

# Primer on Double Taxation Avoidance Agreements

## DOING BUSINESS IN INDIA

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**Ms. Vidya Rajan**, with Indian law firm BRUS CHAMBERS, studies the United Nations Model Convention on Double Taxation Avoidance Agreements. This article gives a brief introduction of the history of DTAA and proceeds to analyse each section therein, while laying down the steps that need to be followed while applying the convention to the assessee in order to gain the benefit of the double taxation Avoidance Agreements.



Double taxation is the levying of tax by two or more jurisdictions on the same declared income, profits, dividend, interest, royalties, etc. The DTAA (Double Taxation Avoidance Agreement) is a positive step taken towards the avoidance of double taxation that may be faced by individuals or enterprises, or persons, in general, including companies in another state apart from their state of residence by virtue of a presence, economic and otherwise in such other state. The initiative of elimination of double taxation was originally taken up by the League of Nations and was pursued in the OEEC (Organisation for European Economic Co-operation), which is presently known as the OECD (Organisation for Economic Co-operation and Development). The DTAA is consent based bilateral agreement between two contracting states, setting out the essentials and the terminology and most importantly the methods of computation of taxes for the avoidance of double taxation. The United Nations Model Convention as well as the OECD Model Convention<sup>1</sup> are consistent with each other with regards to the basic Framework and the

articles of the Conventions, modifying the articles, wherever necessary.

The United Nation Model Convention pertaining to the Double Taxation Avoidance Agreements<sup>2</sup> is only a model as the name suggests and the contracting states may modify or alter the provisions of this convention to best suit the conditions prevalent in such contracting states keeping in mind the framework or the essence of the convention. Thus to read a DTAA it is primordial to appreciate the structure presented by the stated model convention, the architecture and the provisions of each article of DTAA forming the convention.

It is to be noted that primarily all DTAAs follow the same article numbering for each articles therein.

The provisions of the Model Conventions may be grouped as follows:

<sup>1</sup> <http://www.oecd.org/tax/treaties/1914467.pdf>

<sup>2</sup>

[http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf)

- a. **Scope provisions:** Article 1 (Personal Scope), Article 2 (Taxes Covered), Article 29 (Entry into force) and Article 30 (Termination)
- b. **Definition provisions:** Article 3 (General definitions), Article 4 (Resident), Article 5 (Permanent Establishment)
- c. **Substantive provisions:** Article 6 (Income from immovable property), Article 7 (Business Profits), Article 8 (Shipping, Inland Waterways Transport And Air Transport), Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties), Article 13 (Capital Gains), Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services), Article 16 (Directors' Fees And Remuneration Of Top-Level Managerial Officials), Article 17 (Artistes And Sportspersons), Article 18 (Pensions And Social Security Payments), Article 19 (Government Service), Article 20 (Students), Article 21 (Other Income), Article 22 (Capital)
- d. **Provisions for the elimination of double taxation:** Article 23 (Exemption Method/ Credit Method), Article 25 (Mutual Agreement Procedure)
- e. **Anti-avoidance Provisions:** Article 9 (Associated Enterprises), Article 26 (Exchange Of Information), Article 27 (Assistance In The Collection Of Taxes)
- f. **Miscellaneous Provisions:** Article 24 (Non-Discrimination), Article 28 (Members Of Diplomatic Missions And Consular Posts)

Herein is a brief analysis of the United Nations Model Convention on DTAA,

## SCOPE OF THE CONVENTION

### Article 1 -PERSONS COVERED

This article states that the DTAA convention shall be applicable to persons who are residents of one or both of the contracting states to such convention. An analysis of this article will point out that the first and foremost thing to be taken into account is that the entity that seeks to take advantage of the DTAA must be a 'person' as defined in article 3 of the convention and must also be a 'resident' as defined in article 4 of the convention of at least one of the contracting states. An individual who is a resident of a state other than the respective contracting states to the convention cannot seek to take advantage of the DTAA between the said contracting states.

### Article 2-TAXES COVERED

The Model Convention is to apply only to the direct taxes, that is to say the taxes on income and capital and does not include indirect taxes in its gambit. It makes a further provision in order to avoid the difficulty of repeatedly amending the convention by stating that such taxes are to include any other identical or substantially similar taxes which are imposed in the contracting states after the date of signature of the convention, in addition to or in place of the said existing taxes. The Convention imposes an obligation on the contracting parties by making it mandatory for each of contracting parties to inform the other contracting party about any substantial changes in its tax laws.

## DEFINITIONS

### Article 3- GENERAL DEFINITIONS

The convention goes on to define certain important terms used therein thereafter such as 'person', 'company', 'enterprise of a contracting state', 'enterprise of the other contracting state', 'international traffic', 'competent authority' and 'national'. When read with the definition of the term 'company', a 'person' to whom such convention will be applicable shall include an individual, a body of persons, any other entity, whether corporate or non corporate as well as any entity which is treated as a body corporate for the purposes of taxation. However, since the terms 'body corporate', 'enterprise', 'competent authority' are not defined in the Model Convention, it is open to the Contracting States to give the interpretation, that applies best to them. The convention provides that in its application by a contracting party to it, if any term is not defined in the convention, such term will have the definition that it has under the tax laws of the said contracting state for the said purpose. The commentary on article 3 of the model convention clears the ambiguity with respect to the interpretation of any term not defined in the convention by stating that in case of a conflict between the law in force at the time of signing the Convention and the law in force at the time of application of the convention, the latter law will prevail.

It also defines the term 'International traffic' which is relevant with taxation of income from shipping and air transport of an enterprise having its effective management in a state. It deals with International traffic with respect to aircrafts and ships, excluding domestic traffic which is to be taxed in the state where domestic traffic occurs.

### Article 4- RESIDENT

For the purposes of applicability of the convention, a 'resident' of a contracting state is given to define any person, who is liable to taxation in that state according to the domestic laws of that state. Such a liability may arise on account of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. However, for the purposes of applicability of the convention, it is to be noted that, it shall not be applicable to a person who is liable to tax in that contracting state in respect of only the income from sources in that state or capital situated in such contracting state.

The convention further lays down detailed provisions in the event that a person is a resident in both the contracting states, the person's status with respect to the applicability of the provisions of this convention must be determined according to the following factors:

- a. The state where the person has a permanent residence
- b. The state where the person's personal and economic relations are closer
- c. The state in which the person has a habitual abode
- d. The state of which the person is a national

If none of the above factors help in determination of the status of the person, then the competent authorities of the respective contracting states shall determine the same by mutual agreement. Where the individual in question is a company, then it shall be considered as the resident of the contracting state in which there is effective management of such company.

## Article 5- PERMANENT ESTABLISHMENT

Article 5 solely speaks about the 'permanent establishment' of an enterprise in a contracting state other than the contracting state of residence of such enterprise, laying stress to it to be read with and giving essence to article 7 of the Convention. The article describes a 'permanent establishment' as a fixed place of business through which the business of an enterprise is wholly or partly carried out. This article further goes on to elaborate and give illustrations of what establishments may or may not be considered as a 'permanent establishment'. In certain cases, even persons acting as agents for the enterprise may be considered as a 'permanent establishment' in respect of any activities that such agent or person undertakes for the enterprise. However, in order for an agent of an enterprise to be termed as 'permanent establishment', the following factors are considered:

- a. Status of agent, whether dependent or independent;
- b. Authority to conclude contracts in the name of the enterprise in that state;
- c. Maintenance of a stock of goods or merchandise in the state from which he regularly delivers goods and merchandise on behalf of the enterprise.

In case of an insurance enterprise of a contracting state, it shall be deemed to be a 'permanent establishment' in the other contracting state if it collects premiums or insures risks situated therein through an agent other than an independent agent.

In the event of a parent-subsidiary relationship, if the parent company is situated in one of the contracting states and the subsidiary company is situated in the other contracting state, the convention clarifies that neither the parent company, nor the subsidiary company will be considered as a permanent establishment of the other in the other contracting state.

