After studying this chapter, you would be able to

- **identify** the connecting factors for determining the jurisdiction of taxation;
- **appreciate** the features of, and need for, tax treaties;
- **appreciate** the significance of, and need for, tax information exchange agreements as well as the legal framework for exchange of information in India;
- **appreciate** the importance of commentaries in interpretation of tax treaties and the role of Vienna Convention in application and interpretation of tax treaties;
- **integrate, analyze and apply** the above concepts and principles in addressing relevant issues.
7.2 INTERNATIONAL TAXATION

7.1 INTRODUCTION

Article 38(1) of the International Court of Justice¹ provides that the court shall apply the following in deciding on a particular matter –

**International Convention(s) [general or particular]**

- establishing rules expressly recognised by the contesting states

**International Customs**

- serving as evidence of general practice accepted as law

**General principles**

- recognised by civilised nations

**Judicial decisions and teachings of highly qualified publicists of various nations**

- serving as subsidiary means for determination of rules of law

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret any law or agreement, one needs to understand the philosophy of law which has been kept in mind at the time of passing such law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

Tax has been a consequence of business for several hundreds of years; some of the principles would definitely have their bearing on the manner in which law is passed. International tax law has evolved so that conflict of national interests can be resolved (double taxation being the primary issue).

**Source(s) of International Tax Law**

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Source</th>
<th>Particulars relating to the source/origin</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Multilateral international agreements</td>
<td>For example, the Vienna Convention on Law of Treaties (VCLT)</td>
</tr>
<tr>
<td>(ii)</td>
<td>Double Taxation Avoidance</td>
<td>DTAAs may be comprehensive or otherwise. It is to be noted that along with the DTAA, it is the protocols, memorandum of</td>
</tr>
</tbody>
</table>

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¹ [https://www.icj-cij.org/en/statute#CHAPTER_II](https://www.icj-cij.org/en/statute#CHAPTER_II)
### 7.3 TAX TREATIES: OVERVIEW, FEATURES, APPLICATION & INTERPRETATION

<table>
<thead>
<tr>
<th>Agreement (DTAA)</th>
<th>understanding, and exchange of information, etc. forming part of the DTAA which enables interpretation of a DTAA.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(iii) Customary international law and general principles of law</td>
<td>For example, principles of law recognised by civilized nations in their national legal systems, customary law and judicial decisions and the practices of international organizations. Customary international law is the aspect of international law that derives from customs and convention. Along with general principles of law and treaties, custom is also considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of the world’s governments accept, in principle, the existence of customary international law, although there are many differing opinions as to what rules are contained therein.</td>
</tr>
</tbody>
</table>

#### 7.2 DOUBLE TAXATION AND CONNECTING FACTORS

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is “connecting factors”. There are two types of connecting factors, namely, “Residence” and “Source”. It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business **with** another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business **in a** host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link.

- **Juridical double taxation**

  When source rules overlap, double taxation may arise i.e. tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise in their respective jurisdictions. This is known as “juridical double taxation”.

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In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or Double Taxation Convention—DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91, providing unilateral relief in the event of double taxation.

**Example**

Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.

If, instead of UK, ICO has a branch in a state with which India does not have tax treaty, then it can claim unilateral relief under section 91 of the Income-tax Act, 1961 in respect of taxes paid by its branch in that state.

- **Economic double taxation**

  ‘Economic double taxation’ happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different persons (because of lack of subject identity)

**Example**

When one state attributes an income/capital to its legal owner whereas the tax law of other state attributes it in the hands of the person in possession or having economic control over the income, it leads to economic double taxation.

Yet another classic example is tax on distributed surplus by a company which is taxed in the hands of the company distributing such surplus, while the other jurisdiction taxes the said income from distribution in the hands of the shareholder, thus leading to double taxation of the same income albeit in the hands of different persons.

### 7.3 **TAX TREATIES: AN OVERVIEW**

**(1) Definition of “Treaty”**

Treaty is a generic term embracing all instruments binding under international law, regardless of their formal designation, concluded between two or more international juridical persons.

The application of the term treaty, signifies that the parties intend to create rights and obligations enforceable under international law.

Article 2 of Vienna Convention on Law of Treaties, 1969 defines a “treaty” as an international agreement concluded between States in written form and governed by international law,
whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.

(2) Role of Tax Treaties

“Treaty” represents various compromises agreed upon by the respective Contracting States depending upon the economic expediency of a particular country.

Tax, in the country of source is considered as a cost, whereas the same is an obligation in the country of residence. Therefore, there is need to achieve tax efficiency. Double Tax Avoidance Agreements come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

(3) Types of DTAAs

Limited DTAAs are those which are limited to certain types of incomes only. e.g., DTAA between India and Pakistan is limited to income from international air transport only.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

(4) Directive Principles set out in the Indian Constitution

In the Indian context, Article 51 of the Indian Constitution has, inter alia, set out some directive principles which must be followed by the State in the context of International agreements and relationships. It has been provided that-

"The State shall endeavor to -

(a) Promote international peace and security;
(b) Maintain just and honourable relations amongst nations;
(c) Foster respect for international law and treaty obligations in the dealings of organised people with one another; and

(d) Encourage settlement of international disputes by arbitration.

It is pertinent to note that entries 10 and 14 of List I of the Seventh Schedule to the Constitution of India confer the power on Parliament to legislate treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide sections 90 and 90A of the Income-tax Act, 1961.

(5) **Need for tax treaties**

The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force. In addition to allocating the taxing rights and eliminating double taxation, there are various other important considerations as mentioned below:

- **Ensuring non-discrimination between residents and non-residents**
- **Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.**
- **Providing assistance in the collection of the fair and legitimate share of tax.**

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness:** Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.
(ii) **Neutrality and efficiency**: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) **Promotion of mutual economic relation, trade and investment**: In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country’s overall economic growth and development.

(6) **Tax Information Exchange Agreements : An Overview**

A Tax Information Exchange Agreement (TIEA) is an agreement between two jurisdictions and creates for both parties, rights and obligations, which are to be respected. It is not a double taxation avoidance treaty between two states but an agreement between two jurisdictions only for the purpose of exchange of information.

