India too, similar outbursts have been surfacing off and on for the last decade or more. In particular, in Ahmedabad, an Association has been formed to fight against illegal actions taken by Incometax Department and also to make the top echelon of the Indian Revenue Service realize the ground realities in the matter of implementation of tax policies and tax laws. More often than not, highly disputed demands are raised and recovery of such demands is enforced in a ruthless manner, making use of the coercive powers available to the authorities. It is common knowledge that such coercive powers should be used only in some deserving cases of perennial tax evaders. Instructions galore are issued from time to time to curb such approaches of the tax officers. But the managerial avarice of the tax gatherers, in exceeding the budget target fixed for collection, by any means, makes them blind to such arbitrary collection of disputed taxes.

Another significant problem faced by all concerned is the level of corruption encountered in the administration of tax laws. This is also an important factor contributing to the ingenious methods of tax avoision sought to be indulged in by taxpayers and their expert advisers. Consequently, government should find solutions to reduce corruption in the administration of tax laws to avoid leakages of revenue.

In this background, the following suggestions are put forth:

Administrative reforms, in a wholesale manner, should be brought out in the functioning of the revenue departments. The Indian Revenue Service should not be a part of the Government. It should be made an autonomous body in the sense it should have both functional autonomy and financial autonomy on the lines of the Reserve Bank of India. This approach would enable the tax departments to be independent of the politicians and the bureaucratic controls without reducing their accountability both to the parliament and to the judiciary. Such an approach would also lead to more transparency in the functioning of the tax departments. Ways and means of employing professionals – in the fields of accountancy, law, valuation etc. – on case to case basis or on the basis of

certain projects may also be formulated and implemented for improving the quality of tax administration.

Too many voluntary disclosure schemes have been brought about, particularly in the last 30 years by the Government. Such schemes, though upheld by the courts, bear eloquent testimony to

(a) rampant tax evasion;

(b) government acquiescing to such rampant tax evasion;

(c) act as disincentive to honest tax payers;

(d) inefficient and corrupt tax administration; and

(e) that tax evaders and unscrupulous professionals can escape from the clutches of the so-called harsh laws.

With a view to overcoming all these maladies, the government should make it a stringent policy and announce that there would not be any voluntary disclosure schemes for the next 25 years. Such an announcement becomes more imperative in the present scenario when the tax rates in India are highly competitive compared to the tax rates in other countries. Such an announcement would "politely persuade habitual tax evaders to bring in their ill gotten money into the main stream".

Such steps can be easily put into action if the tax departments are vested with autonomous existence.

## 12.7 SCOPE FOR FURTHER RESEARCH

a) Evaluation of quantum of revenue loss on account of DTAAs with tax havens vis-à-vis the economic development supposed to have been achieved due to liberalisation.

b) The impact of Transfer Pricing Regulations (TPR) introduced in 2000 on DTAAs to evaluate whether 'Treaty Override' has been achieved through TPR in this area.

c) Ways and means of developing multi-lateral treaties to substitute bilateral treaties with a view to putting an end to Tax Competition in ASIA. To begin with, a study can be made for evolving a Model convention for SAARC countries and then for Asian countries, with a view to improving regional co-operation and development.

d) Administrative reforms required with a view to bring in transparency and accountability in tax administration coupled with bestowing functional and financial autonomy to Central Board of Direct Taxes may be taken up for research. This would enable the tax administration to curb corruption in the Department and avoid political interference in the day-to-day administration of tax departments.

## CHAPTER-XIII

## EPILOGUE

13.1 As a social scientist when one goes through all these catena of cases of corporate tax avoision, one cannot wish away the large hidden loss to the community, caused by some of the best brains in the world being involved in the perpetual war waged between Trans National Corporate tax avoider and its expert team of advisors, lawyers and Chartered Accountants on the one side and the tax gatherer and his perhaps not so skillful advisors on the other side. Then again there is the sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it. Last, but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of the "artful dodgers".

13.2 It may, indeed, be difficult for lesser mortals to attain the state of mind of Mr. Justice Holmes, who said, "Taxes are what we pay for a civilized society. I like to pay taxes. With them I buy civilization". We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not

unethical and that is stands on no less a moral plane than honest payment of taxation.

13.3 What is the solution to tax avoision? The answer has been propounded by Mahatma Gandhiji in his 'Trusteeship Principles" *(55)* as under:-

a) Trusteeship provides a means of transforming the present capitalist order of society into an egalitarian one. It gives no quarter to capitalism, but gives the present owning class a chance of reforming itself. It is based on the faith that human nature is never beyond redemption.

b) It does not recognize any right of private ownership of property except so far as it may be permitted by society for its own welfare.

c) It does not exclude legislative regulation of the ownership and use of wealth.

d) Thus under State-regulated trusteeship, an individual will not be free to hold or use his wealth for selfish satisfaction or in disregard of the interests of society.

e) Just as it is proposed to fix a decent minimum living wage, even so a limit should be fixed for the maximum income that would be allowed to any person in society. The difference between such minimum and maximum incomes should be reasonable and equitable and variable from time to time so much so that the tendency would be towards obliteration of the difference.

f) Under the Gandhian economic order the charter of production will be determined by social necessity and not by personal whim or greed.

13.4 Can each TNC be persuaded to part with a portion of the tax avoided in international dealings for the benefit of the world community? Why not there be a prescription that a certain percentage of all the taxes avoided in international business be pooled in a fund to be created under the auspices of the UN.

a) *Ooruni neer niraindatre Ulagu avaam*
*Perarivalan tiru* (56)

*(215 verse of Tirukkural)*

When prosperity comes to a man who has understood, and knows his duty to his fellowmen, it is like the village tank that is filled by the rain.

When the village tank gets filled by rain it is an occasion for joy for the whole community. The tank keeps the water from running to waste or being dried up, and serves to quench the people's thirst throughout the year. So should the government feel when a good man prospers.

b) *Payanmaram ulloor pazhutattral Chelvam*

*Nayanudaiyankann padin* (56)

*(216 verse of Tirukkural)*

When wealth comes to a large-hearted man, it is like the village tree coming to be in fruit.

The joy of finding ripe fruit on their own village tree is an apt figure for the prosperity that comes to the large hearted citizen to whom it is joy to spread joy around him, for which prosperity brings him the opportunity.

c) *Marundagittappa maratattral Chelvam*

*Peruntagaiyankann padin* (56)

*(217 verse of Tirukkural)*

If wealth comes to one who is blessed with a large heart it becomes the unfailing drug plant for society's troubles.

13.5 Rajaji comments (on the above three verses):

*"The village tank stores the water from running to waste; so the wise citizen acquires and looks after his acquisitions in order to serve all. The village tree bears ripe fruit; so the liberal-minded citizen freely gives of his wealth to help all around. The medicinal tree is the precious alchemist of nature. Its leaves, bark, fruit and root take out of the earth those essences, which relieve ailments of all kinds. So does the wealth of the great citizen serve to relieve suffering of all kinds? His knowledge and experience make up the alchemy that is needed to put the wealth to effective use for the benefit of the community."*

13.6 The social responsibility of TNCs for the world community will be greatly fulfilled in the global corporate governance. A genuinely civilized person is obedient even to the unenforceable. Let there be an unenforceable Code of Social Responsibilities for TNCs to be monitored by UN/WB/IFA. Let these agencies collect voluntary contributions from TNCs and spend the same on 'Welfare Measures' in under-developed and developing nations. Let the 'source country' from which tax has been avoided, be the main beneficiary of such voluntary contributions from the TNCs.

