

# SATURDAY INTERNATIONAL TAX GYAN !!!

## #taxmadeeasy



# What are Triangular cases in cross border transaction?



SITG No. 224

21.09.2024



# Meaning of Triangular Cases

In simple terms, the term "triangular" is something having three angles. In the context of cross border taxation, the term "Triangular cases" would generally mean situations involving three jurisdictions. The taxing rights and obligations, the jurisdictions, needs to be analyzed for all three jurisdictions.

These situations are known as "triangular cases" and they typically arise where a person who is resident in two states for tax purposes (a **dual resident**), or a person who is **resident in one state and has a permanent establishment (PE) in another, has dealings with a resident of a third state.**

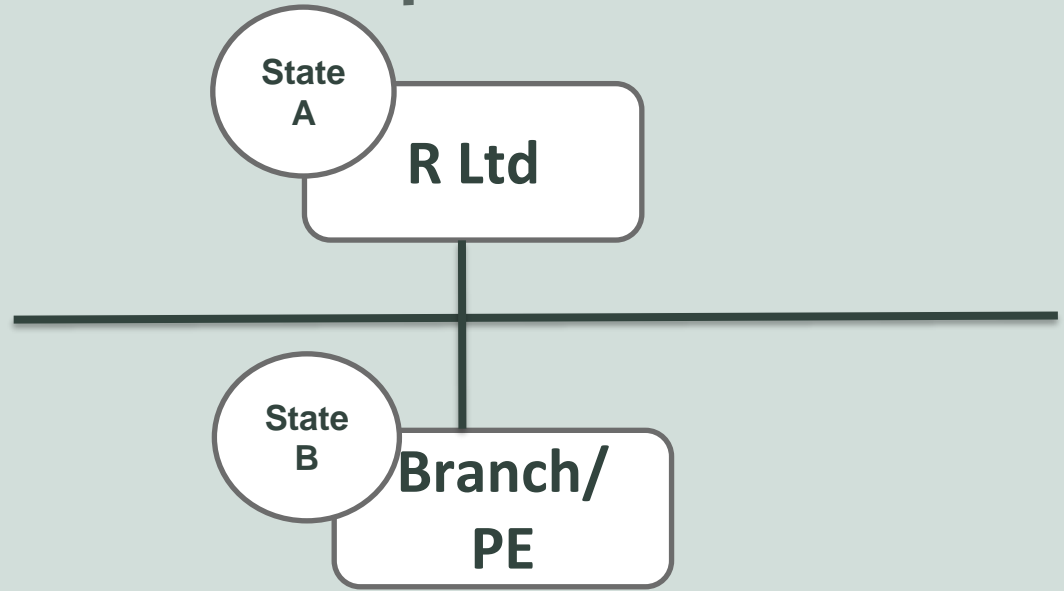
## 1. Triangular cases involving PE

The OECD Report on Triangular cases describes the triangular cases as situations wherein-

- a) **Income** from dividends, interests or royalties is **derived from a source in State S**;
- b) Such income is **related to a PE** in State P;
- c) The **PE depends on an enterprise resident in State R.**

# Certain basic principles to keep in mind

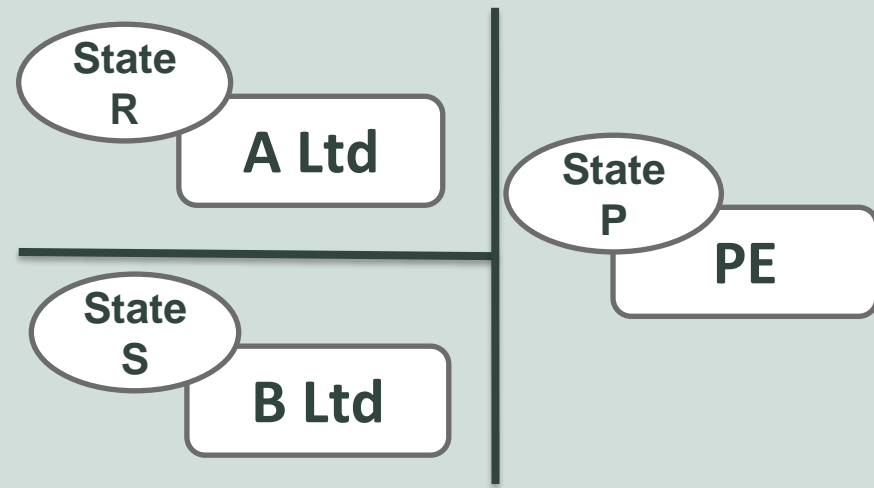
## 1. Residential status of a branch :-



A bank or an entity which opens a branch outside India might fall under the category of PE as per DTAA and might be taxed separately in that foreign country for its income linked to such PE. However, getting taxed separately in a foreign country doesn't necessarily mean that such PE is a separate legal entity and resident of such foreign country, it is still a part of that entity in its resident country.