**Purpose of TIEAs**

The purpose of the TIEA is to promote international co-operation in tax matters through exchange of information between two jurisdictions. Without such TIEAs, it would not be possible for a tax jurisdiction to exchange or request information from other jurisdictions for tax purposes.

TIEAs are intended for use with countries for which a DTAA is not considered appropriate, mainly because they have no, or low, taxes on income or profits. While TIEAs are much narrower in scope than DTAAs, they are more detailed than DTAAs on the subject of information exchange. They specify the rules and procedures for how such information exchange is to occur.

**OECD Model Tax Information Exchange Agreement**

In order to ensure the implementation of domestic laws, countries are executing agreements (TIEAs) based on the OECD Model Tax Information Exchange Agreement (TIEA)² The OECD, in 1998, in a report “Harmful Tax Competition: An Emerging Global Issue” identified “lack of effective exchange of information” as one of the key criterion in determining harmful tax practices. As a result of the OECD’s Harmful Tax Practices Project, the OECD Global Forum Working Group was formed in 2001. This Forum includes many tax havens and secrecy jurisdictions such as Bermuda, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino. The Working Group was entrusted with the task of developing a legal instrument that could

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be used to establish effective exchange of information. Accordingly, it developed the 'Agreement on Exchange of Information on Tax Matters. The OECD Model TIEA, published in 2002, represents the effective exchange of information for the purposes of the OECD’s initiative on harmful practices. The Agreement serves both as a multilateral instrument and a model of bilateral treaties or agreements. The bilateral version is intended to serve as a model for bilateral exchange of information agreements. The Agreement came into force on January 1, 2004 with respect to exchange of information for criminal tax matters and on January 1, 2006 with respect to other matters.

The list of Articles of TIEA Model Agreement is given below:

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<thead>
<tr>
<th>Article</th>
<th>Heading</th>
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<td>Exchange of information upon request</td>
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<td>5A</td>
<td>Automatic Exchange of Information</td>
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<td>6</td>
<td>Tax Examinations Abroad</td>
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<td>7</td>
<td>Possibility of declining a request</td>
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<td>8</td>
<td>Confidentiality</td>
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<td>9</td>
<td>Costs</td>
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<td>10</td>
<td>Implementation Legislation</td>
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<tr>
<td>11</td>
<td>Language (May not be required in Bilateral agreements)</td>
</tr>
<tr>
<td>12</td>
<td>Other international agreements or arrangements (May not be required in Bilateral agreements)</td>
</tr>
<tr>
<td>13</td>
<td>Mutual Agreement Procedure</td>
</tr>
<tr>
<td>14</td>
<td>Depositary’s functions (unnecessary in Bilateral agreements)</td>
</tr>
<tr>
<td>15</td>
<td>Entry into Force</td>
</tr>
<tr>
<td>16</td>
<td>Termination</td>
</tr>
</tbody>
</table>

Discussion of some of the important Articles of Tax Information Exchange Agreement:

(a) **Scope and objective of TIEA and Jurisdiction**

Article 1 of the Model agreement defines the scope to provide the assistance in tax matters to the competent authorities of the contracting parties through exchange of information. The agreement provides for exchange of such information that is foreseeably relevant for the administration and enforcement of their domestic laws concerning taxes covered by the
Agreement. Such information shall include information that is foreseeably relevant to the determination, assessment and collection of such taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters. However, as per Article 2 providing for jurisdictional scope of the agreement, a Contracting Party is not obligated to provide information which is neither held by its authorities nor in the possession or control of persons who are within its territorial jurisdiction.

(b) Exchange of Information upon request

Article 5 provides that the competent authority of the requested party must provide the information upon request. Such information shall be exchanged irrespective of whether or not the conduct being investigated would constitute a crime under the laws of the requested Party, if such conduct occurred in the requested Party country.

Upon receipt of information request, if the information in the possession of the competent authority of the requested Party is not sufficient to enable it to comply with the request for information, that Party must use all relevant information gathering measures to provide the applicant Party with the information requested. Such information must be exchanged without regard to whether the requested Party needs such information for its own tax purposes.

Model Agreement provides that each Contracting Party must ensure that its competent authorities have the authority to obtain and provide upon request:

(i) information held by banks, other financial institutions, and any person acting in an agency or fiduciary capacity including nominees and trustees;

(ii) information regarding the ownership of companies, partnerships, trusts, foundations etc.

(c) Possibility of declining a request

Article 7 identifies the situations in which a Contracting Party is not required to supply information in response to a request.

(i) A Contracting Party shall not be required to obtain or provide information that the other Contracting Party would not be able to obtain under its own laws for purposes of the administration or enforcement of its own tax laws. The competent authority of a Contracting Party may decline to assist where the request is not made in conformity with this Agreement.

(ii) The competent authority of the Contracting Party may decline to assist a request for information if the same is not made in conformity with this Agreement.

(iii) A Contracting Party may decline a request for information if the disclosure of the information would be contrary to public policy (ordre public). “Public policy” or “ordre public” refer to information which concerns the vital interests of the Party itself.
(iv) A request for information shall, however, not be refused on the basis that the tax claim to which it relates is disputed.

(v) A Contracting Party may decline a request for information if the information is requested by the other Contracting Party to administer or enforce a provision of the tax law of that other Contracting Party, or any requirement connected therewith, which discriminates against a national of the first-mentioned Contracting Party as compared with a national of the other Contracting Party in the same circumstances.

(d) Confidentiality

Article 8 of the Agreement provides that any information received by a Contracting Party pursuant to this Agreement must be treated as confidential. The information may be disclosed only to persons or authorities (including courts and administrative bodies) of the Contracting Party involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement.

Such information can be used only for such purposes by such persons or authorities. The information may be disclosed in public court proceedings or in judicial decisions. Unless the express written consent is given by the competent authority of the Contracting Party providing the information, the information may not be disclosed to any other person or entity or authority or any other jurisdiction.