13.7 The above said principles are not utopian. They are practicable and are being practiced by many highly evolved human beings. For instance, Mr. Narayana Moorthy, Mentor of Infosys, has been acknowledged in the current scenario as a philanthropist, who has been giving back to the society a substantial portion of what has been earned by the company. Similarly, BITS Pilani was born, thanks to the visionary and missionary zeal of Late G.D. Birla. Bill Gates of 'Microsoft' is known to have contributed millions of dollars for charitable purposes. The income earned out of invention of dynamite by Alfred Nobel had given birth to Nobel Prizes. History is replete with such examples in many parts of the world. Otherwise, the saying of Oliver Goldsmith, "where wealth accumulates men decay" will come true. Let the TNCs redeem themselves from the malady of spiritual impoverishment, which is the root cause of tax avoision methods. Remedy for the malady lies in Gandhiji's 'Trusteeship Principles'.

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## ***SUPERVISOR'S BIO-DATA***

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## ***CANDIDATE'S BIO-DATA***

Mr. C.P. Ramaswami graduated in Science from Presidency College, Madras and in Law from Madras Law College. Practiced for two years as a lawyer on the civil side and then served Indian Revenue Service for about 28 years from 1976 to 2004. He had served in various wings of the Incometax Department, like Investigation, Judicial and Settlement Commission etc. Received special commendations and accolades from the Union Finance Ministers and RBI Governor and the Income Tax Appellate Tribunals for his contribution in unraveling the Securities' Scam of 1992 and in representing the Department in Special Bench cases. Many of these judgments have been reported in journals. He has published many articles on taxation, corporate governance in journals and books. He has presented many papers in National and International Seminars. He has been a visiting faculty to many Academies like National Academy of Direct Taxes, Nagpur, Vallabhai Patel National Police Academy, Hyderabad, UTI Institute of Capital Market, Navi Mumbai, Direct Taxes Regional Training Institutes at Bangalore, Kolkata, Lucknow and Mumbai. Presently, he is practicing as an advocate in the A.P. High Court on the taxation side.

# Article

# Tax planning : Does Westminster's prevail over McDowell's ?

C. P. Ramaswami†

Lord Denning delivered the Romanes Lecture at Oxford in May, 1959, on the title 'From Precedent to Precedent'. He said "This land of ours, this England, has been spoken of by the poet as the land where —

*"A man may speak the thing he will;*
*A land of settled government,*
*A land of just and old renown,*
*Where Freedom broadens slowly down*
*From precedent to precedent".*

(From "You Ask me Why" by Tennyson)

"If lawyers hold to their precedents too closely, forgetful of the fundamental principles of truth and justice which they should serve, they may find the whole edifice comes tumbling down about them. They will be lost in —

"That codeless myriad of precedent,
That wilderness of single instances".

The common law will cease to grow. Like coral reef, it will become a structure of fossils. If it is to avoid this fate, the law cannot afford to be a 'lawless science' but should be a science of law. Just as the scientist seeks for truth, so the lawyer should seek for justice. Just as the scientist takes his instances and from them builds up his general propositions, so the lawyer should take his precedents and from them build up his general principles. Just as the propositions of the scientist fall to be modified when shown not to fit all instances, or even discarded when shown to be in error, so the principles of the lawyer should be modified when found to be unsuited to the times or discarded when found to work injustice". (From the 'Discipline of Law' — Lord Denning, First Indian Reprint 1993 — pp. 291-292).

These principles apply with equal force to Courts — while following or not following a precedent. Our Supreme Court, like the House of Lords, is generally bound by its precedents. Still, it has powers to overrule any precedent by going through the route of a larger bench.

The recent decision rendered by a Division Bench of the Supreme Court in the case of *Union of India v. Azadi Bachao Andolan*, (2003) 263 ITR 706 (*UOI v. ABA* for short), is a landmark judgement on the interpretation of tax treaties and on the powers of the Central Board of Direct Taxes (CBDT) to issue circulars/ notifications in the tax administration. This decision, *inter alia*, held that :

(a) S. 90 of Income-tax Act, 1961 empowers the Central Government to enter into Double Taxation Avoidance Convention (DTAC for short) with foreign governments. Whenever any requisite notification has been issued by CBDT, the provisions of Ss.(2) of S. 90 spring into operation and an assessee who is covered by the provisions of DTAC is entitled to seek benefits thereunder, even if the provisions of the DTAC are inconsistent with the provisions of Income-tax Act, 1961.

(b) Circular No. 789 dated 13-4-2000 issued by the CBDT, as a clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius DTAC is not *ultra vires*.

(c) The contention of respondents that the DTAC between India and Mauritius is *ultra vires* is not acceptable — even if the DTAC is susceptible to 'treaty shopping' on behalf of the residents of third countries.

(d) A tax treaty or convention must be given a liberal interpretation. A holistic view has to be taken in this regard.

(e) The 'Rule in McDowell' did not dissent from or overrule the decision of Privy Council in Bank of Chettinad's case 8 ITR 522, which wholeheartedly approved the *dicta* in the passage of direct opinion of Lord Russel in Westminster's case, and despite the 'hiccups' in the McDowell's case, the law has remained the same. An act, which is otherwise valid in law cannot be treated as

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*non-est* merely on the basis of some underlying motive (supposedly resulting in some economic detriment or prejudice to the national interest, as perceived by the respondents).

While deciding on the above issues, the Division Bench adhered to the doctrine of *stare decisis* with regard to interpretation of tax treaties. However, on the issue of tax planning, it is submitted with utmost respect, the Bench had not followed the same doctrine. The bench has made many observations on the *ratio decidendi* of the decision rendered by a Constitution Bench of the Supreme Court (comprising of five Judges) in the case of McDowell's (1985) 154 ITR 148 (McDowell's for short).

The adverse notes on McDowell's passed by the Division Bench in *UOI v. ABA*, 263 ITR 706 (SC) are :

(a) At page 755 ".....we are unable to read or comprehend the majority judgement in McDowell's case (1985) 154 ITR 148 (SC) as having endorsed this extreme view of Chinnappa Reddy J., which, in our considered opinion, actually militates against the observations of the majority of the judges which we have just extracted from the leading judgement of Ranganath Mishra J., (as he then was).

(b) Again at page 755,

The basic assumption made in the judgement of Chinnappa Reddy J. in McDowell's case (1985) 154 ITR 148 (SC) that the principle in Duke of Westminster's case (1936) AC 1 (HL) has been departed from subsequently by the House of Lords in England, with respect, is not correct...".

(c) At page 758,

".....With respect, therefore, we are unable to agree with the view that Duke of Westminster's case (1936) AC 1 (HL); 19 TC 490 is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster's case (1936) AC1 (HL); 19 TC 490 is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah J. in *CIT v. Raman*, (1968) 67 ITR 11 (SC) are very much relevant even today....".

(d) At page 760,

".....It thus appears to us that not only is the principle in Duke of Westminster's case (1936) AC1 (HL); 19 TC 490 alive and kicking in England, but it also seems to have acquired judicial benediction of the Constitutional Bench in India, notwithstanding the temporary turbulence created in the wake of McDowell's case (1985) 154 ITR 148 (SC).

(e) At page 762-763,

".....Having anxiously scanned McDowell's case (1985) 154 ITR 148 (SC), we find no reference therein to having dissented from or overruled the decision of the Privy Council in Bank of Chettinad's case (1940) 8 ITR 522 (PC). If any, the principle appears to have been reiterated with approval by the Constitution Bench of this court in Mathuram's case (1999) 8 SCC 667 at page 12. We are, therefore, unable to accept the contention of the respondents that there has been a very drastic change in the fiscal jurisprudence, in India, as would entail a departure. In our judgement, from Westminster's case (1936) AC 1 (HL); 19 TC 490 to Bank of Chettinad's case (1940) 8 ITR 522 (PC) to Mathuram's case (1999) 8 SCC 667, despite the hiccups of McDowell's case (1985) 154 ITR 148 (SC), the law has remained the same...".

