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Article

'Liable to Tax': History and impact on Treaties

By **Ravi Sawana**

Introduction

The DTAAs[1], as per 'Article 1 – Personal Scope', applies to those persons who are residents of either of the two country. Article 4 of the DTAA defines the term 'resident of a contracting state'. Article 4(1) of the OECD Model Convention of 2017 *inter-alia* provides that the term 'resident of a contracting state' means any person under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criteria of similar nature. However, it is worth noting that the OECD Model Convention of 2017 does not define the term 'liable to tax'.

In almost all the treaties, the determination of residency under Article 4(1) requires that the person to be 'liable to tax' in its country so as to claim protection from double taxation under the respective DTAAs. However, this term was neither defined under the DTAAs nor under the domestic income-tax law of India.

Klaus Vogel in his commentary on DTAAs says that '*To the extent that an exemption is agreed to, its effect is in principle independent of both whether the Contracting State imposes a tax in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax….Thus, it is said that the treaty prevents not only 'current' but also merely 'potential' double taxation…..only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one of the Contracting States dependent upon whether the income or capital is taxable in the other Contracting State, or upon whether it is actually taxed there.*'

In the Indian context, in order to determine whether a person is resident under Article 4(1), the Courts in India were faced to answer as to whether such person is 'liable to tax' in the other country. In absence of any definition, the Indian rulings[2] [except in [1999] 239 ITR 650 (AAR) & (2005) 276 ITR 306 (AAR)] have interpreted this term in manner that 'liable to tax' does not mean actual liability or payment of tax by a person in its country. It is sufficient if the country has sovereign powers to tax irrespective of actual exercise of such power. 'Liable to tax' cannot be equated with 'subject to tax'. Thus, based on such an interpretation, the benefit of DTAAs have been extended even to those persons who were not paying any taxes in their home country. E.g. in the case of India-UAE DTAA, as it stood prior to amendment in 2007, it has been noted that even in the absence of any existing tax liability on the individuals residing in UAE, the sovereign of UAE has power to levy tax on income earned by persons residing there. The fact that UAE has not exercised its sovereign power to levy tax on individuals, cannot be a ground to say that an individual is not 'liable to tax' in UAE. Even a potential liability to pay tax in UAE, would amount

[1] Double Taxation Avoidance Agreements.

[2] (2003) 263 ITR 706 (SC), [2006] 6 SOT 329 (Mumbai), [2011] 47 SOT 454 (Delhi), [2010] 39 SOT 132 (Mumbai), [2014] 66 SOT 224 (Pune) and [1995] 213 ITR 317 (AAR).

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to 'liable to tax'. Based on this, benefit of India-UAE DTAA has been accorded to individuals.

Finance Act, 2020 – Deemed Residency

The Finance Act, 2020 introduced the concept of 'deemed residency'. Clause (1A) to Section 6 of the Income-tax Act, 1961 ('**Act**') was introduced. This clause provided that if an individual, who is a citizen of India, has income from Indian sources exceeding fifteen lakh rupees and such individual is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature, then such an individual shall be treated as 'deemed resident' of India[3]. Though the concept of 'deemed residency' was dependent on 'liable to tax', the Finance Act, 2020 did not introduce any definition of this phrase.

Finance Act, 2021 – 'Liable to tax' defined

Section 2(29A) of the Act now defines 'liable to tax' to mean existence of income-tax liability on the person under the laws of its country for the time being in force. The definition further expressly includes a person who has subsequently been exempted from such liability in that country. The first part of definition puts a condition of actual liability to income-tax liability. Thus, the fact that there is potential for the sovereign to levy tax in future, may no longer be sufficient to qualify as 'liable to tax'. The second part of the definition recognises the principle laid down in *Azadi Bachao Andolan* [2003] 263 ITR 706 (SC)] that liable to tax does not necessarily mean actual payment of tax and expressly covers persons, who are exempted from payment of taxes, either conditionally or unconditionally.

Impact on interpretation of DTAA

The question which now arises is whether the definition of 'liable to tax' introduced under the Indian domestic law will have a bearing on determination of residency under DTAA [usually Article 4(1)].