Exchange of Information - Article 26 of OECD and UN Model tax Convention

Information can also be exchanged between two jurisdictions by way of entering into tax treaty. OECD and UN Model Tax Conventions provide a framework for negotiation between counties to enter into tax treaties. Article 26 of these Conventions deals with the international exchange of information between the tax authorities of Contracting States. Since international law does not allow a State to conduct a tax investigation in another State without its consent, this Article empowers both Contracting States to exchange information required under the tax treaties and the domestic tax laws. Its purpose is wider than mere tax compliance; it is also meant to counter tax evasion and avoidance. This article in no case impose on a Contracting State the obligation:

(a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

However, a Contracting State cannot decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.
Article 26 also provides for the information which may be exchanged and the manner in which such a request has to be made.

**Legal framework for Exchange of Information in India**

India has taken proactive steps to combat the menace of illicit funds generated both as a result of tax evasion and corruption. Firstly, the Government of India increased the co-operation with other countries by entering into tax treaties and Tax Information Exchange Agreements and secondly laying down anti avoidance regime in jurisdictions where there is a lack of effective exchange of information.

(a) **India’s Tax Information Exchange Agreement (TIEAs)**

Section 90(1) of Income-tax Act, 1961 empowers the Central Government to enter into an agreement with the Government of any country outside India or specified territory outside India, *inter alia* for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory or investigation of cases of such evasion or avoidance.

Accordingly, India has entered into TIEAs with certain countries like Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Jersey, Saint Kitts & Nevis, Argentina etc. The move is in line with the decision taken in G-20, which took up the issue of tax havens and tax evasions.

India signed its first treaty with Bermuda in the year of 2010. India and Bermuda signed a Tax Information Exchange Agreement to facilitate greater information exchange on potential cases of tax evasion. Thereafter, India signed information agreement with a popular tax haven, Isle of Man. That agreement would provide banking and ownership information on companies besides exchange of past information in criminal tax matters. Information will have to be treated as secret and could be disclosed only to specified persons or authorities, which are tax authorities or the authorities concerned with determination of tax appeal. The agreement also has a specific provision that mandates that the requested party shall have to provide upon request the information even though that party may not need such information for its own tax purposes.

(b) **Introduction of specific anti avoidance measures in respect of transactions with persons located in notified jurisdictional area**

The objective of anti-avoidance measures is to discourage assessees from entering into transactions with persons located in countries or territories which do not have effective information exchange mechanism with India. Accordingly, section 94A of the Income-tax Act, 1961 empowers the Central Government to notify any such country or territory outside India as a NJA (Notified Jurisdictional Area), having regard to the lack of effective exchange of information with such country or territory.
The following are the anti-avoidance measures introduced in respect to transactions with a person in a NJA

(i) A transaction, where one of the parties thereto is a person located in a NJA would be deemed to be an international transaction and all parties to the transaction to be deemed as associated enterprises. Accordingly, all the provisions of transfer pricing is to be attracted in case of such a transaction. However, the benefit of permissible variation between the ALP and the transfer price [provided for in the second proviso to section 92C(2)] based on the rate notified by the Central Government would not be available in respect of such transaction.

(ii) Payments made to any financial institution located in a NJA would not be allowed as deduction unless the assessee authorizes the CBDT or any other income-tax authority acting on its behalf to seek relevant information from the financial institution on behalf of the assessee.

(iii) No deduction in respect of any other expenditure or allowance, including depreciation, arising from the transaction with a person located in a NJA would be allowed unless the assessee maintains the relevant documents and furnishes the prescribed information.

(iv) Any sum credited or received from a person located in a NJA to be deemed to be the income of the recipient-assessee if he does not explain satisfactorily the source of such money in the hands of such person or in the hands of the beneficial owner, if such person is not the beneficial owner.

(v) The rate of TDS in respect of any payment made to a person located in the NJA, on which tax is deductible at source, will be the higher of the following rates –
   (1) rates specified in the relevant provision of the Income-tax Act, 1961; or
   (2) rate or rates in force; or
   (3) 30%.

For example, the Central Government had, on 1st November 2013, invoked the provisions of section 94A and notified Cyprus as an NJA owing to inadequate exchange of information by Cyprus tax authorities. In November, 2016, the Central Government issued a press release announcing the signing of the revised Cyprus tax treaty. Subsequent to this notification, Government of Cyprus released the text of the revised Cyprus tax treaty. Thereafter, vide Notification No.1 dated 14.12.2016, the Government rescinded the earlier notification resulting in Cyprus not being a NJA under the Income-tax Act, 1961. In December, 2016, the Central Government, vide another press release, confirmed the completion of internal procedures to amend the Cyprus tax treaty and stated that Cyprus’ status as an NJA under section 94A of the Act has been rescinded. Thus, the deeming fiction provided in section 94A to deem Cyprus tax residents or a person located in Cyprus as an associated enterprise and
treat any transactions with them as an international transaction will no longer be applicable. The claim for deduction of any expenditure/allowance arising on account of transactions with Cyprus tax resident or a person located in Cyprus would now be allowable under general provisions of the Act without documentation requirements prescribed under section 94A. Further, any taxable income accruing/arising to a Cyprus tax resident or a person located in Cyprus would now be subject to the withholding tax rates prescribed under the Act or the revised Cyprus tax treaty, whichever is beneficial to the taxpayer.

For example, payments made to Cyprus tax residents or persons located in Cyprus would now be subject to withholding tax as follows:

(i) Royalties/fees for technical services, earlier liable to withholding under section 94A at the rate of 30%, would now be liable to withholding at 10% under the Act.

(ii) Interest income, earlier liable to withholding under section 94A at the rate of 30%, would now be liable to withholding at 10% under the Cyprus tax treaty or at an applicable lower rate under the Act, whichever is beneficial.

7.4 FEATURES OF TAX TREATIES

(1) Basic Features\(^3\) of Tax treaties

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\(^3\) Illustrative features only

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(i) Tax residency

Benefits of tax treaty would be available only if the person is a resident of one or both of the Contracting States. Generally, it is Article 4 of the tax treaty which governs provisions relating to residence.

In some cases, due to differences in the residential rules of the treaty countries, there are likely chances that a person may be considered to be a resident of both the Contracting States. In such cases, individuals would be considered to be resident of the Contracting State in accordance with Article 4(2) of the treaty whereas in case of persons other than individuals, Article 4(3) of the treaty, commonly referred to as ‘tie breaker rule’ would ultimately determine the residential status of such person. Determination of residence of companies under Article 4(3) would be under the case by case approach requested by the concerned taxpayer through Article 25 (Mutual Agreement Procedure).