All the above observations extracted are based on the assumption that the view of Chinnappa Reddy J., in McDowell's militates against the observations of the majority of the judges from the leading judgement of Ranganath Mishra J., (as he then was). It is respectfully submitted that this assumption is factually found to be incorrect for the following reasons :

(a) In the leading judgement of Ranganath Mishra J., in McDowell's case 154 ITR 148 (SC) at page 171 Ranganath Mishra J's., judgement (extracted at page 754 and 755 of 263 ITR in UOI v ABA) is followed by a two-line paragraph as under :

"On this aspect, (*i.e.* on tax planning) one of us, Chinnappa Reddy J., has proposed a separate and detailed opinion with which we agree". (*emphasis supplied*).

(b) Similarly, the first sentence of Chinnappa Reddy J., 154 ITR 148 at page 152 reads,

> "While I entirely agree with my brother, Ranganath Mishra J., in the judgement proposed to be delivered by him, I wish to add a few paragraphs, particularly to supplement what he has said on the 'fashionable' topic of tax avoidance".

Thus, it is clear from the above two concurring judgements and mutually absorbing views that there is no dissidence in the findings of two learned Judges who delivered the judgements in McDowell's. On the contrary, they are supplementing and complementing each other, thereby reinforcing the pith and substance of the judgement.

The judgement of Supreme Court in the case of *UOI v. ABA*, (2003) 263 ITR 706 at page 763 has, *inter alia*, held 'despite hiccups of McDowell's case' [154 ITR 148 (SC)], in the judgement of their Lordships, the law has remained the same from Westminster's case to Bank of Chettinad's case to Mathuram's case, and that Justice Chinnappa Reddy's opinion was incorrect.

The conclusion at page 763 extracted *supra*, and the view that Chinnappa Reddy J's., judgement is incorrect, are based on the assumption that the view of Chinnappa Reddy J., militates against the observations of the majority/leading judgement of Ranganath Mishra J., (as he then was). From a reading of the judgement in McDowell's case it is clear that the judgement of Chinnappa Reddy J., was not delivered in difference or in isolation. The two judgements in McDowell's are in fact concurring and no portion of one 'militates' against any portion of another. Their Lordships examined the different manifestations of a likely issue through the concurring judgements and finally agreed on the judicial view.

The Division Bench, while deciding Azadi Bachaon Andolan 263 ITR 706, missed on these total agreements between the opinions of Chinnappa Reddy J., and Ranganath Mishra J., and assumed that the opinion of Chinnappa Reddy J., was a lone furrow. The Division Bench held that the opinion of Chinnappa Reddy J., in McDowell's was a 'hiccup'. Indeed, with the unequivocal agreement of Ranganath Mishra J., quoted above with that of Chinnappa Reddy J., the Duke of Westminster's principle was 'departed from'. How was it departed from ?

The *ratio decidendi* in McDowell's case had been spelt out in unequivocal terms by Justice Chinnappa Reddy in 154 ITR 148 at page 160,161 as under :

> "We think that the time has come for us **to depart from the Westminster principle** as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J. and similar observations made elsewhere. The evil consequences of tax avoidance are manifold. First, there is substantial loss of much needed public revenue, particularly in a welfare state like ours. Next, there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation. Then there is "the large hidden loss : to the community (as pointed out by Master Sheatcroft in 18 Modern Law Review 209) by some of the best brains in the country being involved in the perpetual war waged between the tax-avoider and his expert team of advisers, lawyers and accountants on the one side and the tax-gatherer and his perhaps not so skillful advisers on the other side. Then again there is the "sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it". Last, but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of the 'artful dodgers'. It may, indeed, be difficult for lesser mortals to attain the state of mind of Mr. Justice Holmes, who said "Taxes are what we pay for a civilised society. I like to pay taxes. With them I buy civilisation." But, surely, **it is high time for the judiciary in India too to part its ways from the principle of West-minster and the alluring logic of tax avoidance.** We now live in a welfare State whose financial needs, if backed by the law, have to be respected and met. We must recognise that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less a moral plane than honest payment of taxation. In our view, the proper way to construe a taxing statue, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not

unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it. A hint of this approach is to be found in the judgement of Desai J. in Wood-Polymer Ltd., *in re* & Bengal Hotels Limited, *in re* (1977) 47 Comp. Cas. 597 (Guj.), where the learned judge refused to accord sanction to the amalgamation of companies as it would lead to avoidance of tax.

It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of 'emerging' techniques of interpretation as was done in Ramsay, Burma Oil and Dawson, to expose the devices for what they really are and to refuse to give judicial benediction . . ." (*emphasis supplied*).

And this ratio has been endorsed, (at the risk of repetition) by Justice Ranganath Mishra in McDowells. That means Westminster's has been explicitly departed from. However, the Division Bench held in Azadi Bachao Andolan that 'the Westminster's principle is still alive and kicking'.

In the case of Assistant Collector of *Central Excise v. Dunlop India Ltd.*, (1985) 154 ITR 172 (SC) at page 180 it was held, "We desire to add and as was said in *Cassel and Co. Ltd. v. Broome*, (1972) AC 1027 (HL), we hope it will never be necessary for us to say so again that "in the hierarchical system of courts" which exists in our country, "it is necessary for each lower tier" including the High Court, "to accept loyally the decisions of the higher tiers". "It is inevitable in a hierarchical system of courts that there are decisions of the Supreme Appellate Tribunal which do not attract the unanimous approval of all members of the judiciary ..... But the judicial system only works if someone is allowed to have the last word and that last word, once spoken, is loyally accepted" (see observations of Lord Hailsham and Lord Diplock in *Broome v. Cassell*). **The better wisdom of the Court below must yield to the higher wisdom of the court above."** (*emphasis supplied*) *Mutatis Mutandis*, it is humbly submitted that the last sentence quoted above may be re-stated that better wisdom of the Division Bench must yield to higher wisdom of the Constitution Bench of the Supreme Court.

If the Division Bench wanted to disagree with the unanimous view of Chinnappa Reddy J., their Lordships may refer the matter to the Hon'ble Chief Justice of India for constituting a larger bench with a view to reconsidering McDowell's principle — as laid down by Supreme Court in many a case.

It is a well-settled Rule of Precedence that a Division Bench is bound by the decision of a Constitution Bench constituting of five judges, even if it doubts the correctness of that decision. At the most, they may refer the matter to a Three Judge Bench. In the case of *Bharat Petroleum Corporation Limited v. Mumbai Shramik Sangh and Others*, (2001) 4 SCC 448, a Constitution Bench comprising of five Judges : (S. P. Bharucha, V. N. Khare, N. Santosh Hegde, Y. K. Sabharwal and Shivaraj V. Patil, JJ) held at page 449 :

"We are of the view that a decision of a Constitution Bench of this Court binds a Bench of two learned Judges of this Court and that judicial discipline obliges them to follow it, regardless of their doubts about its correctness. At the most, they could have ordered that the matter be heard by a Bench of three learned judges". (*emphasis supplied*).