## TAXATION OF INCOME

### Article 6 - INCOME FROM IMMOVABLE PROPERTY

The convention does not specifically define the term 'immovable property'. However, it lays down that such property may be defined in conformity with the domestic laws of the contracting state in which such 'immovable property' is situated. The convention proceeds to lay down that in case of the income derived by a resident from the immovable property situated in a contracting state other than the one in which such person is a resident, such income may be liable to taxation in such other contracting state in which the immovable property is situated following the principle of law of *situs*. The article lays down that the income derived from immovable property in such a case would also include the income derived from agriculture or forestry or the income derived from the direct use or letting or any other use of immovable property as well as the income derived from the immovable property of an enterprise and the income derived from the immovable property used for the performance of independent personal services. Immovable property shall also include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply,

usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. The convention however provides an exhaustive list of exceptions to this category of immovable property by stating that such 'immovable property' shall specifically not include ships, boats and aircrafts.

It is noteworthy that this article has been worded in a manner so as to provide that the income derived by a resident from the immovable property situated in the other contracting state 'may' be liable to taxation in such other contracting state. This indicates that the income derived may also be liable to taxation in the contracting state of the resident if it so pleases and is subject to an agreement purporting the same.

### Article 7 - BUSINESS PROFITS

This article goes on further to elaborate the necessity to know the importance of a 'permanent establishment'. It states that the profits derived by an enterprise in a contracting state will be taxable only in that contracting state. However, this need not be the case if such enterprise also functions through a permanent establishment in the other contracting state. In the event that the enterprise has such permanent establishment in such other contracting state, then the profits which are attributable to such permanent establishment may become liable to taxation in that other contracting state in accordance with the provisions of this convention. Such taxable profit may also include the sale of goods or merchandise or any other business activities carried on or any other similar activity carried on from that permanent establishment.

For the purposes of this article and of article 23, the profit or income made by an enterprise through its permanent establishment in the other contracting state shall be attributed to such permanent establishment as if the permanent establishment is a distinct entity, functioning wholly independent of the enterprise of which it is a part.

This article further goes onto elaborate that for the purposes of attributing such income or profits derived from the permanent establishment in the other contracting state, the following factors will not be taken into consideration:

- expenses incurred for the purposes of the business of the PE (permanent establishment) including executive and general administrative expenses, whether in the State in which the permanent establishment is situated or elsewhere.

Providing an exception to the above it also states that, the following factors shall not be deducted from the income derived from the PE in order to determine the profits attributable to such PE for taxation purposes:

- a. amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the PE to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the PE.

- b. amounts charged (otherwise than towards reimbursement of actual expenses), by the PE to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

This article provides for uniformity in the determination of the profits attributable to the PE by stating that the method used for determining the profits attributable to the PE must be the same, year by year and also that it may be customary in accordance with the principles of the contracting states in as much as it does not violate the principles of the convention.

#### **Article 8 - SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT**

In case of an aircraft or a ship operating in international traffic or boats operating in inland waterways, the profits derived from such aircraft or such ship or such boat may be taxable only in the contracting State where the effective management of the enterprise is situated. Although effective management is not defined by this convention, it may be deemed to include places where the key managerial employees or the board of directors are situated, the place of executive decisions of the enterprise, etc.

In case of a ship or a boat, if the place of effective management of the enterprise is situated on board a ship or a boat, the place of effective management of the enterprise shall be the contracting state in which the home harbour or the home port of such ship or boat is situated. In the event of there being no such home harbour or port, the place of effective management of the enterprise shall be the contracting state of which the operator of the ship or a boat is a resident.

It also provides for an alternative to the above, for profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by \_\_\_ per cent. (The percentage is to be established through bilateral negotiations.)

#### **Article 9 - ASSOCIATED ENTERPRISES**

In the event of any transactions between two enterprises, having common control arising out of management, control or capital, in different contracting states and if there are certain conditions inter se as a result of which, the enterprises derive such profit, which they would otherwise not have, had they entered into the transaction independent of such conditions, for the purpose of calculating the tax

liabilities of the enterprises, the contracting states may determine the quantum of profits that might have been derived by such enterprises had there been no special financial and transactional advantages given to them as a result of their business relations.

It is to be noted that the principles of double taxation shall also be applicable to this article as far as regards the state of residence provides such deduction in the tax as it deems fit.

However, this article shall not be applicable if by reason of its application any one of the enterprises becomes liable to penalty with respect to fraud, gross negligence or wilful default as a result of the adjustments being made in accordance with this article 9.

#### **Article 10 - DIVIDENDS**

The dividends paid by a company, which is a resident of a contracting state to a resident of the other contracting state, are liable to taxation in the other contracting state. However, nothing in this article precludes the dividends to be liable to taxation by the contracting state of which the company paying the dividends is a resident. If the beneficial owner of the dividends is a resident of the other contracting state, then the tax charged on such dividends shall be subject to bilateral negotiations between the competent authorities of such contracting states. However, if such beneficial owner carries on business in the other contracting state where the company paying the dividends is a resident by reason of it being connected to a PE, such dividend shall not come under the purview of this article 10, but under articles 7 and 14.

In the event that a company is a resident of a contracting state and derives profits or income from the other contracting state, then the dividends paid by such company to a resident of the other contracting state or the dividends paid are in respect of a holding which is effectively connected to a PE in such other contracting state, shall not be liable to taxation in such other contracting state.

#### **Article 11 - INTEREST**

The interest arising in a contracting state, paid to a resident of the other contracting state, is liable to taxation in that other contracting state. However, nothing in this article precludes the interest to be liable to taxation in the contracting state in which it arises. If the beneficial owner of the interest is a resident of the other contracting state, then the tax charged on such interest shall be subject to bilateral negotiations between the competent authorities of such contracting states.

In order to avoid ambiguity, the term 'interest' is defined exhaustively in this very article 11 as income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. However, the provisions of this article shall not be applicable in the following cases:

- a. if the beneficial owner of the interest is a resident of a contracting state and carries on business in the other contracting state in which the interest arises;  
OR

- b. conducts business from such permanent establishment or performs independent services from a fixed base situated in that other contracting state; and
- c. the debt claim in respect of which the interest is paid is effectively connected with:
  - i. such permanent establishment or fixed base;
  - ii. business activities referred to in article 7 of this convention.

On the satisfaction of the abovementioned factors, the articles applicable for the purposes of taxation would be article 7 and article 14. For the purposes of this section, interest shall be deemed to arise in a contracting state when:

- a. when the payer is a resident of that state; OR
- b. the payer has a permanent establishment or a fixed base in a contracting state, in connection with which the indebtedness, on which the interest is paid, was incurred and such interest is borne by such permanent establishment or fixed place.

For the purposes of applicability of this article, it is to be noted that, if the amount of interest paid is greater than the interest agreed upon by the payer and the beneficial owner by virtue of a special relationship between the payer and the beneficial owner or between them and some other person, only the amount of interest payable in the absence of such special relationship shall be taken into consideration. It is also to be noted that such excess payment made on account of the special relationship mentioned above, shall be liable to taxation in accordance with the domestic laws of the contracting states and the provisions of this convention.

#### **Article 12 - ROYALTIES**

The royalties arising in a contracting state paid to a resident of the other contracting state are liable to taxation in that other contracting state. However, nothing in this article precludes the royalties from being liable to taxation in the contracting state in which they arise. If the beneficial owner of the royalties is a resident of the other contracting state, then the tax charged on such royalties shall be subject to bilateral negotiations between the competent authorities of such contracting states.

In order to avoid ambiguity, this article gives an exhaustive definition to the term 'royalties' as payments of any kind received as consideration for:

- a. the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process; OR
- b. the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

However, the provisions of this article shall not be applicable in the following cases:

- a. if the beneficial owner of the royalties is a resident of a contracting state and carries on business in the other contracting state where the royalties arise; OR
- b. conducts business from such permanent establishment or performs independent services

from a fixed base situated in that other contracting state; and

- c. right or property in respect of which the royalties are paid is effectively connected with:
  - i. such permanent establishment or fixed base; OR
  - ii. business activities referred to in article 7

On the satisfaction of the abovementioned factors, the articles applicable for the purposes of taxation would article 7 and article 14. For the purposes of this section, royalties shall be deemed to arise in a contracting state when:

- a. when the payer is a resident of that state; OR
- b. when the payer has a permanent establishment or a fixed base in a contracting state, in connection with which liability to pay royalties was incurred and such royalties are borne by such permanent establishment or fixed place.

For the purposes of applicability of this article, it is to be noted that, if the amount of royalties paid is greater than the royalties agreed upon by the payer and the beneficial owner by virtue of a special relationship between the payer and the beneficial owner or between them and some other person, only the amount of royalties payable having regard to the use, right or information for which they are paid, in the absence of such special relationship shall be taken into consideration. It is also to be noted that such excess payment made on account of the special relationship mentioned above, shall be liable to taxation in accordance with the domestic laws of the contracting states and the provisions of this convention.

#### **Article 13 - CAPITAL GAINS**

The gains derived by a resident of a contracting state from the alienation of immovable property in the other contracting state may be liable to taxation in such other contracting state. Gains that may be taxed by the other contracting states are as follows:

- a. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State; OR
- b. Gains from the alienation of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services; AND
- c. Gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base.

The following categories of gains may be taxed only in the state of effective management of the enterprise is situated:

- a. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport; OR
- b. Gains from alienation of movable property pertaining to the operation of such ships, aircraft or boats.

In the event of alienation of shares of the capital stock of a company or of an interest in a partnership/ trust/ estate whose property consists principally (the value of such immovable property must exceed 50 per cent of the

aggregate value of all the assets owned by such entity to be termed as 'principally consisting of immovable property') of immovable property situated in one of the contracting states, the gains derived from such alienation will become liable to taxation in that state. However, this provision shall be applicable to the abovementioned entities only if they are engaged in the business of management of immovable properties which are used in their business activities.

It is to be noted that if a resident of a contracting state derives gains from the alienation of shares of a company, which is a resident of the other contracting state, such gains shall be liable to taxation in such other contracting state. However, this provision is conditional in as far regards as the alienator should have held a percent of the capital of that company at any time during the twelve month period preceding such alienation. The percent to be held by the alienator is to be decided by bilateral negotiations between the competent authorities of the contracting states.

Any other alienation of property, not specifically mentioned in this article shall be liable to taxation only in the contracting state where the alienator is a resident at the time of such alienation.

#### **Article 14 - INDEPENDENT PERSONAL SERVICES**

This article lays down that any income in respect of independent professional services derived by a resident of a contracting state shall only be liable to taxation in that contracting state. However, it lays down two exceptions to the generality of the above provision by stating that such income may also be liable to taxation in the other contracting state if it fulfils any of the following conditions:

- a. The income is attributable to a fixed base, which the person regularly has available to him in the other contracting state for performing his activities; OR
- b. The income is derived from his activities performed in the other contracting state if his stay in such other contracting state amounts to or exceeds the aggregate of 183 days in any twelve month period commencing or ending in any fiscal year concerned.

For the purpose of clarity, the term 'professional services' is defined to include independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. It is to be noted that the term 'professional services' has been given an inclusive definition and not an exhaustive definition in order to widen its scope and must be construed by the contracting states accordingly.

#### **Article 15 - DEPENDENT PERSONAL SERVICES**

This article lays down that the remuneration received by a resident of a contracting state in respect of his employment shall be taxable only in that contracting state. In the event that such employment is exercised in the other contracting state and such person receives remuneration from such other contracting state, the remuneration received from such other contracting state shall be liable to taxation in such other contracting state. However, such taxation shall be subject to the following conditions:

- a. The recipient's presence in such other contracting state must amount to or exceed the aggregate of

183 days in any twelve month period commencing or ending in any fiscal year concerned; and

- b. The remuneration must be paid by, or on behalf of, an employer who is not a resident of the other contracting State; and
- c. The remuneration must not borne by a permanent establishment or a fixed base which the employer has in the other contracting State.

In case of remuneration received by a person in respect of his employment being exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland water-ways transport, the remuneration shall be liable to taxation in the contracting state where the effective management of the enterprise is situated.

#### **Article 16 - DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS**

The fees and any other remuneration derived by a resident of a contracting state in his capacity as a member of the Board of Directors or as an official in a top level managerial position of a company which is a resident of the other contracting state, may be taxed in that state. It is noteworthy that such a provision for taxation is not mandatory but discretionary and may be set out according to bilateral negotiations between the competent authorities of the contracting states.

#### **Article 17 - ARTISTES AND SPORTSPERSONS**

In case of the income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, the income may be liable to taxation in such other contracting state. This stands true even if the income derived as a result of the abovementioned activities is accrued to some other person, not being from the class of persons mentioned above.

#### **Article 18 - PENSIONS AND SOCIAL SECURITY PAYMENTS**

Any remuneration or any other payments made to a person who is a resident of a contracting state in respect of his past employment or under a public scheme which is part of the social security system of a Contracting State, shall be liable to taxation only in that contracting state. However, in the event that such payments are made by a resident of the other contracting state or any PE situated in such other contracting state, they may also be liable to taxation in the other contracting state.

#### **Article 19 - GOVERNMENT SERVICE**

The remuneration paid by a contracting state to a person as salaries, wages or pensions or any other such remuneration for the services rendered to that state shall be liable to taxation only in that contracting state unless the services are rendered in the other contracting state, in which case, the remuneration shall be taxable in the other contracting state only, if the person fulfils the following conditions:

- a. He is a resident of that other contracting state; AND
- b. He is a national of that other contracting state; OR
- c. He did not become a resident of that State solely for the purpose of rendering the services.

The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State.

#### **Article 20 – STUDENTS**

A student or a business trainee or an apprentice, who is a resident of a contracting state and is present in the other contracting state solely for the purpose of his education and other training purposes shall not be taxed in that other contracting state with respect to the payment that he receives for the purposes of his education, maintenance and training. However, for such payments to be exempt from the tax liability in the other contracting state, it is important to note that such payments must arise from sources outside such other contracting state.

#### **Article 21 - OTHER INCOME**

This article acts as a savings clause where it states that any other item of income of a resident of a contracting state, for which express provisions have not been provided for in the convention, shall be liable to taxation in that contracting state.

### **TAXATION OF CAPITAL**

#### **Article 22- CAPITAL**

For the purposes of taxation, capital has been classified into three main or major categories:

- a. Capital represented by immovable property: If immovable property is owned by a resident of a contracting state and situated in the other contracting state, the capital represented by such immovable property shall be taxable in such other contracting state.
- b. Capital represented by movable property: The capital represented by movable property in the other contracting state shall be taxable in the other contracting state, irrespective of whether it forms a part of the business property of a PE of an enterprise in such other contracting state or whether it pertains to a fixed base available to a resident of a contracting state in the other contracting state for performing independent personal services.

Capital represented by ships, aircrafts and boats: In this case, the capital shall be taxable only in the contracting state where the effective management of the enterprise is situated.

### **METHODS FOR THE ELIMINATION OF DOUBLE TAXATION**

#### **c - EXEMPTION METHOD & CREDIT METHOD**

This article is considered to be the essence of and therefore the most important article of the convention. It provides for the avoidance of the double taxation on the income derived by the person. It is to be noted that such relief from double taxation is given to the person only in the state of residence and not the other contracting state. For instance, if the resident of one contracting state derives income from immovable property situated in the other contracting state and such income is liable to be taxed in the other

contracting state in accordance with the provisions of the convention, the state of residence of such person shall exempt such income from tax. This stands true in the case of any profits or dividends or interest or royalties that a person resident in one contracting state may derive from the other contracting state. If such profits or dividends or interest or royalties are liable to taxation by such other contracting state, the state of residence of such person shall allow the deduction from tax of such amount as paid by the person in the other contracting state. However, it is to be kept in mind that such deduction from the state of residence shall be allowed only for the same head of taxable income and such deduction may not be set off against any other category of taxable income. DTAA may be modelled either on an exemption method or the credit method

**EXEMPTION METHOD** -Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, the first-mentioned State shall, subject to the other provisions of this article, exempt such income or capital from tax.

**CREDIT METHOD** Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

### **SPECIAL PROVISIONS**

#### **Article 24 - NON-DISCRIMINATION**

This article lays down provisions and safeguards against any kind of discrimination amongst the contracting states in terms of taxation:

- a. Nationals: the national of a contracting state shall not be subject to any kind of taxation in the other contracting state, which the resident of such other contracting state shall not be subjected to in similar circumstances.
- b. Stateless persons: Resident stateless persons shall not be subject to taxation of any kind in either of the contracting states, which the residents or nationals of those contracting states shall not be subjected to in similar circumstances.
- c. Permanent establishment: The permanent establishment of an enterprise of a contracting state shall not be subject to a higher quantum of taxation than what the enterprises of that other state are subjected to.
- d. Interest, royalties and other disbursements: For the purpose of determination of taxable profits, the same method of deduction shall be applied to residents of either of the contracting states and present in the other contracting states.

Enterprises: enterprises, whose capital is either owned or controlled, fully or partly, directly or indirectly by the resident of the other contracting state, shall not be subject to any

additional or burdensome taxes which the enterprises of that contracting state shall not be subject to.

#### **Article 25 - MUTUAL AGREEMENT PROCEDURE**

This article lays down the procedure by which the competent authorities of the contracting state shall mutually agree upon the issues relating to taxation that may not have been specifically provided in the Convention. Notwithstanding the generality of this article, it specifically provides for the mutual agreement procedure in the following cases:

- a. Where a person considers that he may be liable to taxation which is not in accordance with the provisions of this Convention, by virtue of any action by one or both of the contracting states he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident. However, the article also lays down a period of limitation for the presentation of the case of a period of 3 months from the date of notification of such action. The person affected must present his case to the contracting state of which he is national or to the contracting state of which he is resident, as the case may be.
- b. There shall be a Competent Authority to resolve any doubts or difficulties in the application or interpretation of the Convention.
- c. The Competent Authority, in order to discuss the issues relating to double taxation with consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure which have not been specifically provided for in this convention.

For the purposes of this article, it is open to the competent authorities of the contracting states to address the issues mentioned above by the following means:

- a. Direct communication with each other
- b. Joint Commission consisting of the competent authorities themselves or their representatives.

Developing bilateral procedures, conditions, methods, techniques, etc. in order to effectively implement the solutions mutually agreed upon.

#### **Article 26 - EXCHANGE OF INFORMATION**

This article provides for the exchange of information between the competent authorities of the contracting states, especially for preventing the avoidance or evasion of taxes by the residents of either of the contracting states. This may be done in order to execute the provisions of the convention as well as for the administration and enforcement of domestic laws concerning the taxes, in so far as they are not in violation of the provisions of this Convention. Such information shared between the competent authorities may or may not be of a confidential nature. The information, when requested by one of the contracting states, shall be provided to it by the other contracting state by utilising all its information gathering measures, irrespective of whether the state gathering information has an interest in it, or whether it is held by a bank or a financial institution. However, such a request from a contracting state does not impose on the

other contracting state, an obligation to carry out any administrative measures contrary to its own or to supply information which would disclose anything contrary to the public policy or which cannot be obtained ordinarily under the normal course of law of the contracting state requesting such information.

#### **Article 27 ASSISTANCE IN THE COLLECTION OF TAXES**

Keeping in essence with the convention, this article has been introduced to help the competent authorities of a contracting state to request the competent authorities of the other contracting state to aid them in collecting revenue claims in respect of taxes in such other contracting states. It is noteworthy that revenue claims not only include unpaid dues in respect of taxes, but also the penalties, interests, costs of collection, costs of conservancy, etc. Therefore, in the event that the competent authorities of a contracting state request the competent authorities of the other contracting state to collect the revenue claim from a person who is liable to pay such revenue claims in the Contracting State, such request must be accepted by the competent authorities of the other contracting state in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other contracting State. Such an obligation is extended to the measures of conservancy to ensure the collection of taxes implemented by the first contracting state. However, it is to be kept in mind that such revenue claim shall not be accorded any priority over the taxes to be collected in the latter contracting state. However, in the event that such revenue claim ceases to exist as a revenue claim, the competent authority of the contracting state must immediately notify the competent authority of the latter contracting state and thereafter suspend or withdraw its request regarding the collection of such revenue claim. It is to be noted that, notwithstanding the generality of this article, it shall not impose an obligation on the other contracting state to carry out any measures, administrative or otherwise, which are contrary or in variance with the domestic laws of such other contracting state.