Exception

As per Article 4(4) of the US Model Convention, where a company is a resident of both Contracting States, such company shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention.

However, Article 4(3) of the India – U.S. DTAA provides that “where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry into Force)”.

(ii) Allocation of taxing rights

Generally, articles 6 – 22 characterises a particular income for the purpose of allocation in the country of source and in the country of residence. One such exception to the general rule is contained in Article 7 i.e., ‘business profits’, which provides that business profits of a resident of a Contracting State shall be taxable only in the country of residence unless a person has a permanent establishment in the other Contracting State (i.e. source country).

(iii) Non-aggravation principle

Tax treaties provide for allocation of taxing rights between the Contracting States. It is pertinent to note that treaty provisions work on non-aggravation principle. In other words, if an income is not taxable under the domestic tax law; such income cannot be taxed even if it is so taxable in accordance with tax treaty provisions. Thus, it is safe to conclude that no new charge can be created under the treaty.
(iv) Tax Credit mechanism

Under this system, the harshness of double taxation is either eliminated or is restricted to a reasonable level. Presently, there are two methods in vogue i.e. the credit method or the exemption method. In some cases, certain types of income are relieved from double taxation by using the credit method while some get relieved from double taxation by using the exemption method. Further, it is possible that the treaty partners (say, Country A and Country B) may use different methods to grant relief from double taxation to its residents.

Difficulties arise in cases of timing mismatch i.e. where two countries follow different tax years, proof of tax payment, rate of currency conversion, computation mechanism, etc. Many of these aspects lack clarity and therefore, result in litigation.

(v) Exchange of Information

In an era where tax evasion and tax avoidance are heavily targeted by Governments the world over, Article 26 assumes a lot of significance. According to this Article, the competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this agreement or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States.

(vi) Limitation on benefits/Entitlement to benefits

Limitation on benefits is yet another powerful anti-avoidance provision in a tax treaty. India has taken an aggressive stand on anti-avoidance and has included limitation on benefits Article in its treaties with the USA, Singapore, U.A.E, Mauritius, etc. Treaty shopping, although legal, is generally discouraged by various countries, including India.

(2) Structure of Tax Treaties

Tax Treaties, namely Double Tax Avoidance Agreements are based on Model Conventions like OECD/UN/US Model Convention. They are exhaustive and self-contained in nature. The OECD /UN Model conventions are composed of the following Articles-

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<th>Heading</th>
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<td>To whom applicable</td>
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<tr>
<td>2</td>
<td>Taxes Covered</td>
<td>Specific taxes covered</td>
</tr>
<tr>
<td>3</td>
<td>General Definitions</td>
<td>Person, company, enterprise, inter-national traffic, competent authority etc.</td>
</tr>
<tr>
<td>4</td>
<td>Resident</td>
<td>Cases when a person is said to be resident of a Contracting State who can access treaty.</td>
</tr>
</tbody>
</table>

4 Indian treaties by and large follow credit method for elimination of double taxation
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<th>Article</th>
<th>Heading</th>
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| 9       | Associated Enterprises | Enterprises under common management and taxation of profits owing to close connection (other than transactions of arm's length nature) |
| 10      | Dividends | • Definition and taxation of dividends  
• Concessional rate of tax in certain situations; |
| 11      | Interest | • Definition and taxation of interest;  
• Concessional rate of tax in certain situations;  
• Taxation of interest paid in excess of reasonable rate, on account of special relationship; |
| 12/12A  | 12: Royalties/12A: Fees for technical services (FTS) [Note: Only the UN Model Convention contains Article 12A on FTS] | • Definition of royalties/FTS – what it includes and covers, and its taxation;  
• Treatment of excessive payment of royalties/FTS due to special relationship;  
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| 16      | Directors’ Fees and Remuneration for Top Level Managerial Officials | • Definition  
• Mode and Country where taxable. |
| 17      | Entertainers and sportspersons/Artists and sportspersons | • Types of activities covered  
• Mode and Country where taxable. |
| 18      | Pensions and Social Security Payments       | Country where taxable                                                  |
| 19      | Government Services                        | Type of remuneration, and country where taxable                        |
| 20      | Students                                   | Taxation / Exemption of payments received by students.                 |
| 21      | Other Income                               | Residual Article to cover income not covered under other ‘Articles’, mode of taxation and country where taxable |
| 22      | Capital (Tax on Wealth)                    | Definition – mode – and country where taxable                           |
| 23 A/B  | Methods of Elimination of double taxation  | Exemption Method / Credit Method                                        |
| 24      | Non Discrimination                         | (Equitable) Basis of taxing Nationals and Citizens of Foreign State    |
| 25      | Mutual Agreement Procedure                 | • Where taxation is not as per provisions of the convention, a ‘person’ may present his case to Competent Authorities of respective states.  
• Procedure in such cases |
| 26      | Exchange of Information                    | • Competent Authorities to exchange information for carrying out the provisions of the convention.  
• Methodology. |
| 27      | Assistance in collection of taxes          | Competent Authorities to settle the mode of application of this Article |
| 28      | Members of Diplomatic missions and Consular posts | Privileges of this category to remain unaffected                       |
| 29      | Entitlement to benefits                    | To eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, |
7.18 INTERNATIONAL TAXATION

<table>
<thead>
<tr>
<th>Article</th>
<th>Heading</th>
<th>Content</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>including through treaty shopping arrangements. This article inserted in both OECD and UN Model Conventions 2017 corresponding to BEPS Action Plan 6: Preventing Treaty Abuse.</td>
</tr>
<tr>
<td>30</td>
<td>Territorial Extension</td>
<td>To include territory not included earlier; by following appropriate steps mutually and as allowed by the constitution.</td>
</tr>
<tr>
<td>31/30</td>
<td>Entry into Force</td>
<td>• Effective date from which convention comes into force; • Assessment year from which it comes into force.</td>
</tr>
<tr>
<td>32/31</td>
<td>Termination</td>
<td>Time – Notice period – Mode.</td>
</tr>
</tbody>
</table>