One school of thought can be that definition of 'liable to tax' provided under Section 2(29A) of the Act can be read into Article 4(1) of the DTAAs. Support in this behalf would be drawn, *firstly*, from the intention of the legislature behind defining this term. *Secondly*, in the absence of any definition under the DTAAs, support would also be drawn from Article 3(2) of the DTAAs which provides that 'any term not defined in this Agreement shall, unless the context otherwise requires, have the meaning which it has under the laws of that State from time to time in force relating to the taxes to which this Agreement applies.' *Thirdly*, support can also be drawn from Explanation 4 to Section 90 of the Act which provides that any term not defined in the DTAAs, shall have the same meanings as assigned under the Act.

Another school of thought which is more logical is that to interpret any definition of domestic law into the treaty, it is necessary to look at the context in which the definition has been provided for under the domestic law. Before reading a domestic law definition into the treaty, Article 3(2) requires 'contextual similarity' by expressly stating 'unless the context otherwise requires'. The context is determined in particular by the intention of the Contracting States when signing the DTAA as well as the meaning given to the term in question in the legislation of the other Contracting State.

[3] Clause (d) to Section 6(6) of the Act was also introduced to treat such individuals as 'resident but not ordinary resident'. Thus, such individual would only be taxable in respect of income accrue or arise or received in India. As regards incomes from foreign sources, such individuals would not be taxable in India.

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An important principle which needs to be kept in mind in the interpretation of the provisions of an international treaty, including one for double taxation relief, is that treaties are negotiated and entered into at a political level and have several considerations as their bases. The main function of a DTAA should be seen in the context of aiding commercial relations between treaty partners and as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect of income falling to be taxed in both jurisdictions.[4] Article 31(1) of the Vienna Convention[5] also states that 'A treaty shall be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its object and purpose'.

The definition provided in the Act envisages actual levy of income-tax under the laws of another country. As contrary to this, the term 'liable to tax', as generally understood, as employed under the DTAA, does not contemplate actual levy or payment of tax. It is sufficient if the Country has sovereign powers to tax irrespective of actual exercise of such power. This assumes more significance because most of the treaties under article 'methods for elimination of double taxation' (as this title is commonly used) allows credit for taxes paid in the foreign jurisdiction provided the income has been 'subject to taxation' therein. 'Subject to taxation' means that the person has actually paid the taxes in foreign jurisdiction. Thus, the treaty has used two different terminologies i.e. liable to tax vis-à-vis subject to tax, with reference to two different contexts.

Now, if the term 'liable to tax' under Article 4(1) is understood as it has been defined under Section 2(29A) of the Act i.e. under Indian Income-tax law, then it would amount to equating the two terms under the DTAA i.e. liable to tax vis-à-vis subject to tax. This cannot be the context of the treaty and understanding of the two Countries when the treaty would have been signed.

Therefore, the context of definition of liable to tax under Section 2(29A) of the Act is different than the use of this term under the DTAA and accordingly, this definition cannot be imported into treaty.

Conclusion

Based on the above discussion, the answer to the question as to whether this new definition of 'liable to tax' can be read into the DTAAs for determination of 'residency' appears to be 'NO'. Thus, as long as a person produces a valid 'tax residency certificate' of a country with which India has a treaty, it can be argued that treaty benefit cannot be denied to such person even if the country in question does not levy any income-tax. Interestingly, this definition would not have any impact for treaties with countries like UAE, where residency is determined by reference to number of days in UAE and not based on liability to tax in UAE.

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[4] UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC).
[5] Vienna Convention on the Law of Treaties.

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Notifications & Circulars

New rules for determining taxability on reconstitution of firms notified

The CBDT has notified Rule 8AA(5) under the Income-tax Rules, providing for characterization of the nature of capital gains (i.e. long term or short term) under Section 45(4) of the Income-tax Act. It provides that where the amount of capital gains chargeable under Section 45(4) is attributed to short-term capital asset if such asset is forming part of a block of assets or a self-generated asset or goodwill, then capital gains shall be chargeable as short-term capital gain. Otherwise, it shall be deemed to be transferred from long term capital asset.