# Certain basic principles to keep in mind

## 2. Applicability of tax treaties :-

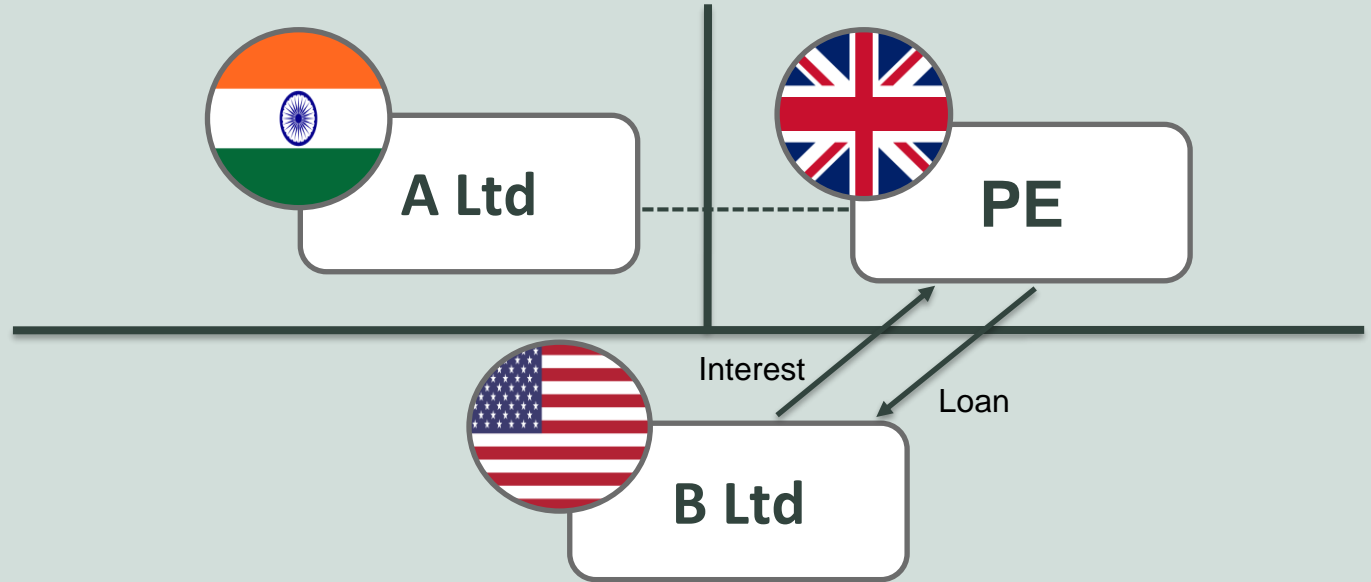


A bilateral tax treaty is signed between two countries and hence it can have only two Contracting State and for taking benefit of a particular treaty, assessee should be a tax resident of either of the countries.

For availing the benefit of treaty, the pre-condition is that you need to a resident of one the countries. However as discussed in the earlier slides, a PE is not a resident of the country where such PE is established and accordingly one needs to check the DTAA between the source country and resident country of such PE.

In the above shown example, A Ltd. and its PE in Country P will be treated as tax resident of Country R. For the purpose of P-S tax treaty, A Ltd. or its PE in Country P will not qualify as "Resident of a Contracting State" hence the benefit of P-S tax treaty can not be availed.

# Example 1



A Ltd. is a tax resident of India (Residence State).

A Ltd. has established a branch (PE) in UK (State of PE)

PE has granted loan to B Ltd., a tax resident of USA (Source State)

B Ltd. has paid interest on loan to the PE.

# Example 1

## Tax rates as per domestic laws

Country	Rate*	
India	30%	30% on corporates
UK	35%	35% on PE of foreign state
USA	30%	Interest earned by a non-resident is taxed @30%

## Tax rates as per Treaty on interest Income

Country	Rate*
India-UK	20%
India-USA	15%
USA-UK	10%

\*These rates are taken as assumption for explaining the concept of Triangular cases in a better way. These might differ from the actual rates.