Broadly, Articles of tax treaties can be divided into six groups i.e., Scope provisions, definition provisions, substantive provisions, provisions for elimination of double taxation, anti-avoidance provisions and miscellaneous provisions, as indicated in the table below:

<table>
<thead>
<tr>
<th>Groups</th>
<th>Article</th>
<th>Heading</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Scope Provisions</td>
<td>1</td>
<td>Scope of the convention</td>
<td>The provisions contained in these Articles determine scope of persons, taxes, and time period covered by a treaty.</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Taxes Covered</td>
<td></td>
</tr>
<tr>
<td></td>
<td>30</td>
<td>Entry into Force</td>
<td></td>
</tr>
<tr>
<td></td>
<td>31</td>
<td>Termination</td>
<td></td>
</tr>
<tr>
<td>(2) Definition Provisions</td>
<td>3</td>
<td>General Definitions</td>
<td>The terms dividend, interest, royalty, fees for technical services etc., are separately defined in the respective Articles.</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>Residence</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>Permanent Establishment</td>
<td></td>
</tr>
<tr>
<td>(3) Substantive Provisions</td>
<td>6</td>
<td>Income from Immovable Property</td>
<td>These Articles are applicable to particular categories of incomes, capital gains or</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>Business Profits</td>
<td></td>
</tr>
</tbody>
</table>

5 Article of UN Model Convention, 2017

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<table>
<thead>
<tr>
<th>Groups</th>
<th>Article</th>
<th>Heading</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8</td>
<td>Shipping, Inland Waterways, Transport and Air Transport</td>
<td>capital and allocate tax jurisdictions between the two Contracting States</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>Associated Enterprises</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>Dividends</td>
<td></td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>Interest</td>
<td></td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>Royalties</td>
<td></td>
</tr>
<tr>
<td></td>
<td>12A</td>
<td>Fees for technical services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>13</td>
<td>Capital Gains</td>
<td></td>
</tr>
<tr>
<td></td>
<td>14</td>
<td>Independent Personal Services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>15</td>
<td>Income from employment / Dependent Personal Services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>Directors’ Fees and Remuneration for Top Level Managerial Officials</td>
<td></td>
</tr>
<tr>
<td></td>
<td>17</td>
<td>Income earned by Entertainers and Athletes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>18</td>
<td>Pension and Social Security Payments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>19</td>
<td>Remuneration and Pensions in respect of Government Services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>Payment Received by Students and Apprentices</td>
<td></td>
</tr>
<tr>
<td></td>
<td>21</td>
<td>Other Income</td>
<td></td>
</tr>
<tr>
<td></td>
<td>22</td>
<td>Capital (Tax on Wealth)</td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>23</td>
<td>Method of elimination of double taxation</td>
<td>Both these Articles are very important as they deal with the central objective of the DTAA i.e. avoidance or elimination of double taxation.</td>
</tr>
<tr>
<td></td>
<td>25</td>
<td>Mutual Agreement Procedure</td>
<td></td>
</tr>
</tbody>
</table>
### 7.20 INTERNATIONAL TAXATION

<table>
<thead>
<tr>
<th>Groups</th>
<th>Article</th>
<th>Heading</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(5) Anti-Avoidance Provisions</td>
<td>9</td>
<td>Associated Enterprises</td>
<td>Entitlement to benefits inserted corresponding to BEPS Action Plan 6: Preventing Treaty Abuse. These Articles are gaining importance day by day, and used widely by the tax authorities to prevent treaty shopping or abuse of treaty benefits.</td>
</tr>
<tr>
<td></td>
<td>26</td>
<td>Exchange of information</td>
<td></td>
</tr>
<tr>
<td></td>
<td>29</td>
<td>Entitlement to benefits</td>
<td></td>
</tr>
<tr>
<td>(6) Miscellaneous Provisions</td>
<td>24</td>
<td>Non-Discrimination</td>
<td>The Article on Non-Discrimination is used to ensure justice and fair tax treatment to the assessee of one of the Contracting State by the other Contracting States. Article 28 on Diplomats ensures that privileges of this category of persons remain unaffected.</td>
</tr>
<tr>
<td></td>
<td>27</td>
<td>Assistance in collection of taxes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>28</td>
<td>Diplomats</td>
<td></td>
</tr>
</tbody>
</table>

#### 7.5 APPLICATION OF TAX TREATIES

In various countries, unless the context otherwise requires, the provisions of the DTAA shall prevail over the domestic tax provisions. No two treaties between the countries are alike. DTAA signed by India with USA is different in comparison to the DTAA signed with other countries like Netherlands. These differences include taxpayers to resort to tax arbitrage strategies. This frustrates Government’s objective and results in unintended tax benefits. Therefore, in specified circumstances, treaty benefits are denied. Some of the circumstances in the Indian context induce (i) General Anti-Avoidance Rules (GAAR)\(^6\) (ii) Targeted anti avoidance rules (transfer pricing), etc. (iii) Beneficial Ownership Conditions (iv) Entitlement to Benefits/Limitation on Benefits Clause/ Articles, etc.

In recent past, India has re-negotiated DTAA with countries like Mauritius, Singapore, etc. to prevent fiscal evasion with respect to taxes on income and capital gains of the investor\(^7\).

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\(^6\) GAAR provisions in India are applicable from Assessment Year 2018-19  
\(^7\) Effective from 01 April 2017

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Article 4 of DTAA – Gateway to avail tax benefits

It is a well-accepted proposition in a tax treaty scenario that a person shall be entitled to a tax treaty only if he is a resident of one or both of the Contracting States.

This provision aims at curbing the ‘treaty shopping’ practices. It must be noted that though ‘Article 4’ of the tax treaty deals with residential status of a person, it does not provide rules for determination of residence. Instead, it refers to the determination in accordance with the provisions of domestic tax law of the respective Contracting State. This is clear from the language which provides that “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..............”. Therefore, the primary requirement is for a person to qualify as a resident under the law of the concerned Contracting State.

Determination of residential status of a person is crucial since it is ultimately the country of residence that may have full right to tax the worldwide income of its resident. Further, in addition to taxing the global income, the country of residence would grant relief in respect of tax paid in the country of source.

