International Fiscal Association

Basics of Double Taxation Avoidance Agreements

Non – Discrimination and Mutual Agreement Procedure

Presented by

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** **Nishith Desai Associates** (NDA), which is based in Mumbai and Silicon Valley, specializes in globalisation of Indian corporates, International Tax & Transfer Pricing, Offshore Funds, Corporate and Securities laws, ADRs, M&A, Information, Communication & Entertainment (ICE) laws, e-commerce laws, and Media & Entertainment laws & Biotechnology. The firm has structured and acted for the largest number of private equity funds for India. NDA acted as underwriter’s counsel in Infosys Technologies and Satyam Infoway’s American Depository Receipt (ADR) offerings in the USA. It also represented Rediff.com, Silverline Technologies and Wipro in the ADR listings. NDA was involved in the first cross-border stock swap merger out of India, that is, BFL’s acquisition of MphasiS, and was also involved in Silverline’s acquisition of Seranova.

The firm is intensely research oriented and has undertaken studies in different areas of law and tax, some of which can be found on its website. The firm did an extensive research study for Global Information Infrastructure Commission (GIIC) on legal and tax issues relating to e-commerce. NDA was also involved in preparing a study for the European Commission on the Market Access Barriers in the Telecommunications Sector in India. The firm assisted the State Government of Andhra Pradesh in drafting the Andhra Pradesh Infrastructure Development Enabling Act (APIDEA). The firm also prepared a comprehensive report on the comparative business and legal practices in Hollywood and Bollywood, which is available on its website.

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NON- DISCRIMINATION AND MUTUAL AGREEMENT PROCEDURE

-This paper must be read in conjunction with the Responsibility Statement.

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INTRODUCTION

In the age of globalization, it is common to find companies making cross-border investments. The need for the companies to constantly increase their market share has made the world a global village. Any cross-border business transaction involves two potential tax claims, *viz.,* in the country to which the company belongs (*i.e.,* the country of domicile/residence) and the country in which the investment is made or where the business is transacted (*i.e.,* country of source of income). Both countries may exercise jurisdiction for taxing a particular income. To facilitate trade between the two countries and to enhance international trade and investment relations countries enter into agreements the purpose of which is to avoid double taxation of the same income. However, there may arise cases where the domestic courts of the contracting states interpret the agreements entered into in a manner inconsistent with the interpretation made by the international community or the model commentaries. To address such cases the treaties provide for a 'mutual agreement procedure' whereby the diplomats of the contracting states on an application made by an aggrieved party discuss the issues so as to settle the matter amicably. Further, there may arise cases where a country provides favourable treatment to its nationals and discriminates against foreigners. To circumvent such cases the bilateral treaties for prevention of double taxation provide for a clause which restricts Contracting States from offering discriminatory treatment to foreign nationals as compared to its nationals. This paper explores the mutual agreement procedure and the provisions relating to non–discrimination as provided in the Double Taxation Avoidance Agreements ("**DTAA**") in a very preliminary way.

NON-DISCRIMINATION

Discrimination means unequal treatment in situations, which are identical or comparable. Article 24 of the OECD model convention is merely a specific enunciation of the general principle of equality. This principle requires that similar situations shall not be treated differently unless differentiation is objectively justified. Differentiation does not mean discrimination, if there is justification. Article 24 does not militate against justified differentiation. What it holds is that similar situations should not be treated differently unless on justification. Different treatment constitutes no discrimination when it is objectively justified or at least in economic matters not arbitrary[1].

Article 24 of the OECD Model Convention, which provides for protection against non-discrimination, reads as follows:

[1] Ruckdescel v hauptzollamy hamburg –St.Annen 1979 2 C.M.L R 445

"*1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.*

2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief's and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description."

Scope:

Article 24 deals with non-discrimination provisions; nationality non-discrimination, permanent establishment non-discrimination, and, deduction and ownership non-discrimination. It endeavors to prevent discrimination of the 'nationals', 'residents' of other Contracting States ("**CS**") carrying on business and 'enterprises' owned by the treaty partners. It aims at ensuring to nationals of another CS, residents of any third state, stateless persons, equality of treatment with the nationals of the contracting state with regard to taxation and any requirement connected therewith[2]. Discrimination is also sought to be prevented with regard to taxation on the permanent establishment, related and controlled companies, and deductibility of expenses by way of interest, royalties and other disbursements for determination of taxable profits of an enterprise. Avoidance of discrimination consists in prevention of imposition by the state of liability that is more burdensome than the liability on its nationals in the matter relating to taxation and connected requirements.