#### **Article 28 - MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS**

This Article largely states that this Convention shall not affect any fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

#### **Article 29 ENTRY INTO FORCE**

Article 29 of the convention lays down the provisions for the coming into force of the convention including the mentioning of the place of ratification and the names of the contracting states.

#### **Article 30 TERMINATION**

This Article provides for the termination of this convention by either party. Such termination may be effected through diplomatic channels by giving a prior notice of at least 6 (six)

months of such termination by a contracting party to the other contracting party.

Author Philip Baker QC a noted author on DTAA lays down the following steps for the operation of the convention:

1. At first, the taxpayer has to determine whether the Treaty has been given effect in the domestic law and whether he will fall within the scope of Article 1, i.e. whether he is a resident of either one or both the contracting states. Then, he will be required to check whether the Treaty applies to the tax in question and also whether the Treaty is in operation for the period in question.
2. At this stage, the tax payer is required to check the relevant definition provisions of the Treaty in order to determine the residence, taxability, etc.
3. Next, the tax payer has to determine whether any substantive provisions of the Treaty in respect of income and capital are applicable to him. This requires characterisation, which can be done with the help of commentaries, case laws and reports of the Committee on Fiscal Affairs.
4. At this point, the tax payer has to apply the substantive articles, which is done in either of the following three ways:
  - a. Taxability by the state of source without an upper limit;
  - b. Taxability by the source subject to an upper ceiling set by the Treaty; OR
  - c. Taxability by the State of Residence.
5. The substantive provision determined as above should be read with the provisions of Article 23,

providing relief to eliminate double taxation. Double taxation can be eliminated in either of the following ways:

- a. States applying exemption method of relief grant exemption to incomes falling under the category 4(a) and credit in respect of foreign taxes, if the income falls under category 4(b).
- b. States applying the credit method of relief grant credit for the tax in the state of source in all cases.

The tax payer needs to follow the exemption or credit into the domestic law of the two states. If the tax payer does not get the benefit to which he is entitled, he has a right to initiate Mutual Agreement proceedings, under Article 25.<sup>1</sup>

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<sup>i i</sup> Prescribed readings for the legal pronouncements pertaining to DTAA in India:

1. Union of India v. Azadi Bachao Andolan, 263 ITR 706, 723-4
2. CIT v. Visakhapatnam Port Trust, 144 ITR 146
3. Commissioner of Income-tax v. Nirlon Synthetic Fibres and Chemicals Ltd., 137 ITR 1 (Bom)
4. Commissioner of Income Tax v. P.V.A.L. Kulandagan Chettiar, (2004) 267 ITR 654 (SC)
5. Siemens A.G. vs. ITO, (1987) 22 ITD 87 (SB)
6. CIT v. V.R.S.R.M. Firm & Others, 208 ITR 400
7. CIT v. R.M.Muthaiah, (1993) 202 ITR 508
8. Meganbhai v. Union of India, AIR 1969 SC 783
9. CIT v. Isthmian Steamship Lines, (1951) 20 ITR 572
10. Timken India Ltd. vs. CIT, (2002) 256 ITR 460 (Kar)
11. CIT vs. Tata Iron & Steel Company Ltd., 66 TITJ 463; (2000) 248 ITR 190 (Bom)
12. Tata Iron & Steel Co. Ltd. vs. Dy. Commissioner of Income-tax, 62 ITJ 17
13. CIT vs. Laxmi Textile Exporters Ltd., (2000) 245 ITR 521 (Mad)
14. Cape Brandy Syndicate v. IR, 1921 (1) KB 64
15. CIT v. Ajax Products Ltd., 55 ITR 741, 747
16. Jiwandas v. CIT, 4 ITC 40
17. CIT v. Bhattacharjee, (1979) 118 ITR 461
18. CIT v. J. H. Gotla, (1985) 156 ITR 323 (SC)
19. Elphinstone Spinning and Weaving Mills Co. Ltd. v. CIT, (1955) 28 ITR 811 (Bom)
20. CIT v. Kishoresinh Kalyansinh Solanki, (1960) 39 ITR 522 (Bom)