Place of effective management is an important criterion for availing treaty benefits by a corporate. India-U.A.E DTAA (as revised) further limits the application of treaty by providing that the treaty would be applicable to U.A.E company only if it is incorporated in U.A.E and is controlled wholly in U.A.E. Only such company would be regarded as resident of U.A.E. Further, the India–U.A.E DTAA provides that if a person other than an individual is resident of both the States, then it should be deemed to be resident of the State in which its Place of effective management is situated.

Computation of income liable for the purpose of taxation

The provisions of tax treaty inter alia allocates taxing rights between the treaty partners, provides relief or reduces or eliminates the harmful effects of double taxation. However, it is to be noted that except for the provisions under ‘Article 7 i.e. Business Profits taxation’, generally the treaty does not provide rules for computation of income. It would depend upon the domestic tax law provisions. Treaties, at best, distribute the taxing rights between two states. It may limit the rate of tax (generally, in the state of source) or provide the upper limit up to which taxes can be levied. Certain treaties do reduce the incidence of tax by providing or restricting the scope of the subject matter of taxation.

Distributive Rule

Tax treaties only distribute or assign taxing jurisdiction. It does not impose tax. Having assigned the jurisdiction of tax between the State of Residence and State of Source, the domestic tax laws of the respective State determine taxing rules. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

English lawyers called it “Classification and Assignment Rule”, whereas German jurists called it the “Distributive Rule”. According to this principle, “to the extent that an exemption is agreed to, its effect
is, in principle, independent of whether the Contracting States imposes a tax, in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax". The point here is that having agreed to give the right of tax to the other state, that state may or may not levy tax and if the state in whose favour right to tax is devolved, chooses not to tax such income, then, it may result in double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, this rule ensures that double taxation does not arise in future also, if the source states decides to levy tax.

(A) **Treaties are entered into for “Mutual Benefits”**

Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally.

Treaties are negotiated and entered into at a political level and have several considerations as their basis. Thus, treaties should be seen in the context of aiding commercial relations between treaty partners.

(B) **A tax treaty provision may have an unequal effect**

State A imposes tax but state B does not impose a tax, yet wordings of the treaty are reciprocal – so that if and when State ‘B’ does introduce such a tax, the treaty rates would be operative in State ‘B’. Until such time there would be an unequal effect. Moreover, State ‘A’ may make a distributive rule operative upon fulfillment of certain condition or comparable feature.

7.6 **INTERPRETATION OF TAX TREATIES**

(1) **Introduction**

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the Vienna Convention on Law of Treaties (VCLT). These rules of interpretation are not restricted to tax treaties but also apply to any treaty between two countries. Therefore, any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD/UN Model Conventions has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation.

In India, even before insertion of Section 90(2) by the Finance (No.2) Act, 1991, with retrospective effect from 1-4-1972, CBDT had clarified *vide Circular No. 333 dated 2-4-1982* that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income.

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8 Tax Treaty Interpretation – The International Tax Treaties Service
The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAAs which are applicable to the taxpayers, then, the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer.

Interpretation of any statute, more so international tax treaties, requires that we follow some rules of interpretation. In subsequent paragraphs, we shall deal with rules of interpretation of tax treaties.

(2) Basic Principles of Interpretation of a Treaty

Principles or rules of interpretation of a tax treaty would be relevant only where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible. If words are clear or unambiguous, then there is no need to resort to different rules for interpretation.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Just as each country’s legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law. We would be discussing some of the rules of interpretation of Vienna Convention on law of Treaties in the later part of this chapter.

Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) **Golden Rule – Objective Interpretation:** Ideally, any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. The term has to be interpreted contextually.

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the intention of the parties, it should not be adopted.9

(ii) **Subjective Interpretation:** Under this approach, the terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

In Abdul Razak A. Meman’s case [2005] 276 ITR 306, the Authority for Advance Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

(iii) **Purposive Interpretation:** In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the ‘objects and purpose’ method.

In case of Union of India v. Azadi Bachao Andolan 263 ITR 706, the Supreme Court of India observed that “the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international

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9 Prof. J. G. Starke in Introduction to International Law 10th Edition
treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases."

The Apex Court also agreed with the contention of the Appellant that “the preamble to the Indo-Mauritius DTAA recites that it is for ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty”.

(iv) **The Principle of Effectiveness:** According to this principle, a treaty should be interpreted in a manner to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which ‘on the whole’ will render the treaty ‘most effective and useful’, in other words, enabling the provisions of the treaty to work and to have their appropriate effects\(^{10}\).

(v) **Principle of Contemporanea Expositio:** A treaty’s terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

In *Abdul Razak A. Meman’s case* [2005] 276 ITR 306, the AAR observed that “there can be little doubt that while interpreting treaties, regard should be had to material *contemporanea exposition*, which means that a statute is best explained by following the construction put upon it by judges at the time it was made, or soon after. This proposition is embodied in Article 32 of the Vienna Convention, referred to above, and is also referred to in the decision of the Hon’ble Supreme Court in *K. P. Varghese v. ITO* [1981] 131 ITR 597.”

(vi) **Liberal Construction:** It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

In *John N. Gladden v. Her Majesty the Queen* \(^{11}\), the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed that “contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item under consideration is concerned.”

The Court further recognised that “we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms.”

(vii) **Treaty as a Whole – Integrated Approach:** A treaty should be construed as a whole and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

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\(^{10}\) Prof. J. G. Starke in *Introduction to International Law* 10\(^{th}\) Edition

\(^{11}\) 85 D.T.C. 5188 at 5190, Source: *UOI v. Azadi Bachao Andolan* 263 ITR 706 (SC)
(viii) **Reasonableness and consistency**: Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.

An important aspect to be noted regarding the rules of interpretation is that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act.

**(3) Extrinsic Aids to Interpretation of a Tax Treaty**

A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

**Provisions in Parallel Tax Treaties**

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y?

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

**International Articles/Essays/Reports**

International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained “useful material” through international articles.