Explanation to the provisions:

Paragraph 1:

In applying paragraph 1, the underlying question is whether two persons who are residents of the same CS are being treated differently solely on account of a different nationality. This paragraph establishes the principle that for the purposes of taxation, no discrimination on the grounds of nationality shall be permitted. The commentary on the OECD Model Convention states that this paragraph does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State as the two persons are not in the same circumstances with respect to their residence. This paragraph further provides that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc) must not be more onerous for foreigners than for nationals3. Further, even third country residents can invoke this provision.

Paragraph 2:

[2] Indian Double taxation Agreements & Tax Laws by D.P.Mittal page number 1.453
[3] Paragraph 10 of the commentary of the OECD Model Convention on Article 24

On September 28, 1994 a number of states (including a few OECD member countries) concluded in New York a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. As per this Convention a, stateless person should be understood as a person who is not considered as a national by any State under the operation of its law. This provision enables national treatment to be extended to stateless persons. The purpose of this paragraph is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting state solely to stateless persons who are residents of that or the other Contracting State.

Paragraph 3:

As per this paragraph, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. Further, the *proviso* leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

Paragraph 4:

This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident[4]. It is open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes[5].

Paragraph 5:

This paragraph restricts a Contracting State from giving a less favourable treatment to an enterprise, the capital of which is owned or controlled by one or more residents of the other Contracting State. This provision seeks to put an end to discrimination only to an enterprise and not to the persons owning or controlling their capital. To summarize, its object is to ensure equal treatment for taxpayers residing in the same

[4] Paragraph 55 of the Commentary on the OECD Model Convention
[5] *Ibid*

state and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

Paragraph 6:

This provision implies that this article applies to taxation of every kind and description levied by, or on behalf of, the State, its political subdivisions or local; authorities. The provisions of non-discrimination as provided under the UN model convention are similar to those provided under the OECD model convention.

Judicial thinking:

The Indian judiciary has adjudicated on a few cases in the recent years, which we have briefly discussed in this article.

- In the case of **Bank of America vs. Deputy Commissioner of Income tax** reported in *(2001) 78 ITD 1*, the Mumbai Tribunal held that if as per the Agreement between the two countries there is a restriction in the rate of tax chargeable in the case of foreign companies, the effect shall have to be given to the provisions of the Agreement in preference to the provisions of the Indian Income Tax Act, 1961 ("**ITA**"). The ruling delivered by the court in this case is in line with the international law principle of *Pacta sunt servanda*[6].

- In the case of **Societe Generale** reported in *236 ITR 103* the Authority for Advance Ruling ruled that the rate of tax fixed by an Act of Parliament, even if the rate of tax on non-domestic companies was higher cannot be whittled down by reference to the provisions of an earlier agreement between France and India, even if such agreement had the force of law; and, therefore, the rate of tax payable by a non-domestic company could not be reduced by relying on Article 26 of the DTAA between India and France. The authority further held that the word 'taxation ' in the non-discrimination article did not include 'rate of tax', and thus there was no discrimination if the rate of tax levied on foreign companies is higher than that levied on domestic companies. The appellant aggrieved by the view taken by the authority filed a special leave petition before the apex court. The Supreme Court set aside the advance ruling delivered by the authority on the ground that the authority did not have jurisdiction to decide the question raised by the applicant in view of the fact that the assessment proceedings in

[6] *Pacta sunt servanda* discussed in the Conduit Companies Report of the committee on Fiscal Affairs explains, that it is technically not possible for the tax authorities in India to deny tax treaty benefits.

respect of the applicant relating to the same assessment year as in the application was pending before an income tax authority.

- In the case **ABN Amro**[7] decided by the Calcutta Tribunal, the Income-Tax Appellate Tribunal (ITAT) considered the dispute with reference to the rate of tax. The Tribunal held that by virtue of Article 24(2) of the DTAA between India and the Netherlands, the Dutch bank could not be subjected to taxation in a less favourable manner than an Indian banking company. The ITAT dissented from the AAR ruling in the Societe Generale (*supra*) case arguing that it was an accepted position that the provisions of the DTAA will prevail over the national law and, therefore, the discriminatory rates provided in the Finance Act should be taken as non-operative.

It may be relevant to note that the Finance Act, 2001, amended section 90 of the ITA to provide that the charge of a higher rate of tax on foreign companies is not to be regarded as less favourable charge/levy of tax as compared to domestic companies. This amendment was brought in with retrospective effect from April 1, 1962. It is worth a thought as to how such a unilateral change in the domestic law can dilute the effect of the double taxation avoidance agreement, which is a bilateral agreement with another country.