# Issues in taxability in current example

In the above example, we have a couple of issues which are as under:-

1. **Determining the tax liability on interest income earned by PE of A Ltd. In all these 3 different states, i.e. Residence state (India), source state (USA) and State of PE (UK).**
2. **How much FTC can be claimed by A Ltd. In UK for taxes paid in USA, and in India for taxes paid in both USA and UK.**

# Taxability in USA

## 1. Taxability in USA (Source state) :-

- a) **As per domestic law:-** in the given example, under the domestic law of USA, Interest paid by B Ltd. to the PE of A Ltd. Would be subject to tax @30%.
- b) **As per USA-UK treaty:-** The provisions of Article 11 are applicable to *"interest arising in a Contracting State and paid to a resident of the other Contracting State"*.

Although the flow of fund would be from USA to UK, the benefit of Article 11 of USA-UK tax treaty would not be available for the following reasons:

- PE of A Ltd is not a separate legal entity and does not qualify as "resident of UK".
  - PE (i.e. A Ltd.) is a tax resident of India, but India is not a Contracting State for the purpose of USA-UK tax treaty.
- c) **As per India-USA treaty:-** In terms of India-USA tax treaty, the rates of tax in USA would be capped at 15% as conditions of the Article 11 of India-USA treaty gets satisfied for the following reasons:-
    - PE (i.e. A Ltd) is a tax resident of India.
    - Interest is arising in USA and paid to a tax resident of other Contracting State (i.e. A Ltd of India)
    - The fact that loan was extended is by PE from UK is not relevant.

Hence, tax withhold in USA would be 15% as per India-USA treaty.



# Taxability in UK

## 2. Taxability in UK (PE State) :-

- a) **As per domestic law:-** UK would charge full rate of 35% on interest income earned by PE of foreign state as per domestic law of State P.
- b) **As per USA-UK treaty:-** As discussed above, although the flow of fund would be from USA to UK, the benefit of USA-UK tax treaty would not be available to PE (i.e. A Ltd.) since PE is a tax resident of India and not UK.
- c) **As per India-UK treaty:-** In terms of Article 7 of the India-UK tax treaty, UK is authorized to levy tax on the profits attributable to A Ltd.'s PE.

Hence, tax chargeable in UK would be @35%.

3. **Taxability in India :-** Since A Ltd. is resident of India, it's global income would be chargeable in India. Hence, Interest earned by PE of A Ltd. would also be taxable in India @30%.

# Availability of credit

## Availability of credit in UK (PE State) :-

Article 23 gives tax credit only to a tax resident. PE is not a tax resident of UK and hence, credit for taxes paid in USA is not available in UK.

## Availability of credit in India :-

Under both India-USA and India-UK tax treaty, India has the obligation to give credit for the taxes paid in other State. However, the credit will be restricted to the taxes payable under the domestic law of India on the doubly taxed income.

## Calculation of effective tax

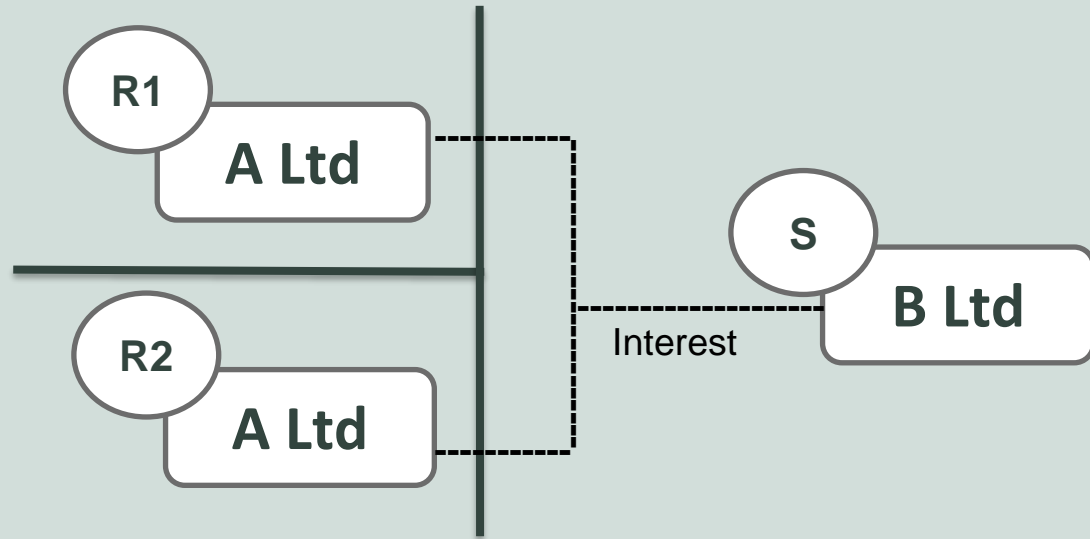
<b>Interest earned by PE</b>		<b>100</b>
<b>Tax in USA</b>	<b>15</b>	
<b>Tax in UK</b>	<b>35</b>	
<b>Tax in India</b>	<b>30</b>	
<b>FTC in India for taxes paid in USA</b>	<b>(15)</b>	
<b>FTC in India for taxes paid UK (restricted to tax liability in India)</b>	<b>(15)</b>	
<b>Effective tax</b>		<b>50</b>
<b>Income after tax</b>		<b>50</b>