The doctrine of *stare decisis* means, 'keep to what has been decided previously'. McDowell's decision was rendered by a Constitution Bench comprising of five judges where the earlier decision of the Supreme Court in the case of *CIT v. A. Raman & Co.*, (1968) 67 ITR 11 rendered by a bench of three judges was considered but the Bench dissociated itself. The decision of Privy Council in the case of Bank of Chettinad Ltd., (1940) 8 ITR 522 was also rendered by three judges. It may be seen that the cases of Bank of Chettinad and A. Raman & Co., have been considered by McDowell's decision rendered by a bench consisting of five judges. Perhaps the Bench, while deciding Azadi Bachao Andolan missed the judicial consensus and so observed in 263 ITR 706 at page 762 :

"The judgement of the Privy Council in Bank of Chettinad's case (1940) 8 ITR 522,

wholeheartedly approving the *dicta* in the passage from the opinion of Lord Russel in Westminster's case (1936) AC 1 (HL); [1935] 19 TC 490, was the law in this country when the Constitution came into force. This was the law in force then, which continued by reason of Article 372. Unless abrogated by an Act of Parliament, or by a clear pronouncement of this court, we think that this legal principle would continue to hold good".

It is **submitted with utmost respect** that the reliance placed on the decision of Constitution Bench in Mathuram's case [1999] 8 SCC 667 is begging the question. This was the decision rendered on Property Tax and on the *'vires'* of provisions in MP Municipality Act, 1961. It has no relevance to tax planning. It was found that the rate of tax was not prescribed. It was in this context that the passage from Westminster's was quoted to the effect that the subject is not taxable by inference or analogy, but only by the plain words of the statute applicable to the facts and circumstances of his case. Jurisdiction to tax and interpretation of taxing statute are different from colourable devices or adopting dubious methods, which are not considered as part of tax planning.

Indeed, the SC had held on many an occasion that any decision rendered by it should be applied in the relevant context. In this regard, how a precedent of the Supreme Court is applicable to subsequent cases has been spelt out by the Supreme Court in the case of Sun Engineering Works Ltd., (1992) 198 ITR 297 at page 320 as under :

"It is neither desirable nor permissible to pick out a word or a sentence from the judgement of this Court, divorced from the context of the question under consideration and treat it to be the complete 'law' declared by this Court. The judgement must be read as a whole and the observations from the judgement have to be considered in the light of the questions which were before this Court. A decision of this court takes its colour from the questions involved in the case in which it is rendered and, while applying the decision to a later case, the court must carefully try to ascertain the true principle sentences from the judgement, and not to pick out words or sentences from the judgement divorced from the context of the questions under consideration by this court, to support their reasonings.."

Applying the above said principle, in the context of tax planning, the precedent set up by the Constitution Bench in McDowell's case will be the appropriate and binding precedent and not the precedent set in Mathuram's case, which is on an entirely different issue. At the most the observations in Mathuram's case might fall in the realm of *obiter dicta* with reference to taxing statutes.

In the light of the above pronouncement of the Apex Court, the reliance placed by the Division Bench in the case of *UOI v. ABA* on the Constitution Bench decision in the case of Mathuram's (1999) 8 SCC 667, it is humbly submitted, may not be appropriate. The ratio in Mathuram's case is on *vires* of the charging section of MP Municipality Act, 1961 (mainly in the absence of prescribing any rate of tax). Whereas the *'ratio decidendi'* of McDowell's case was on the issue of tax planning *vis-à-vis* tax avoidance.

In fact, the issue whether *obiter dicta* of a Larger Bench of the Supreme Court would be binding on a Smaller Bench of the Supreme Court in terms of Article 141 of the Constitution has been left open by a three judge Bench of the Supreme Court in the case of *Post Graduate Institute of Medical Education & Research, Chandigarh v. K. L. Narsimhan*, (1997) 6 SCC 283 vide para-20 of the judgement.

According to the law of precedents, as enunciated by the Supreme Court, any decision of a Larger Bench would prevail over that of a Smaller Bench. More so, when the judgement of the Larger Bench has been pronounced in an authoritative manner — as in the case of McDowell's (quoted *supra*).

The House of Lords in *Craven v. White*, (1990) 183 ITR 216 reconsidered the decision in Ramsay's and observed that Ramsay principle can be applied to a series of transactions containing an intermediate transaction designed to avoid tax. Any tax avoidance scheme can be called a subterfuge when it seeks to obtain for a tax payer a reduction in his taxable income without suffering any financial loss or expenditure. The decision by the Division Bench in the case of *UOI v. ABA*, on the interpretation of DTAC between India and

Mauritius and on the *vires* of the Board's circular is unexceptional. If there were any dispute on the residential status of the corporations having an electronic existence in Mauritius, the Assessing Officers should have referred the matter to the Board for deciding the issue under the tie-breaker clause of the DTA Agreement. Instead, they were trying to go behind and check those on the veracity of the residential certificate. That is why the Board's circular was issued.

It is often noticed that Assessing Officers apply McDowell principle as if it were a statutory provision. Perhaps the tax practitioners will resort to a similar use of the 'Rule in McDowell' as propounded in the case of Azadi Bachao Andolan, 263 ITR 706. This Article has been written only to improve awareness on the judge made law relating to tax planning.

It can be said that subterfuges (in the name of tax avoidance schemes) have never been tolerated by the Courts. For instance, in the Bank of Chettinad's case a scheme was put in place to show that interest income accrued outside British India. Privy Council did not approve of it. Even prior to McDowell, subterfuges — colourable devices were struck down by Courts — like Bank of Chettinad, In re Wood Polymer, Siddho Mal & Sons, etc. Similarly, even after McDowell, legitimate tax avoidance schemes have been upheld by Courts, like Azadi Bachao Andolan, Arvind Narottam, Banyan & Berry, M. V. Valliyappan, etc.

Thus, it is respectfully prayed that the observations of the Bench in *UOI v. ABA*, 263 ITR 706 with reference to tax planning coupled with Rule in McDowell's merit reconsideration and review for a judicial demarca-tion of permissible limits of tax 'avoision'.

One may draw inspiration from an obiter in the case of Distributors (Baroda) Ltd. (1985) 155 ITR 120, the Supreme Court held at page 124 ".... To perpetuate an error is no heroism. To rectify it is the compulsion of the judicial conscience. In this, we derive comfort and strength from the wise and inspiring words of Justice Bronson in *Pierce v. Delameter*, (A.M.Y. at page 18): "a judge ought to be wise enough to know that he is fallible and, therefore, ever ready to learn : great and honest enough to discard all mere pride of opinion and follow truth wherever it may lead : and courageous enough to acknowledge his errors".

*(Continued from page 13)*

**— ARTICLE : 'ASHOK LEYLAND LTD.' — OVERRULED**

Madras High Court in *T.P.S.R Factory Pvt. Ltd. v. Dy. Commercial Tax Officer*, 1967 20 STC 419. Neither the State Legislature nor the Central Legislature has any legislative jurisdiction to levy tax on mere branch transfers of the goods. Such transactions cannot be treated as sale at all, vide Bombay High Court in *Varun Polymol Organises Ltd. v. State of Maharashtra*, 1995 97 STC 55 Bom. If in the absence of F Form declaration inter-State movement of goods, whether or not against a sale, has to be deemed to be an inter-State sale, exigible to tax u/s.6 of the Central Act, such levy would be deemed to be a tax on inter-State consignment of goods for which law referred to in Article 269(3) of the Constitution has yet to be enacted by the Parliament.

The expressions 'subject to the other purposes contained in the Act, or 'for the purpose of this Act' or 'for all purposes of this Act', it is respectfully submitted, have not been construed in the proper context of the various provisions of the Act and the Rules thereunder.

We thank Thee for this place in which we dwell; for the love that unites us; for the peace accorded to us this day; for the hope with which we expect the morrow; for the health, the work, the food, and the bright skies that make our lives delightful; for our friends in all parts of the earth, and our fridenly helpers in this foreign isle. Give us courage and gaiety and the quiet mind. Spare to us our friends, soften to us our enemies. Bless us, if it may be, in all our innocent endeavours. If it may not, give us the strength to encounter that which is to come, that we be brave in peril, constant in tribulation, temperate in wrath, and in all changes of forturne, and down to the gates of death, loyal and loving to one another.