**Cahiers published by International Fiscal Association (IFA), Netherlands**

“Cahiers de Droit Fiscal International” is the main publication of the IFA, which is published annually and deals with two major topics each year. Cahiers were relied upon in case of *Azadi Bachao Andolan’s* (supra) case by the Supreme Court.

12 Prof. J. G. Starke in Introduction to International Law 10th Edition

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Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

**MFN clause is usually found in Protocols and Exchange of Notes to DTCs. Under this clause a country agrees to extend the benefits to the residents of the other country, which it had (first country) promised to the residents of third country. It tries to avoid discrimination between residents of different countries.**

Normally, the benefit under this clause is restricted to a specific group like OECD countries or developing countries. The nature of benefits under MFN clause could either be application of lower rate of tax or narrowing the scope of the income liable to tax or allowing higher deduction in respect of executive and general administrative expenses of head office.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of Azadi Bachao Andolan, the Apex Court observed that ‘the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty’. These observations are very significant whereby the Apex Court has upheld ‘economic considerations’ as one of the objectives of a Tax Treaty.

**Mutual Agreement Procedure [MAP]**

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also serve as precedence in case of subsequent applications.
Basic Principles of Interpretation of a Treaty

- **Golden Rule - Objective Interpretation**
  - Any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind.

- **Subjective Interpretation**
  - Treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as 'objects and purpose' method.

- **Teleological or Purposive Interpretation**
  - A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

- **The Principle of Effectiveness**
  - Terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

- **Principle of Contemporanea Expositio**
  - A treaty should be interpreted in a manner to have effect rather than make it void.

- **Liberal Construction**
  - It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

- **Integrated Approach**
  - Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument.

- **Reasonable ness and consistency**
  - Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

Extrinsic Aids to Interpretation of a Tax Treaty

- **Provisions in Parallel Tax Treaties**
- **International Articles/Essays/Reports**
- **Protocol**
- **Preamble**
- **Mutual Agreement Procedure [MAP]**
(4) Commentaries on OECD/UN Models and their importance

Interpretation of any statute, more so international tax treaties requires that we follow some rules of interpretation. Commentaries are one of the important rules of interpretation of tax treaties.

There are two commentaries available – one by OECD and the other by UN, based on their respective models. OECD Commentary is authentic and revised from time to time. UN Commentary is by and large based on OECD commentary. UN commentary was published in 1980 and has been revised from time to time. One can refer to the commentaries for interpretation and application of various provision contained in a DTAA.

Views expressed in the commentaries carry great authority. Where Contracting States adopt the text of the Article as per OECD Model convention without any change, and if these countries happen to be OECD Countries, the OECD commentary is directly applicable. In case of a DTAA between developed and developing countries, normally UN model is followed. UN Model and UN Commentary both being largely based on OECD Model and Commentary respectively, OECD Commentary is also quite helpful in interpretation of treaties based on UN Model.

OECD Model Commentary has been widely used in interpretation of tax treaties. The Commentary on the OECD Model Convention states that: “the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge’s deliberations.”

The OECD has framed a model convention to guide countries to draft DTAA. In the Azadi Bachao Andolan case, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

Both UN and OECD Model Commentaries are a great help in interpretation of tax treaties. Their importance in interpretation of tax treaties can hardly be over emphasized [Credit Lyonnais v. DCIT (2005) 94 ITD 401 (Mum)]. OECD, however, plays a greater role in providing standardized or systematized approach in interpretation of tax treaties.

Model Commentaries give the authoritative interpretation of the provisions of DTAA [Sonata Information Technology Ltd. v. ACIT (2006) 103 ITD 324 (Bang)]

(5) Foreign Courts’ Decisions

In CIT v. Vishakhapatnam Port Trust’s case [1983] 144 ITR 146, the Andhra Pradesh High Court observed that, “in view of the standard OECD Models which are being used in various countries, a new area of genuine ‘international tax law’ is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant.”
In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

*Union of India v. Azadi Bachao Andolan* [2003] 263 ITR 706 (SC)
*CIT v. Vishakhapatnam Port Trust* [1983] 144 ITR 146
*Abdul Razak A. Meman’s case* [2005] 276 ITR 306(AAR)

### (6) Ambulatory v. Static Approach

Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, a question often arises what meaning to be assigned to the said term – the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two views on the subject, namely, Static and Ambulatory.

All Model Commentaries including the Technical Explanation on US Model Tax Convention favors ambulatory approach, however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the term.

India-Australia Treaty, in Article 3(2) adds the expression “from time to time in force” to provide for an “ambulatory” interpretation.

### (7) Ambulatory Approach subject to Contextual Interpretation

Article 3(2) of the OECD Model Convention provides that meaning of the term not defined in the treaty shall be interpreted in accordance with the provisions of the tax laws of the Contracting State that may be applying the Convention. However, this provision is subject to one caveat and that is if the context requires interpreting the term ‘otherwise’, then the meaning should be assigned accordingly. For example, India-US treaty provides that assignment of meaning under the domestic law to any term not defined in the treaty shall be according to the common meaning agreed by the Competent Authorities pursuant to the provisions of Article 27 (Mutual Agreement Procedure). And if it is not so agreed, only then, the meaning would be assigned from the domestic tax law and that too, provided the context does not require otherwise.
In case of Union of India v. Elphistone Spinning and Weaving Co. Ltd [2003] 4 SCC 139, the Supreme Court observed that “when the question arises as to the meaning of a certain provisions in a Statute it is not only legitimate but proper to read that provision in its context. The Context means the statute as a whole, the previous state of law, other statutes in pari materia, the general scope of statute and the mischief that it was intended to remedy.”

In Pandit Ram Narain v. State of Uttar Pradesh[1956] SCR 664, the Supreme Court observed that the meaning of words and expressions used in an Act must take their colour from the context in which they appear.

As per section 90(3) of the Income-tax Act, 1961, any term used but not defined in the Act or in the DTAA, shall, unless the context otherwise requires, and is not inconsistent with the provisions of the Act or the DTAA, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Further, in this regard, Finance Act, 2017 has amended the provisions of section 90/90A of the Act by way of insertion of an Explanation, according to which, the term not defined in DTAA, but defined in the Act, to be assigned the meaning given in the Act and explanation, if any, given to it by the Central Government.