[7] This is an unreported judgement and hence our summary is based on an article written by T. C. A. Ramanujam, which appeared on the following web-site: http://www.blonnet.com/businessline/2001/10/20/stories/122064tc.htm

MUTUAL AGREEMENT PROCEDURE

Tax agreements are special rules and in this sense they override the domestic tax laws on the basis of the doctrine of *Generalia specialibus non-derogant*. In other words, to invoke the said maxim, the general and special rules shall occupy the same field. In case of a conflict, the special provision must prevail. Double tax avoidance agreements are special rules and, therefore, they preside over tax laws and the parties must follow the principle of *Pacta sunt servanda*. There may arise instances where the domestic courts of a country interpret the terms of a DTAA in a manner not consistent with that known internationally. If there are any disputes in the interpretation / implementation of the terms of DTAAs, normal remedies of appeal *etc*. provided in the Income-tax Act are available to the aggrieved party. The DTA Agreements also contain mutual agreement procedure. The aggrieved party may approach the Competent Authority (**CA**) of the Contracting State wherein he is a resident, who, if he is unable to resolve the dispute by himself will approach the Competent Authority of the other Contracting State to arrive at a solution after mutual discussion[8].

Article 25 of the OECD Model Convention, which provides for the mutual agreement procedure, reads as follows:

"*1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, 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 or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.*

2.The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time-limits in the domestic law of the Contracting States.

3.The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or

[8] http://www.laws4india.com/indiantaxlaws/dtaa/dtaa-rd.asp

application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs."

Scope:

The competent authorities of the two Contracting States are identified in paragraph 1(f) of Article 3 (General Definitions). This Article provides the mechanism for taxpayers to bring to the attention of the competent authorities, issues and problems that may arise under the Convention. It also provides a mechanism for co-operation between the competent authorities of the Contracting States to resolve disputes and clarify issues that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. In addition, the Article authorizes the competent authorities to consult or deny the benefit of the Convention where affording such a benefit would lead to avoidance of tax in a manner inconsistent with the Convention.

Who can apply?

If a person is a citizen or resident of a Contracting State, he can request assistance from the competent authority of that State, if the person believes that the actions of the Contracting State, a treaty country, or both, cause or will cause a tax situation not intended by the treaty between the two countries. If the request provides a basis for competent authority assistance, the competent authority of the respective Contracting State will consult with the treaty country competent authority on how to resolve the situation.

Explanation to the provisions:

Paragraph 1:

This paragraph provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result in taxation that is not in accordance with the Convention he may present his case to the competent authority of either Contracting State. All standard models allow taxpayers to bring competent authority cases only to the competent authority of their country of residence, or citizenship/nationality.

However, paragraph 16 of the OECD Commentary to Article 25 suggests that countries may agree to allow a case to be brought to either competent authority. Thus for example, under this approach, an Indian permanent establishment of a corporation resident in the treaty partner country that faces inconsistent treatment in the two countries would be able to bring its complaint to the competent authority in either Contracting State.

Although, most cases brought to the attention of the Competent Authorities, under this paragraph, will involve economic double taxation, the scope of this paragraph is not limited to such cases. For example, if a Contracting State treats income derived by a company resident in the other Contracting State as attributable to a permanent establishment in the first-mentioned Contracting State, and the resident believes that the income is not attributable to a permanent establishment, or that no permanent establishment exists, the resident may bring a complaint under paragraph 1 to the competent authority of either Contracting State.

Further, it must be noted that is not necessary for a person bringing a complaint, first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Lastly[9], the provision fixing the starting point of the three-year time limit as the date of the 'notification of the action resulting in taxation not in accordance with the provisions of the Convention' should be interpreted in the way most favourable to the taxpayer. Thus, even if such taxation should be directly charged in pursuance of an administrative decision or action of general application, the time limit begins to run only from the date of the notification of the individual action giving rise to such taxation, that is to say, under the most favourable interpretation, from the act of taxation itself, as evidenced by a notice of assessment or an official demand or other instrument for the collection or levy of tax.

Paragraph 2

This paragraph instructs the competent authorities in dealing with cases brought by taxpayers under paragraph 1. It provides that if the competent authority of the Contracting State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek an agreement with the competent authority of the other Contracting State pursuant to which taxation not in accordance

[9] OECD Model Commentary on Article 25 - paragraph 18

with the Convention will be avoided. Any agreement is to be implemented even if such implementation otherwise would be barred by the statute of limitations.