— Robert Louis Stevenson

SEVENTEEN

# Public Interest in Corporate Governance

*C. P. Ramaswamy*

*Any organisation in order to survive and achieve success must have a sound set of beliefs on which it premises all its policies and actions and the most important single factor on corporate success is faithful adherence to those beliefs. The author ensembles the deliberations upon the inculcation of genuine and true spirits of serving the public interest by Corporate personalities. The quintessence of value is truth coupled with fairness. In this article he tries to correlate Corporate Governance with Gandhiji's trusteeship principle's narrating some landmark judgements in the realm of public interest and Corporate Governance which only signifies that the judicial system has to recognize the need for good governance.*

In simple truism, public interest and corporate governance could be called as synonyms. In the real sense corporate governance is for public interest.

*Ambrose Bierce* in his book called "Devil's Dictionary", defined a corporation as an ingenious device for making individual profit without individual responsibility. In common parlance an incorporated company is an artificial juridical person. A Corporation is clothed by a corporate veil, thicker than the "fabled Emperor's clothes" and thinner than gossamer and visible only to the legal fraternity. It is expected to act in a transparent manner-through the board of directors. Transparent to the shareholders, to the creditors, to the company law authorities and to the courts. Every action taken by the corporation should be fair to all these concerned persons. That is where public interest comes.

That government is said to be a good government, which governs the least. When it comes to the corporate governance, can the same principle be applied? Then, what is public interest in the context of corporate governance? In the words of *Lord Macnaghten* "the company is at law a different person altogether from the subscribers and though it may be that after incorporation

the business in precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the act".

*That government is said to be a good government, which governs the least. When it comes to the corporate governance, can the same principle be applied?*

An incorporated company is a legal entity having a legal personality and is described as an artificial person in contrast with the human being, a natural person. By fiction of law it has been attributed aspects of a human being. It can sue and to be sued. It has a perpetual succession. It can own and dispose of the property and so on and so forth. But over a period, the abuses of this corporate personality became apparent. The courts have lifted the veil in order to see that corporate personality is not blandly used as a cloak for fraud or improper conduct. In *United States v. Milwaukee Refrigerator Transit Co.* (1905) 142 Fed. 247, the law on the point was summed up as under. "A *Corporate will be looked upon as a legal entity as a general rule ..... but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons*".

In-re Wood Polymer Ltd. (1977) 109 ITR 177 (Guj.) at page 193 Justice D.A.Desai remarked as under : "*The Court should disregard separate legal personality of a company and ascertain who are in control of the company because in doing so there is an overriding public interest to be served. Ordinarily corporate personality is to be respected, but when a benefit is misused, the court is not powerless and it can lift the veil of corporate personality to see the realities behind the veil because in so doing, the court subserves the important public interest, namely, to arrest misuse or abuse of benefit conferred by law. One such field in which the court lifts the veil and looks behind the realities is the field of taxation. Professor Gower in his treatise, Modern Company Law, 3rd edition, says that only trusted creditor in whose favour Solomon rule has been substantially mitigated is the revenue. In Bankvoor Handel en Scheepvaart N.V. v. Slatford (1951) 2 ALL ER 779, 799(KBD), Devlin J. has observed :*

"No doubt, the legislature can forge a sledgehammer capable of cracking open the corporate shell, and it can, if it chooses, demand that the courts ignore all the conceptions and principles which are at root of company law." In the field of taxation, the legislature has done precisely the same thing.

If the veil is lifted in this case, the realities are startling.

Some corporates consider taxation, of any kind, as a drain on their profit. They are prepared to adopt ways and means to circumvent tax laws with a view to reducing their tax burden. They do not consider it as a duty, in the interest of public, to pay due taxation in accordance with law.

> *"No doubt, the legislature can forge a sledgehammer capable of cracking open the corporate shell, and it can, if it chooses, demand that the courts ignore all the conceptions and principles which are at root of company law."*

Those corporates which are not driven by profit motive alone, have stood the test of time and established themselves as giant corporates. For instance, corporates like Citicorp, Ford, General Electric, Johnson & Johnson, 3M, Proctor & Gamble, Sony etc. have shattered many myths surrounding the corporate world.

In the book called "Built to Last", the authors James Collins and Jerry Porras have listed the realities, which made these corporates explode many popular myths. Such companies are called by the said authors as 'visionary companies'. The myths and underlying realities listed by them are :

Myth - 1 : It takes a great idea to start a great company.

Myth - 2 : Visionary companies require great and charismatic visionary leaders.

Myth - 3 : The most successful companies exist first and foremost to maximise profits.

Myth - 4 : Visionary companies share a common subset of 'correct' core values.

Myth - 5 : The only constant is change.

Myth - 6 : Blue chip companies play it safe.

Myth - 7 : Visionary companies are great places to work, for everyone.

Myth - 8 : Highly successful companies make their best moves by brilliant and complex strategic planning.

Myth - 9. : Companies should hire outside CEO's to stimulate fundamental change.

Myth - 10 : The most successful companies focus primarily on beating the competition.

Myth - 11 : You cannot have your cake and eat it too.

Myth - 12 : Companies become visionary primarily through 'vision statement'.

*Realities* : The visionary companies did not begin life with any great idea. Some even began with outright failures. Maximizing profit and shareholder wealth has not been their primary objective. They had a core ideology and sense of purpose beyond just making money. The crucial variable is: how deeply they believed in their ideology and how consistently they lived, breathed and expressed the ideology in all their activities without compromising their cherished core ideals, how they changed and adapted to different environments. They set up high standards and lived upto them. They engaged in house development of managers. Very rarely they engaged outsiders as CEOs. They persuade visionary objectives and made some of their best moves more by accident then by design.

*Those corporates which are not driven by profit motive alone, have stood the test of time and established themselves as giant corporates.*

The above analysis by *James Collins* and *Jerry Porras* clearly brings out the fundamental characteristics required and manifested in corporates to make them last forever. In reality, such corporates act in harmony with public interest. If one recalls the '*Seven Deadly Sins*' listed by *Mahatma Gandhi*, then how these corporates have generally avoided these sins would be clear. The seven deadly sins are :

- Commerce without ethics
- Knowledge without character
- Politics without principle
- Pleasure without conscience
- Science without humanity
- Wealth without work
- Worship without sacrifice.

If any corporate indulges in any activity attracting any one or more out of the above seven, it can be easily guilty of acting against public interest. Mahatmaji always said that nature has provided adequately for every man's need but not for anybody's greed.

When wheat had to be imported from USA to India under 'PL-480 Scheme' in the late 60's, upto 5% of impurities was permitted. When their wheat stock did not contain impurities, the American Traders added 5% of impurities. This is only one small incident of how profit motive drives people mad at the cost of others life.

*Gandhiji's 'trusteeship principle' is a profound statement on every type of governance with built in public interest. Corporate governance is no exception to that truth.*

If Arthur Anderson had been truthful in its report on Enron, it would not be facing the infamy of prosecution currently. Nor would Enron be called upon to wind up globally.

Harshad Mehta and others abused the funds of Public Sector Undertakings for personal ends and everybody joined in the rat race for making quick money forgetting a statement "if you invest in a fever then your profit is a disease". Bank officials joined hands in the melee. Only two of the auditors (Shri S. P. Chhajed and Shri Arvind H. Dalal both past presidents of ICAI) were truthful in reporting the malpractices of the banks concerned in their audit reports.

All others were sweeping everything under the carpet against public interest. They conveniently forgot their responsibility as independent auditors. Their words carried lot of weight with the public concerned, who relied on such audited reports for making or taking decisions of far reaching consequences.