All three countries  
to assessee



# Triangular situation due to Dual residency

## Example 2 :-



A Ltd. is a company incorporated in state R1.

The **POEM** of A Ltd is in state R2.

B Ltd, a tax resident of state S, has paid interest to A Ltd.

MLI Provision are not yet applicable to the tax treaty between R1-R2 and in terms of the provision of Article 4(3) of the treaty, **A ltd is a tax Resident of state R2.**

Treaty	Tax on Interest
R1-S	10%
R2-S	15%

Relevant extracts of Article 4 of the tax treaty are reproduced hereunder:

1. *For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.*
2. *.....*
3. *Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.*

State S has tax treaty with State R1 (R1-S) as well as State R2 (R2-S). Article 4(3) of the tax treaty R1-S and R2-S does not address triangular situation as this provision gives solution for a **dual residency of two Contracting State to a treaty and does not provide solution when the person is tax resident of one of the Contracting State and a third State**. The third State does not qualify as a "Contracting State" for the purpose of the tax treaty.

As per Article 4(1) of the tax treaty R1-S, A Ltd. is a tax resident of State R1.

As per Article 4(1) of the tax treaty R2-S, A Ltd. is a tax resident of State R2.

# Taxability

## From perspective of State S:-

Taxing rights available to State S under the tax treaties are as follows:-

- R1-S :- State S can levy tax @10% on interest in come.
- R2-S :- State S can levy tax @15% on interest income.

State S is required to comply with the provisions of both the tax treaties and hence can withhold tax at a rate lower of the two i.e. 10%. If State S withholds tax @15% in terms of the provisions of State R2-State S treaty, then it can be seen as a violation of State R1-State S treaty.

## From perspective of State R1:-

Under the domestic law of State R1, the global income of A Ltd. is subject to tax @30%. Accordingly, State R1 will give credit for the taxes paid by A Ltd. in State S (i.e. 10% under the treaty) and will collect tax @20%.

The fact that for the purpose of tax treaty between R1-R2A Ltd. is a tax resident of State R2, will have no implication for the reason that A Ltd. has earned income from State S, which is a third state for the purpose of R1-R2 treaty.

# Taxability

## From perspective of State R2:-

Under the domestic law of State R2, the global income of A Ltd. is subject to tax @35%. Accordingly, State R2 will give credit for the taxes paid by A Ltd. in State S (i.e. 10%) and will collect tax @22%.

The fact that for the purpose of tax treaty between R1-R2, A Ltd. is a tax resident of State R2, will have no implication because A Ltd. has earned income from State S, which is a third state for the purpose of R1-R2 treaty.

Interest earned			100
Tax in State S [Lower of R1-S & R2-S treaty]		10	
Tax in State R1	30		
Tax credit under R1-S treaty	(10)	20	
Tax in State R2	35		
Tax under R2-S treaty	(10)	25	
Effective tax rate			55
Income after tax			45

Assessee after paying  
tax in 3 counties



**In the current case, there is ambiguity about tax credit in State R1 for tax paid in State R2 as well as tax credit in State R2 for tax paid in State R2.**

**In our opinion, there should be some more clarity in case of dual residency which is common in case of USA citizen also as they are always a resident on USA and in such case practically we choose to take full credit in one country but still there needs to be some clarity.**

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