New Rule 8AB has been inserted which deals with the attribution of income taxable under Section 45(4) of the Act to the capital assets remaining with the specified entity, under Section 48 of the Act. Further, new Form No. 5C has also been introduced in which the details of amount attributed

Manner of computation of Capital Gains and WDV of asset under Section 50 prescribed

The Finance Act, 2021 has inserted a proviso to Section 50(2) of the Income-tax Act providing that the computation of the Written Down Value ('WDV') and the Capital gains of a block of asset of which goodwill is a part, shall be as per the prescribed manner. Now, the CBDT has inserted Rule 8AC in the Income-tax Rules, 1962 prescribing the manner in which the WDV and the Capital Gain shall be computed.

The new Rule provides for a mechanism whereby the actual cost of the goodwill (net of depreciation allowed) is effectively eliminated from the computation of the Capital Gains as well as the WDV of the block of assets.

Exemptions – Omission of certain Rules and Forms under Income-tax Rules

The Income-tax Act, 1961 provides tax holidays, deductions and exemptions to specified categories of persons upon fulfilment of certain conditions. The related rules and forms to claim these benefits have also been prescribed. However, the sun-set date for claiming these benefits have come to an end and therefore, these benefits are no longer available.

Recently, the Central Boards of Direct Taxes ('CBDT') has notified Rule 130 under the Income-tax Rules, 1962 which has come into force from the date of publication of notification in the official gazette i.e. 29 July 2021. This rule seeks to omit 24 existing rules under the Income-tax Rules, 1962 and 72 Forms, relating to various tax benefits under the Income-tax Act, 1961 which are now no longer available. This omission is in order to simplify the statute.

However, due to oversight and inadvertent error, the CBDT has also omitted Rule 16D and Form 56F which are related to deductions provided under both, Sections 10A and 10AA of the Act. Even though the deduction under Section 10A is no longer available, however, deduction continues to be available under Section 10AA until the Assessment Year 2036-2037, to the relevant undertakings or units commencing business before the 1st day of April 2021.

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Ratio Decidendi

Assessing Officer must follow the procedure laid down under Rule 28AA, while passing an order under Section 197

The Assessee was entitled to receive certain interest income from its group companies which were subject to withholding tax provisions under Section 194A of the Income-tax Act, 1961 ('Act'). Since the assessee was a loss-making company, it applied for a certificate of deduction of TDS at Nil rate under Section 197 of the Act.

The Assessing Officer ('AO') passed an order under Section 197 rejecting the application on the ground that the assessee has failed to furnish the rate of interest at which it borrowed the funds from the market, which were thereafter lent to the group companies at the rate of 9.45%.

On writ petition, the Delhi High Court set aside the order passed under Section 197 by holding that it was cryptic and provided no reason for the rejection. It was of the view that while considering the applications made under Section 197, the AO must follow the mandate of Rule 28AA and cannot proceed on any other basis. The matter was consequently remanded back to the AO for *de novo* hearing. [*Hero Wind Energy Private Limited* v. *CIT* - TS-543-HC-2021(DEL)]

Proceeds from sale of certified emission reduction credit, are capital receipt and not business income

The assessee received certain amount on the sale of Certified Emission Reduction Credit ('Carbon Credits'), which it had earned on the Clean Development Mechanism in its wind energy operations. In the return of income, these sale proceeds were treated as capital receipt and not offered to tax. The AO treated the proceeds from sale of carbon credits as business income under Section 28(i) of the Income-tax Act. The CIT(A) confirmed the findings of the AO.

On appeal, the Income-tax Appellate Tribunal ('Tribunal'), relying on the decision in the case of *CIT* v. *My Home Power Ltd.* [2014] 365 ITR 82 (AP)], held that receipts from sale of carbon credits are in the nature of capital receipts.