Similar was the case of *Nick Leeson* in Singapore of Bank of Barclay. When someone is entrusted with public money he should act with much more circumspection and due care and caution in the interest of public. It is common knowledge that corporates are floated to mop up either public money in the form of subscriptions or in the form of credits from the public financial institutions and banks. From the balance sheet of public sector banks it is seen that millions of rupees of loans advanced are written off as irrecoverable. Such instances are too many because public interest was thrown to the winds even at the time of advancing such loans.

It is common knowledge that fly by wire companies are floated with a view to stripping finances and share capital and NBFCs are registered to lure depositors with high rate of interest. Later such corporates have vanished from the scene-defrauding pensioners and widow of their hard earned savings.

Of course, the depositor's greed makes them vulnerable and gullible to such temptations.

Given an option and the elbowroom, corporates would like to comply with all statutory laws and regulations only in form and not in substance. All the ingenuity is expended to maximize profits at any cost by defrauding workmen or revenue. Such measures are carried out without any compunction by those, who are in charge of corporate governance. It is left to the courts to lift the corporate veil or break the corporate shell and remove that facade of corporate personality.

The following three illustrations highlight this point. These are landmark judgements in the realm of Public Interest in Corporate Governance.

*The first case:*

*CIT vs. Sri Meenakshi Mills Ltd. and two others* (63 ITR 609): The three respondent companies which were engaged in the production and sale of cotton yarn at Madurai had each a branch at Pudukottai (a former Native State which was at the relevant time outside British India). The sale proceeds of the branches were periodically deposited in the Pudukottai branch of the Madurai Bank Ltd. either in current accounts of in fixed deposits, which earned interest. That bank was incorporated with Thyagaraya Chettiar as its founder director and with its head office at Madurai. Out of the 15,000 shares which were issued by that bank, 14,766 shares were held by Thyagaraja Chettiar, his two sons and the three respondent companies. These three respondent companies borrowed moneys from the Madurai branch of the bank on the security of the fixed deposits made by their branches with its branch at Pudukottai. The loans granted to them were far in excess of the available profits at Pudukottai.

The Appellant Tribunal found that the three respondent companies had a preponderant, if not the whole, voice in the creation, running and management of the bank; that neither was Pudukottai a cotton producing area nor had it a market for cotton; that, having regard to the special position of Thyagaraja Chettiar, and the balance - sheets of the bank and the lack of investments in Pudukottai, the bank itself was started only to help the financial operations of Thyagaraja Chettiar, and the respondent companies; that the Pudukottai branch of the bank had transmitted funds deposited by the respondent companies to enable its Madurai branch to advance loans to them at interest with the knowledge of the respondent companies, who were the major shareholders of the bank; and that, therefore, the entire transactions formed part of an arrangement or scheme;

Held, on the facts, that the entire transactions formed part of a basic arrangement or scheme between the respondent companies and the bank that the monies deposited by the respondent companies at Pudukottai should be brought into British India after they were taken by the bank outside the taxable territories. Section 42(1) of the Indian Income Tax Act, 1922, applied, and the entire interest on fixed deposits made out of profits earned in Pudukottai by the Pudukottai branches of the respondent companies was assessable to tax.

Held also, that the High Court was not justified in interfering with the findings of fact reached by the Appellate Tribunal and holding that there was no arrangement or scheme between the lender and the borrower for the transference of funds from Pudukottai to Madurai.

The court has power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligations.

*The second case:*

*In-re Wood Polymer Limited and In-re Bengal Hotels Pvt. Ltd.* (1997) 109 ITR 177: Merely because it is shown to the court that the requisite formalities in relation to the proposed scheme of amalgamation have been carried out the court is not bound to sanction the scheme. The court has discretion in the matter either to sanction or to refuse to sanction the scheme.

Where the scheme of amalgamation, of which sanction is sought contemplates dissolution of the transferor-company without winding up, the second proviso to section 394(1) of the Companies Act, 1956, would come into play; and the court is precluded from making an order for dissolution of the transferor-company unless the official liquidator has, on scrutiny of the books and papers of the company, made a report that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest (emphasis supplied).

Where, in the report of the official liquidator it was stated that the transferor-company appeared to have been created solely to facilitate the transfer of a building to the transferee-company without attracting the liability to pay capital gains tax, and in the scheme of amalgamation dissolution of the transferor-company without winding up was sought.

Held, that, notwithstanding that the formalities had been complied with, sanction to the scheme ought to be refused. The court would not, by approving such a scheme of amalgamation, be a party to an arrangement for avoiding payment of capital gains tax.

If the only purpose discernible behind the amalgamation is defeating tax by creating a paper company and transferring an asset to such company which can without consequence be amalgamated with another company to whom the capital asset was to be transferred so that on amalgamation it may pass on to the amalgamating company, it would distinctly appear that the provision for such a scheme of amalgamation was utilised for the avowed object of defeating tax. It is true that the parties may so arrange their affairs that it may amount to avoidance of tax liability and not evasion of tax; law frowns upon tax evasion and not on tax avoidance. But such a benefit cannot be permitted to be enjoyed when it could not be done without the aid of the court. The court is charged with a duty, before it finally permits dissolution of the transferor-company by dissolving it without winding up, to ascertain whether its affairs have been carried on, not only in a manner not prejudicial to its members but in even public interest.

*Public interest looms large in this background and the machinery of judicial process is sought to be utilised for defeating public interest and the court would not lend its assistance to defeat public interest.*

The expression "public interest" must take its colour and content from the context in which it is used. The context in which the expression "public interest" is used, enables the court to find out why the transferor-company came into existence, for what purpose it was set up, who were its promoters, who were controlling it, what object was sought to be achieved through creation of the transferor company and why it was being dissolved by merging it with another company. That is the colour and content of the expression "public interest" as used in the second proviso to section 394(1) of the Act which have to be enquired into. If the only purpose appears to be to acquire certain capital asset through the intermediary of the transferor-company created for that very purpose to meet the requirement of law, and in the process to defeat tax liability which would otherwise arise, it could not be said that the affairs of the transferor - company sought to be amalgamated, created for the sole purpose of facilitating transfer of capital asset through its medium, have not been carried on in a manner prejudicial to public interest.

Public interest looms large in this background and the machinery of judicial process is sought to be utilised for defeating public interest and the court would not lend its assistance to defeat public interest. The court would, therefore, not sanction the scheme of amalgamation (emphasis supplied).

*The third case:*

*Workmen of Associated Rubber Industry Ltd.* v. *Associated Rubber Industry Ltd. and Another* (1986) 157 ITR 77 (S.C): The respondent company had purchased some years back Rs. 4.5 lacs worth of shares of Inarco and the dividends received in respect of those shares were taken into account for the purpose of calculating the bonus payable to its workmen. In 1968, the respondent transferred all those shares to Aril, a wholly owned subsidiary company. Aril had no other business or sources of income whatever except receiving the dividends on Inarco shares. The dividend income was not transferred to the respondent company and it did not find a place in its profit and loss account with the result that the available surplus for payment of bonus to workmen got reduced, and bonus was paid at the rate of 4 percent only for 1969 instead of at 16 percent, to which the workmen would otherwise have been entitled. Subsequently, in 1971, Aril was wound up and amalgamated with the respondent company. The workmen raised an industrial dispute-claiming bonus at 16 percent for 1969. The Industrial Tribunal and the High Court on a writ petition rejected the claim on the ground that the respondent and Aril were two independent companies with separate legal existence and the profit made by Aril could not be treated as the profit of the respondent company. On appeal to the Supreme Court:

Held, reversing the decision of the High Court, that a new company was created wholly owned by the principal company, with no assets of its own except those transferred to it by the principal company, with no business or income of its own except receiving dividends from shares transferred to it by the principal company and serving no purpose whatsoever except to reduce the gross profits of the principal company. These facts spoke for themselves. There could not be direct evidence that the second company was formed as a device to reduce the gross profits of the principal company for whatever purpose. An obvious purpose that was served and which stared one in the face was to reduce the amount to be paid by way of bonus to workmen. It was such an obvious device that no further evidence, direct or circumstantial, was necessary. Since the creation of Aril was a device to reduce the amount to be paid as bonus to the workmen of the respondent company, the separate existence of the two companies had to be ignored and the amount of dividend from Inarco received by the Aril had to be taken into account in assessing the gross profit of the respondent company for the purpose of calculating the rate of bonus payable to the workmen of the respondent company. The workmen entitled to be paid bonus at the rate of 16 percent for 1969.

BY THE COURT

"It is the duty of the court, in every case where ingenuity is expended to avoid taxing and welfare legislations, to get behind smoke-screen and discover the true state of affairs. The court is not to be satisfied with form and leave well alone the substance of a transaction ..... Avoidance of welfare legislation is as common as avoidance of taxation and the approach in considering problems arising out of such avoidance has necessarily to be same? (emphasis supplied)

These decisions are only illustrative and not exhaustive.

*Walter Scott* said "*Without courage there is no truth and without truth there is no other virtue.*" In corporate governance, what is required is the gumption to act truthfully in the interest of public. What is truthful behaviour? *Shakespeare* has answered that in Hamlet, the Prince of Denmark:

> "*Above all*
> *To thine own self be true*
> *And it must as the night follow the day*
> *Thou canst not then be false to any man*"

*Winsten Churchill* once said "Man often tumbles upon truth, but he gathers himself up and quickly runs away from it." This explains the case of Anderson and Enron and all other scams, which one has come across in the corporate world in the last century. That is why no business house survived beyond three generations in the Indian corporate scenario.

What is required is adherence and obedience to law both in letter and in spirit. All laws are common sense codified in a particular style of language. Public interest is always borne in mind while enacting the statutes. Corporates should avoid the practice of complying with the laws only in form and not in substance.

In India, one corporate entity, which has been openly clinging to such lofty ideals in Corporate Governance is 'Infosys'. This can be called a 'visionary company'. A visionary is one, who can see beyond the vision. 'Infosys' belongs to that category of corporates, which have been 'built to last.'

When 'Infosys' came for public issue, there were not enough subscribers. The financial institutions and brokers, who underwrote the public issue, grudgingly subscribed to the large unsubscribed portion of the issued capital. But within a decade, Infosys proved its mettle that it cares for public in the real sense of the term public interest. Shri Narayana Murthy has been leading from the front, based on Gandhian ideals, demonstrating to the whole world

that such ideals are pragmatic and not utopian. When 'Public Interest' clashes with 'Private Interest', the latter must give way to the former. By stepping down from the helm of affairs of 'Infosys', Shri Narayana Murthy never allowed such clash of interest or egos. Altruism and detachment are the hallmarks of public interest. Infosys, by its Corporate Governance, bears eloquent testimony to this principle.

*All laws are common sense codified in a particular style of language. Public interest is always borne in mind while enacting the statutes. Corporates should avoid the practice of complying with the laws only in form and not in substance.*

Growth of Infosys is inspirational. It is desired that it is infectious also. More the Corporates getting infected by 'Infosys syndrome', better it is for public interest.

Essence of all values is truth coupled with fairness. That is why Rotary Club International prescribes to its members to 'apply the 4-way tests', in all their activities - both 'Rotarian' and personal or professional. The '4-way tests' are :—

"The 4-way test of the things we think, say or do:—

a) Is it the truth?

b) Is it fair to all concerned?

c) Will it build goodwill and better friendship?

d) Will it be beneficial to all concerned?

These principles are incorporated in Section 311 of Companies Act, 1956, wherein the financial affairs have to be presented every year to the public in a 'true and fair' manner. Prior to 1956, that usage was 'true and correct', which was intended to mean only arithmetical accuracy of accounts in a true manner. This has been consciously changed to 'true and fair', to mean a fair presentation to all concerned.

*Albert Einstein* once said, "Do not be men of success. Be men of values". Corporate governance should apply this dictum in day to day governance. Then there is no danger to 'Public Interest' from any of their activities. Success or failure is ephemeral whereas values are eternal. That 'ends do not justify means' is the 'value of values'. This simple principle would ensure and safeguard public interest in corporate governance.

*Success or failure is ephemeral whereas values are eternal. That 'ends do not justify means' is the 'value of values'. This simple principle would ensure and safeguard public interest in corporate governance.*

*Trividham narakashyedhamdwaaram naashanmaatmanah:*
*Kaamah krodhastathaa lobhastasmaadettrayam tyajet*
*Ch-4, 16-21, Geeta*

*"Desire, anger and greed disturb the supreme peace and all the happiness of the soul. Not only this but also these three vices are like gateway to hell and sources of greatest unhappiness. Hence Arjun as also any student of karmayoga should abandon all three in the beginning. This is an unfailing remedy for getting rid of pain and sorrows."*

TWENTY-NINE

# Corporate Governance and Globalization

*C. P. Ramaswamy*

*The pecuniary benefits of globalisation should be harnessed in resonance with the humane and societal upliftment of the downtrodden. Corporates owe a responsibility towards the society, as society is the power behind their operation and the reason for their very existence. The author focuses upon the moral and ethical stimulation for wholesome better governance to combat globalisation. Endorsing Swami Vivekanandji, he reiterates that the path of character excellence can only be travelled by dynamic and value based man-making education. The author also corroborates sanskrit verses to enlighten the illumination of ethical responsibility. The article analyses some examples of global corporate irresponsibilities and the only course to ameliorate the state of affairs is to understand and assimilate the societal and humane values also.*

Globalization is a euphemism for economic hegemony. Historically, such monopoly trade generally emanated from the West to the East — with the hon'ble exceptions of Sony's and Toyota's following suit in the last century. For public consumption it is called free market economy. But the old saying reads that there is no free lunch. For the merchant, even honesty is a financial speculation. In that background transnational corporations are established erasing political boundaries, democracies and autocracies and all forms of governance. The singular objective of the multinational corporations is to increase the share value.

The principle of demand and supply is the marrow of free market economy. The entire capitalist world revolves around this principle. In a quiz programme in Moscow Radio, it was asked, " What is the difference between Capitalism and Communism?". The answer was, "Capitalism is man exploiting man and Communism is the opposite of it". That is why *Thomas Jefferson* Said, Almost two centuries back, that the selfish spirit of commerce knows no country and feels no passion or principle but that of gain. Free market economy

supposedly encourages healthy competition. In reality, competition is sought to be crushed. When Pepsi and Coke entered India a decade back, all local soft-drink manufacturers have been systematically phased out in the name of competition. It is the advent of turbo-capitalism by which competitors are wiped out. One is reminded of the prophesy of *Jawaharlal Nehru* (as reported in New York Times, 7th September, 1958) "The force of a capitalist society, if left unchecked, tends to make the rich richer and the poor poorer."

The success of global corporations is measured by the improved bottom line and increased share value. What is the value of values? *Albert Einstein* once said, "Do not be men of success but be men of values". If men of values lay the foundation of all corporates, - then corporate social responsibility would become an achievable object.

What is corporate social responsibility? Is it to ensure that every household has a music system made by Sony or Phillips? Or everyone should have a Nikon or Yashica camera? Or the highways should be filled with Toyotas, Fords and Hondas? The simple answer to all the queries would be an emphatic no. Corporates earn all their profits from the society and so they must ensure and pave the way for the welfare of the society and to upbring all the down trodden. In such an endeavour also global corporations should indulge, without looking at political boundaries. They should not shift all their polluting industries to the under developed countries. In their financial engineering, they should not escalate tension between countries to keep their industries producing arms and ammunitions going.

These are not utopian thoughts because behind every successful corporation there are efficient human beings. So far, their efficiency is being measured only by the profit they have made for the corporations they work. If there is a metamorphosis in their approach and in their concept of efficiency, then the global society will be the beneficiary. How? The answer lies in a verse from *Chandogya Upanisad*. *Swami Ranganathananda* explained this verse in one of his discourses on 'social responsibility of public administrators'. Top echelon of all corporates are public administrators because (a) the capital of the corporates is derived from the public (b) the borrowings are made from public (c) the profit is earned from the public (d) if losses are incurred, then the GDP suffers. Therefore, the principle explained by *Swami Ranganathananda* from *Chandogya Upanisad* is worth considering for implementation in the corproate world also.

*Corporates earn all their profits from the society and so they must ensure and pave the way for the welfare of the society and to upbring all the down trodden.*

It is a very simple Sanskrit utterance. It reads "*Yadeva vidyaya karoti, sraddhaya, upanisada, tadeva viryavattaram bhavati*". It means — *Yadeva karoti* — whatever is done; *vidyaya* — through knowledge — what we call today the 'know-how'. The first thing to acquire is the 'know-how' of a task. Is that enough? No, says the *Upanisad*, and adds: *sraddhaya* — through *sraddha* — faith or conviction; there must be faith in the great urges and longings of man in front of me, faith in the work I am called upon to do to fulfil those urges, and faith in myself - *atma-sraddha* - in my capacity to rise to the occasion. Even these two are not enough. A third quality is also necessary, namely, *upanisada*, through deep thinking and contemplation. Actions done with these three energies behind them alone become not only efficient, *viryavat*, but more and more efficient, *viryavattaram*, says the verse.

Till 1970s and 1980s more emphasis was laid on mere knowledge or vidya or the know-how. *Bertrand Russel* once said that mere knowledge does not have motivation within it. Because that comes from a different source, *viz.*, filled by emotions and sentiments of a man. He said that the knowledge that two sides of a triangle are greater than the third side does not motivate us to go by the shorter side while walking. Mere academic brilliance does not lead one to ideals of human excellence or to patriotism and national dedication, which alone can stimulate the knowledge to develop into character excellence. In the luminous words of *Swami Vivekananda*, the education should be dynamic and "man-making education" leading to a nation building resolve. Motivation should be human motivation and not monetary motivation.

When multinational corporations (manufacturing lifesaving drugs) like Glaxo, Pfizer or SKB are driven by human motivation then their profit motive would be properly channelised. They would not like to fleece their consumers from poor nations. Present pricing policy of corporates world over is nicely summed up by a statement of *Ali Ahmed Attiga* in OPEC, 1974, which reads: "A fair price for oil is whatever you can get plus ten per cent."

*Mere academic brilliance does not lead one to ideals of human excellence or to patriotism and national dedication, which alone can stimulate the knowledge to develop into character excellence.*

From the above discussions one question emerges: what is the basic ill of the global corporate world? In their unstinted pursuit of profits and pelf, corporates stoop to win contracts globally. Bribery is euphemistically called as creative negotiation. For instance, Enron came to India in the business of power generation. In the process, it had no compunction in violating any of the Indian laws. A funny term was used for the speed money paid, which was

called as "educational expenses". In the celebrated satire 'Yes Minister', *Sir Humphrey Appleby* would not like to use words like slush fund, sweeteners or brown envelopes. According to him these are crude and unworthy expressions for creative negotiations. And then the other actor in the satire '*Bernard*' gives a list of informal guidelines for making such payments - a list that is in highly confidential circulation among top multinational companies. The list reads as under :—

*(1) Below $100,000*

- Retainers
- Personal donations
- Special discounts
- Miscellaneous outgoings

*(2) $100,000 to $ 500,000*

- Managerial surcharge
- Operating costs
- Ex-gratia payments
- Agents' fees
- Political contributions
- Extra-contractual payments

*(3) $ 500,000 plus*

*Introduction fees*

- Commission fees
- Managements' expenses
- Administrative overheads
- Advance against profit sharing.

The root cause for the above state of affairs is the managerial avarice of improving the bottom line at any cost. Of course, the corporates are not the only entities to be blamed. When greed overwhelms good governance, 'all the world is a stage and all the regulators, auditors, corporates and banks are the players. They have their exits and their entrances' - like the great fall of 1929, like the great fall of 1989, like the collapse of BCCI (which was nick named as

Bank of Crooks and Criminals International). Indeed, in the case of BCCI, even after the liquidators sued *Price Waterhouse* and *Ernst & Young* for $ 8.5 billion in connection with the 1985 audit of the bank, the Bank of England or any other regulator did not take any disciplinary action against any of their staff members. Their attitude was 'you ask no questions - we tell no lies'. The behaviour of the American regulators in this regard was 'equally commendable'. Though the investigation headed by *Senator John Kerry* was more penetrating and the regulators' shortcomings were described in various hearings and publications, they all walked away. None was sued for negligence.

*When greed overwhelms good governance, 'all the world is a stage and all the regulators, auditors, corporates and banks are the players. They have their exits and their entrances'*

Similarly, *Neek Leeson* erased the partitions between the dealing desk and back office operations for almost three years at Singapore branch of British Merchant Bank, Barings. His seniors were living in their own paradise that Leeson had discovered a financial paradise. His employers were busy in counting their fat bonuses from his exploits of embezzlement.

*The corporate responsibility depends on the moral caliber of the human beings managing the affairs of each corporate – in any capacity as manager, regulator or auditor. Each of these players must realize his responsibility to the society and bestow the same in their day to day duties.*

Similar criminal misappropriation of funds belonging to public sector undertakings in India were routed through both public sector and foreign banks by Harshad Mehta and other stock brokers all over India, which lead to the securities and stock scam of 1992 and culminated in liquidation of Bank of Karad and Metropolitan Co-operative Bank. Despite this experience, within a decade thereafter, the regulators and the bourses failed to contain Khetan Parekh from executing another fraud on the stock market through a co-operative bank. Contributory negligence of a greater degree was committed by the auditors in all these instances. Though in US and UK auditors of both BCCI and Barings were 'perceived to have deep pockets' and were sued for damages, no such action was taken against any of the erring auditors in India. Even the Institute of Chartered Accountants of India had not black listed any of the auditors who gave clean chits to the banks or the PSUs or the brokers involved in the 1992 scam.

## Twenty-Nine — Corporate Governance and Globalization

The human nature has not changed in the recorded history of 5000 years. The corporate responsibility depends on the moral caliber of the human beings managing the affairs of each corporate - in any capacity as manager, regulator or auditor. Each of these players must realize his responsibility to the society and bestow the same in their day to day duties. Otherwise, corporates guided by them will be epitomes of corporate irresponsibility (like the illustrative cases discussed supra).

In short, what is corporate social responsibility in the global scenario? The answer is embedded in a short Tamil verse from Thirukkural.

*'Vanigam Cheivarkku Vanigam Peni*
*Piravum Tamapor Cheyin'.*

It means: "A trader is known to be a successful and good trader when he guards another's interests as his own." This principle should be the motto for WTO as well as for Global Corporate Governance.

***The greatest challenge is to ensure that not only the wealth created is sustainable but also that the benefits of globalisation accure to everyone.***
***— Sir Bryan Nicholson***