Paragraph 3

Paragraph 3 imposes a duty on the competent authorities to resolve any difficulties or doubts that may arise as to the interpretation or application of the tax treaty entered into between the Contracting States. They are also authorised to mutually consult each other for the elimination of double taxation in cases not provided for in the tax treaty entered into between the Contracting States.

Paragraph 4

Paragraph 4 provides that the competent authorities may communicate with each other for the purpose of reaching an agreement. This makes clear that the competent authorities of the two Contracting States may communicate without going through diplomatic channels. Such communication may be in various forms, including, where appropriate, through face-to-face meetings of representatives of the competent authorities.

Right to be heard [10]:

While the Contracting States may avoid any formalism in the mutual agreement procedure, it is nevertheless their duty to give taxpayers whose cases are brought before the joint commission certain essential guarantees, namely:

- the right to make representations in writing or orally, either in person or through a representative;
- the right to be assisted by counsel.

Commonly referred cases under MAP [11]:

In practice, the procedure applies to cases – by far the most numerous- where the measures in question leads to double taxation which is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:

[10] OECD Model Commentary on Article 25 - paragraph 42
[11] OECD Commentary on Article 25 of the Model Convention (2000)

- The questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of Article 7;
- The taxation in the State of the payer – in case of a special relationship between the payer and the beneficial owner- of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12;
- Cases of application of legislation to deal with thin capitalisation when the state of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11;
- Cases where lack of information as to the taxpayers' actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15).

Pending Suits [12]:

A case may arise where a mutual agreement is concluded in relation to a taxpayer who has brought a suit for the same purpose in the competent court of either Contracting State and such suit is still pending. In such a case, there would be no grounds for rejecting a request by a taxpayer that he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgement in the suit still pending. On the other hand, it is necessary to take into account the concern of the competent authority to avoid any divergence or contradiction between the decision of the court and the mutual agreement, with the difficulties or risks of abuse that they could entail. In short, therefore, it seems normal that the implementation of a mutual agreement should be made subject:

- to the acceptance of such mutual agreement by the taxpayer, and
- to the taxpayer's withdrawal of his suit at law concerning the points settled in the mutual agreement.

Other Issues [13]:

[12] OECD Commentary on Article 25 of the Model Convention (2000) – paragraph 31
[13] http://www.intltaxlaw.com/treaties/usmodel/techexpl.htm#Article 25

Treaty effective dates and termination in relation to competent authority dispute resolution:

A case may be raised by a taxpayer under a treaty with respect to a year for which a treaty was in force after the treaty has been terminated. In such a case the ability of the competent authorities to act is limited. They may not want to exchange confidential information, nor they may reach a solution that varies from that specified in its law.

A case also may be brought to a competent authority under a treaty that is in force, but with respect to a year prior to the entry into force of the treaty. The scope of the competent authorities to address such a case is not constrained by the fact that the treaty was not in force when the transactions at issue occurred, and the competent authorities have available to them the full range of remedies afforded under this Article.

Triangular competent authority solutions:

International tax cases may involve more than two taxing jurisdictions (e.g., transactions among a parent corporation resident in country A and its subsidiaries resident in countries B and C). As long as there is a complete network of treaties among the three countries, it should be possible, under the full combination of bilateral authorities, for the competent authorities of the three States to work together on a three-sided solution. Although country A may not be able to give information received under Article 26 (Exchange of Information) from country B to the authorities of country C, if the competent authorities of the three countries are working together, it should not be a problem for them to arrange for the authorities of country B to give the necessary information directly to the tax authorities of country C, as well as to those of country A. Each bilateral party of the trilateral solution must, of course, not exceed the scope of the authority of the competent authorities under the relevant bilateral treaty.

Cases pending before an authority:

The commentary on the OECD/ UN Model makes it clear that MAP is in addition to and not in substitution of the remedies in the domestic courts or tribunals. MAP could be invoked in addition to any legal form of appeal in the country concerned. In a case decided by the German Federal Supreme Tax Court[14] quoted in CIT V. Vishakapatnam Port Trust [1983] 144 ITR 146 (AP) the court has held that the

[14] Simon's Taxes P.163 9(F. 1.263) 1-2-1967, 1220/64 [B.St B.1 1967/11 495]

existence of the 'mutual agreement procedure' does not prevent the court from proceeding with the case. The same view has been taken by the Swiss Federal Tribunal 17-3-1967 BGE 931-489, quoted in CIT V. Vishakapatnam Port Trust (*Supra*).

Thus to conclude, though the mutual agreement procedure has not been invoked many a time, it can be a useful tool to settle disputed cases of international taxation.

Responsibility Statement

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