On revenue's appeal, the Madras High Court, relying the decision in the case of *CIT* v. *My Home Power Ltd.* (supra) and its earlier rulings in the cases of *CIT* v. *Ambika Cotton Mills Ltd.*, and *S.P. Spinning Mills (P.) Ltd.* v. *ACIT*, dismissed the revenue's appeal. In the said cases, it had been held that carbon credits were not an offshoot of business but an offshoot of environmental concerns. No asset is generated in the course of business, but it is generated due to environmental concerns. Further, the generation of carbon credits is not even directly linked with the power generation done by the assessee. Therefore, it was held that proceeds from Carbon Credits were capital receipts and not a business income. [*CIT* v. *VMD Mills (P.) Ltd.* - [2021] 127 taxmann.com 811 (Madras)]

Whether protection under tax treaties for taxation of dividend in the source jurisdiction extends to DDT under Section 115-O in the hands of a domestic company, even in absence of a specific treaty provision to this effect? – Issue referred to Special Bench of ITAT

The assessee company distributed dividend to its non-resident shareholders who were fiscally domiciled in France. The assessee paid dividend

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distribution tax ('DDT') under Section 115-O of the Act. In the cross-objection filed by the assessee, it was contended that DDT is tax on dividend income of the shareholders. In the present case, shareholders are residents of France and therefore, DDT rate cannot exceed the rate at which such dividends can be taxed under the benefits of the India France Double Taxation Avoidance Agreement ('DTAA'). In support thereof, the assessee relied on Delhi Tribunal decision in the case of *Giesecke & Devrient India Pvt Ltd.* v. *ACIT* which had held that tax rates specified in DTAA in respect of dividend must prevail over DDT.

The Tribunal doubted the correctness of the decisions in *Giesecke & Devrient India Pvt Ltd.* and *Indian Oil Petronas Pvt. Ltd*. on the dividend distribution tax rate being restricted by the treaty provision dealing with taxation of dividends in the hands of the shareholders, based on following reasons:

i. The decision of the SC in *Godrej & Boyce Mfg. Co. Ltd.* held that the payment of DDT does not discharge the tax liability of the shareholders, and it is a liability of the company and discharged by the company. Therefore, DDT cannot be treated as tax paid on behalf of the recipient, i.e. the shareholders. Further, the division bench in *Giesecke & Devrient India Pvt Ltd*'s case did not have any occasion to deal with this judicial precedent from Hon'ble SC.

ii. Reliance by the assessee on decision of the Apex Court in *Tata Tea Co. Ltd.* [(2017) 398 ITR 260 (SC)] was misplaced.

iii. The treaty protection sought in this case goes beyond the purpose of the treaty as the payment of DDT is wholly tax-neutral *vis-à-vis* foreign resident shareholder and could only benefit the domestic company. The payment of DDT is neither available to the shareholder as credit nor prejudices the interest of shareholder and therefore, DDT cannot be equated with tax paid by shareholder on dividend.

iv. If a tax treaty intends to extend the protection with respect to DDT, it must specifically provide for the same under the treaty itself, as provided under the India Hungary DTAA. However, no such specific provision is provided under the India France DTAA, therefore it cannot be interpreted in such a manner.

v. When the taxes are paid by the resident of India, in respect of its own liability in India, such taxation in India, in our considered view, cannot be protected or influenced by a tax treaty provision, unless a specific provision exists in the related tax treaty enabling extension of the treaty protection.

vi. The dividend distribution tax, not being a tax paid by or on behalf of a resident of treaty partner jurisdiction, cannot thus be curtailed by a tax treaty provision.

Thus, the Tribunal was of the view that it was a fit case for the constitution of a Special Bench, consisting of three or more Members, so that all the aspects relating to this issue can be considered in a holistic and comprehensive manner. It directed the Registry to place the matter before the President for his kind consideration and for appropriate orders. [*DCIT* v. *Total Oil India (P.) Ltd.* – [2021] 127 taxmann.com 774 (Mumbai - Trib.)]

Alteration of book profits (for MAT) as certified by an accountant, is beyond the AO's powers and re-computation under Section 115JB is not allowable

In the return of income, the assessee declared book profits after providing for liability towards

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administrative charges on molasses imposed by the Excise Department which formed part of the rates and taxes related to earlier Financial Years 2007-08 and 2008-09. The assessee had explained that no such provision was created in earlier years due to a stay order imposed by the High Court of Allahabad on recovery of these administrative charges by the Excise Department. However, on a SLP filed by the Revenue, the Supreme Court had directed the assessee to deposit the entire amount due to the State and maintain proper records.

The AO rejected the assessee's explanations and recomputed the book profits and increased them by INR 1.03 crore under Section 115JB, made for the provision of administrative charges for the assessment year on the ground that the P&L a/c has not been maintained by the assessee in accordance with the Companies Act, 1956. On appeal, the CIT(A) upheld the action of the AO.

On appeal, the Tribunal relied on the decisions of the Supreme Court in the cases of *Apollo Tyres* [255 ITR 273] and *Malayala Manorama Co. Ltd.* [300 1TR 251], to hold that the jurisdiction of the AO under Section 115JB is limited to examine whether the books of account are certified by the prescribed auditors under the Companies Act as having been properly maintained in accordance with the Companies Act. Therefore, the AO is not empowered to embark upon a fresh query in determining the book profit so as to arrive at a re-computation to increase or decrease the same.

Further, it was observed that the book profits as per the accounts maintained by the assessee complied with the Accounting Standards under the Companies Act. In this regard, the Tribunal relied on the decision of the Delhi High Court in *CIT* v. *Khaitan Chemicals & Fertilizers Ltd.*, where it has been held that expenses or liabilities from a prior period are to be adjusted in computing the net profit in the current period under Section 115JB. [*Tikaula Sugar Mills Ltd.* v. *ACIT* - TS-531-ITAT-2021(DEL)]

Change in domicile of a company would not lead to denial of Treaty benefits

The assessee was originally incorporated and registered in the British Virgin Islands ('BVI') in 1991 as an 'international business company'. Subsequently, this company was re-domiciled in Mauritius in 1998 as a private company limited by shares, on the issuance of 'certificate of incorporation by continuation' by the Registrar of Companies ('ROC'), Mauritius. Another certificate was issued by the ROC in BVI, stating that the company has discontinued its operations in the country.

One of issues in appeal related to availability of India-Mauritius DTAA benefit, the Revenue contended that the assessee was incorporated in BVI and therefore, the benefits of India-Mauritius DTAA cannot be granted to the assessee.

The Tribunal held that this is a case of 'Corporate re-domiciliation' which is the process of shifting the domicile of a company from one jurisdiction to another, while maintaining the same legal identity and staying alive for all purposes. The reasons for such re-domiciliation could be related to the appropriateness of the business and legal conditions in a country with respect to such company's purpose and future prospects. Further, it was held that a re-domiciliation of the company by itself, cannot lead to denial of treaty entitlements of the jurisdiction in which the company is now re-domiciled. Although, the fact of re-domiciliation of the company could trigger detailed examination or the re-domiciled

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company being actually fiscally domiciled in that jurisdiction, however, in the present case there is no material to suggest that the assessee company is now not fiscally domiciled in the Mauritius. Therefore, there cannot be any reason to reject the treaty entitlement in question.

As regards computation of profits attributable to existence of dependent agent permanent establishment, the Tribunal adopted 'two taxpayers approach' which was also upheld in *DDIT* v. *Set Satellite (Singapore) Pte Ltd* [(2007) 106 ITD 175 (Mum)] and recommended by Klaus Vogel and approved by OECD. The 'two taxpayers approach' entails that a 'Dependent Agent' ('DA') and a 'Dependent Agent Permanent Establishment' ('DAPE'), are two distinct things. It is as a result of existence of a DA that the foreign enterprise is 'deemed to have' a permanent establishment in the country in which DA is situated. The DAPE is a hypothetical establishment, taxability of which is on the basis of revenues of the activities of the foreign enterprise attributable to the PE, in turn based on the FAR analysis of the DAPE, minus the payments attributable in respect of such activities. In simple words, whatever are the revenues generated on account of functional analysis of the DAPE are to be taken into account as hypothetical income of the said DAPE, and deduction is to be provided in respect of all the expenses incurred by such foreign enterprise to earn such revenues, including, of course, the remuneration paid to the DA.