(8) Objectives of Tax Treaties

Objectives for signing a tax treaty also play a significant role in its interpretation as they determine the context in which a particular treaty is signed. For example, OECD and UN Model Conventions have different objectives to achieve. The same are as follows:

(i) OECD Model Convention: Principal objectives of the OECD Model Convention are as follows:

The principal purpose of double taxation conventions is to develop economic relationship between the Contracting States and to enhance their cooperation in tax matters. It is intended for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

(ii) UN Model Convention: The principal objectives of the UN Model Convention are as follows:

- To protect tax payers against double taxation (whether direct or indirect)
- To eliminate double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)
- To encourage free flow of international trade and investment
- To encourage transfer of technology
TAX TREATIES: OVERVIEW, FEATURES, APPLICATION & INTERPRETATION

- To prevent discrimination between taxpayers
- To provide a reasonable element of legal and fiscal certainty to investors and traders
- To arrive at an acceptable basis to share tax revenues between two States
- To improve the co-operation between taxing authorities in carrying out their duties

(iii) Indian Tax Treaties: Section 90 of the Income-tax Act, 1961 contains the objectives of signing tax treaties in general. The same are as follows:

(a) for granting of relief in respect of –
   (i) income on which taxes have been paid, both income-tax under this Act and income-tax in that country; or
   (ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

Thus, it can be observed that there are several objectives for entering into tax treaties by the Government of India besides the primary objective of avoidance of double taxation as enumerated above.

(9) Process of negotiating a tax treaty13:

(i) Entering into a tax treaty involves the following steps or stages: Signature, Ratification, Conclusion and Entry into force.

(ii) The process of negotiating a tax treaty typically begins with initial contacts between the countries.

(iii) In deciding whether to enter into tax treaty negotiations with other countries, a country will consider many factors, the most important of which is the level of trade and investment between the countries.

(iv) Once the countries have decided to negotiate, they will exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations.

(v) Typically, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams will agree on a particular text — usually one of the countries’ model treaties — to use as the basis for the negotiations. After presentations by both sides about their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of the treaty is agreed on, the parties initial it.

(vi) After such agreement has been reached, arrangements will be made for the treaty to be signed by an authorized official (often an ambassador or government official).

(vii) After signature, each State must ratify the treaty in accordance with its own ratification procedures. The treaty is generally concluded when the countries exchange instruments of ratification.

(viii) The treaty enters into force in accordance with the specific rules in the treaty.

7.7 ROLE OF VIENNA CONVENTION IN APPLICATION AND INTERPRETATION OF TAX TREATIES

The International Law Commission initiated the work on the Vienna Convention on Law of Treaties in the year 1949 which was completed in the year 1969. It came into force in the year 1980. As of January, 2018, it was ratified by 116 Countries.

Since tax treaty is a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty). Therefore, it would be worthy to understand some of the Articles of the Vienna Convention of Law of Treaties which would help appreciate the manner of application and interpretation of tax treaties.

**Principles enunciated in the Vienna Convention on Law of Treaties**

<table>
<thead>
<tr>
<th>Article No.</th>
<th>Article Heading</th>
<th>Principle enunciated</th>
</tr>
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<tbody>
<tr>
<td>26</td>
<td><em>Pacta Sunt Servanda</em> <em>(in good faith)</em></td>
<td>Every treaty in force is binding upon the parties and must be followed by them in good faith.</td>
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<tr>
<td>28</td>
<td>Non-retroactivity of treaties</td>
<td>Unless a different intention appears from the treaty or is otherwise established, treaty provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party. In other words, unless otherwise provided, treaties cannot</td>
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<th>Article No.</th>
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<tr>
<td>29</td>
<td>Territorial Scope of Treaties</td>
<td>Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.</td>
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<tr>
<td>31</td>
<td>General Rule of Interpretation</td>
<td>• A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose.&lt;br&gt;• The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure&lt;br&gt;(a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;&lt;br&gt;(b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto.&lt;br&gt;• The following shall be taken into account, together with the context in that:&lt;br&gt;(a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;&lt;br&gt;(b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;&lt;br&gt;(c) Any relevant rules of international law applicable to relation between the parties.&lt;br&gt;• A special meaning shall be given to a term if it is established that the parties so intended.</td>
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<td>32</td>
<td>Supplementary means of interpretation</td>
<td>Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:</td>
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<td>(a) leaves the meaning ambiguous or obscure; or</td>
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<td>(b) leads to a result which is manifestly absurd or unreasonable.</td>
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<td>33</td>
<td>Interpretation of Treaties Authenticated in two or more languages</td>
<td>• When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.</td>
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<td>• A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.</td>
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<td>• The terms of the treaty are presumed to have the same meaning in each authentic text.</td>
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<td>• Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.</td>
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<td>34</td>
<td>General Rule regarding third states</td>
<td>A treaty does not create either obligations or rights for a third State without its consent.</td>
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<td>42</td>
<td>Validity and Continuance in force of treaties</td>
<td>• The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention.</td>
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<td>• The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty.</td>
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<tr>
<td>60</td>
<td>Termination or Suspension of the operation of a treaty as a consequence of a breach</td>
<td>• A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part.</td>
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<td>• A material breach of a multilateral treaty by one of the parties entitles:</td>
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<td>(a) the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either:</td>
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<td></td>
<td>(i) in the relations amongst themselves and the defaulting State, or</td>
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<td>(ii) as between all the parties;</td>
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<td>(b) a party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State;</td>
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<td>(c) any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty.</td>
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<td>• A material breach of a treaty, for the purposes of this Article, consists in:</td>
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<td>(a) a repudiation of the treaty not sanctioned by the Convention; or</td>
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<td>(b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty.</td>
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<td>• The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.</td>
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<td>61</td>
<td>Supervening impossibility of performance</td>
<td>• A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it, if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation.</td>
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<td>• Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation</td>
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| 62         | Fundamental change of circumstances | • A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless –  
  (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and  
  (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty.  
  • A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty –  
  (a) if the treaty establishes a boundary; or  
  (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.  
  • If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation. |
| 64         | Emergence of new peremptory norm of general international law | If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated |