110

SATURDAY INTERNATIONAL TAX GYAN !!!

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Deputy Commissioner of IT International Tax Circle 3(2)(1), Mumbai
V.
Marubeni Corporation, Japan

The withholding rate mentioned in DTAA is inclusive of cess and surcharge whereas we need to add cess and surcharge in withholding tax rate prescribed in Income Tax Act.

Date: 16.07.2022

[2022] 139 taxmann.com 458 (Mumbai - Trib.)

FACTS OF THE CASE

- The assessee is a foreign company and tax resident of Japan.
- The assessee has various streams of income from India. **These incomes includes income from technical services, shipping business and interest income on suppliers' credit.**
- This interest income is received by the assessee from Tata Hitachi Construction Co. which is also a customer of the PE of assessee in India.
- The interest income was offered to tax at the rate of 10% in terms of the provision of Article 11(2) of India-Japan DTAA.
- The AO analysed this plea in such a way that since, PE of the assessee is present in India, such interest shall be taxed @40% (plus applicable surcharge and cess) which is a normal tax rate for a foreign company.

ISSUE 1

Whether presence of PE in India amounts to taxability of interest income at rate higher than 10%

REVENUE'S CONTENTION

- The AO stated the interest received is effectively connected with the PE of assessee and therefore the said income shall be taxable as per Article 11(6) read with Article 7 of the DTAA and not as per Article 11(2).
- The AO stated that the interest income on loans in the form of suppliers credit given to Indian parties is not taxable at special rates as per Article 11(2) of the India-Japan DTAA specially because the assessee had a permanent Establishment in India during the said time.

ASSESSEE'S CONTENTION

- The assessee stated that its PE is not connected with its customer from whom interest income is received & therefore such income shall be taxable under Article 11(2).

Relevant provisions related to India-Japan DTAA

ARTICLE 11- INTEREST (Clauses of relevant article are as under)

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.
2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest.
6. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

Relevant provisions related to India-Japan DTAA

ARTICLE 7- BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in that other Contracting State but only so much of them as is directly or indirectly attributable to that permanent establishment.

RULING

- As per the DTAA, interest income is taxable at the source jurisdiction i.e. in India (as in this case) at the rate of 10% on gross basis under Article 11(2).

- Article 11(6) provides an exception to this taxation @ 10% on the gross basis. This article provides that where such an enterprise
  ✓ carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performing professional services from a fixed base situated therein,
  ✓ and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base, the provisions of Article 7 or Article 14, as the case may be, shall apply.

- The important thing here is the presence of effective connection between the interest income and the PE. If such connection is effective, then Article 11(6) will be attracted otherwise the income will be taxable as per the specific article and not as business income.

RULING

- As far as interest income is concerned, for this effective connection to be held, following conditions are required to be satisfied:
  - ✓ whether the debt claim in respect of which interest is paid is forming part of the assets of the permanent establishment, or
  - ✓ Whether any economic ownership of the debt claim is allocated to the permanent establishment, or
  - ✓ Whether the permanent establishment plays a critical role in earning of that interest income.

  None of the above conditions is satisfied in the given case, so PE was not effectively connected with the interest income of the assessee.

- It was also held that, even if the interest income is connected with the assessee company's permanent establishment, it can only be brought to tax in India, under Article 7, when the interest income is directly or indirectly attributable to the permanent establishment and **no part of interest income, by any stretch of logic, can be said to be directly or indirectly attributable to the Indian permanent establishment of the assessee company.**

ISSUE 2

Whether tax rate applicable under the DTAA includes surcharge and cess?

REVENUE'S CONTENTION

- The AO has levied surcharge and cess along with the normal rate of tax applicable on FTS income under Article 12 of DTAA.

ASSESSEE'S CONTENTION

- In response, the assessee contended that, the Assessing Officer has erred in levying surcharge and health and education cess on FTS income when the same is liable to tax at the rate of 10% as prescribed in Article 12 of the India –Japan Tax Treaty.

Relevant provisions related to India-Japan DTAA

❖ **ARTICLE 2 : TAXES COVERED**

1. The taxes to which this Agreement shall apply are:
   a) In India:
      income-tax including any surcharge thereon;
   b) In Singapore:
      the income-tax(hereinafter referred to as "Singapore tax").
2. The Agreement shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of the present Agreement in addition to, or in place of, the taxes referred to in paragraph 1. The competent authorities of the Contracting States shall notify each other of any substantial changes which are made in their respective taxation laws.

❖ **ARTICLE 12 : ROYALTIES AND FEES FOR TECHNICAL SERVICES –**

1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the royalties or fees for technical services, the tax so charged shall not exceed 10 per cent.

RULING

- On the basis of the relevant Articles of the DTAA, it can be seen that the tax on interest cannot exceed 10% (in case of loan granted by bank) or 15% (in all other cases)

- The term tax as defined under Article 2(1) clearly states that tax means income tax including surcharges. Whereas, Article 2(2) further extends the scope of tax by adding the statement referred in above slide.

- Educational Cess, as added by Finance Act 2004, is nothing but in its nature, it is additional surcharge and was in force much after the agreement of double tax avoidance between India and Japan (which was signed on 24th January 1994). Therefore, satisfying getting covered under the Article 2(2) of DTAA.

- **It was held that this rate of 10% or 15% as the case may be, already includes the amount of surcharge and cess.** The appeal of the AO was dismissed, and the cross objection of the assessee was allowed.

OUR COMMENTS

Let's take an example of FTS income which is taxable at 10% under both income tax and India-Japan DTAA. These rates of 10% are not equal since one of them is inclusive of surcharge and cess while other isn't.

Calculation as per DTAA	
FTS income	100
Tax @10%	10
~~Add: Surcharge~~	~~0~~
~~Add: Cess~~	~~0~~
Total tax	10
Under DTAA, tax rate is flat, which means surcharge and cess are already included in such rate.	

Calculation as per income tax Act.	
FTS income	100
Tax @10%	10
Add: Surcharge @10%	1
Add: Cess @4%	0.44
Total tax	11.14
As per Income Tax Act, tax rate does not include any cess or surcharge.	

- Thus, it can be seen from this example that, even though the base rate is same under the Act and DTAA, total tax is not same under both.

OUR COMMENTS

- All Income of a foreign company cannot be taxed in India if it has a PE in India. Only those income which are related or connected to the PE are to be taxed in India.

- Even though the base tax rate in Income Tax Act and DTAA might be same in various cases however it is important to note that in the Income Tax rate cess and applicable surcharge will be added to calculate effective tax rate for withholding tax whereas in DTAA the tax rate is flat and no cess or surcharge is to be added.

- Hence, we should never compare the base rate of Income Tax Act and DTAA but should compare effective tax rate while preparing Form 15CB also many times 4% of cess can also create a difference while calculating the amount of tax.

- Thus, it is advisable to have TRC to take benefit of tax rate mentioned in DTAA.

Section/Article	Article 2,7,11 & 12 of DTAA
DTAA/Country	India-Japan
Court	Mumbai- Trib.
Date of decision	20.06.2022

Note: Case law name in Red- in favour of the revenue, Green- In favour of the Assessee, Orange = Partial

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