As regards taxability of DAPE, the Tribunal held that as long as DA is paid an arm's length remuneration for the services rendered, nothing survives for taxation in the hands of the DAPE. Viewed thus, the existence of a DAPE is wholly tax neutral. [*ADIT* v. *Asia Today Ltd.* [2021] 129 taxmann.com 35 (Mum)]

Failure on part of Assessing Officer to follow procedure under Section 144C(1) is not a merely procedural or inadvertent error, but a breach of a mandatory provision

The assessee, an Indian company, had entered into certain international transactions. These transactions examined by the Transfer Pricing Officer ('TPO') who proposed transfer pricing adjustment. As against the adjustment proposed by TPO, the assessee filed its reply before the National e-Assessment Centre. Subsequent thereto, a final assessment order under Section 143(3) read with Sections 143(3A) and 143(3B) of the Act was passed against the assessee. The assessee filed a writ petition before the High Court of Bombay ('HC'), challenging the validity of the final assessment order.

As regards the question whether the provisions of Section 144C(1) of the Act are mandatory and directory in nature, the HC held that Section 144C(1) of the Act are mandatory in nature.

As regards the question whether failure to give an opportunity of fling objections to Petitioner under Section 144C(2) of the Act would be a mere procedural error or a jurisdictional error, the HC, relying on the decision in case of *Commissioner of Income Tax, Vadodara-2* v. *C-Sam (India) (P.) Limited* [2017] 84 taxmann.com 261 (Gujarat) and other similar decisions, held that failure to follow the procedure under Section 144C(1) would be a jurisdictional error and not merely procedural error or irregularity. Further, such a jurisdictional error cannot be saved by Section 292B of the Act as it is an incurable illegality. [*SHL (India) (P.) Ltd.* v. *DCIT* - [2021] 128 taxmann.com 426 (Bombay)]

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DEPB incentives are not subject to arm's length pricing computation

In the return of income, the assessee claimed deduction under Section 80-IA of the Act. The AO referred the computation of ALP in respect of international transactions to the TPO. Before the TPO, the assessee argued that DEPB incentives should be considered for adjustment under Section 10B(1)(a)(ii) of the Act which provides that the international transaction prices shall be adjusted to account for differences which could materially affect the price in the open market. The TPO held that such incentives are available only in India which could not be passed in favour of any entity outside the territory. On appeal, the CIT(A) directed the AO to verify and consider the DPEB benefit for comparability analysis and re-work the consequential adjustment of the selling price.

On revenue's appeal, the Tribunal held that Chapter-X of the Act which deals with computation of ALP, is 'special' provision as against all other general provisions including Section(s) 10, 10A, 10AA and 10B etc. The assessee's argument seeking to include DEPB as an adjustment for 'ALP' computation because it is in the nature of an operating income, ought not be accepted as it tends to have an overriding effect on application of chapter-X of the Act as per stricter interpretation rule. [*DCIT* v. *Nava Bharat Ventures Ltd.* - TS-314-ITAT-2021(HYD)-TP]

Notional interest adjustment on delayed receivables not permissible where assessee is a debt-free company

The assessee, an Indian company, had provided software programming and applications developers services and marketing support services to its associated enterprises. During the transfer pricing proceedings, the TPO held that assessee has not received the payments for the invoices within the stipulated time as provided in the service agreement with the AE's. Therefore, the delayed payments are being treated as unsecured loans advanced to the AE and computed interest adjustment @ 12.51% (6 months LIBOR plus 400 basic point for computing notional interest) for the delayed period. The DRP upheld the action of TPO.

On appeal, the Tribunal observed that the assessee was a debt-free company. It relied on the decision of *PCIT* v. *Bechtel India Pvt. Ltd.* [TS-508-HC-2016(DEL)-TP] and held that when the assessee is having their own funds and not paying interest on any loans, then there is no obligation on the assessee to charge interest from the interest free loan given nor any provision of the Act mandate the AO to add notional interest received to the total income. Accordingly, the notional interest adjustment proposed by the TPO was deleted. [*Avaya India Pvt. Ltd.* v. *ACIT* - TS-286-ITAT-2021(DEL)-TP]

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