

UNIT 191 – UPSC - International Taxation

The rapid growth of open-economy tax scrutiny since many decades differs stridently from earlier patterns, when academic research on taxation posited that the national economy was closed. National tax system deals with various ways of international flows of goods and capitals that may significantly affect the efficiency of resource location in the integrated world economy. Free movement of goods and capital across national borders has important implications for both direct and indirect taxation. International taxation is an area of knowledge pertaining to the international aspects of tax laws and global tax treaties. The tax is levied on the residents of a specific nation residing in that country and earning income by wages in the case of individuals and business income or in the case of commercial organizations and multinational corporations. Multifarious tax laws pose troubles in interpretation and implementation both. Therefore, tax legislation and tax treaties should be straightforward and clear and understandable to common man. Multinational companies require professionals in international taxation as they are lowering the tax liabilities. Diamond and Mirrlees (1971) stated that small open economies acquire very high costs in attempting to tax to local capital investment, since local factors bear the burden of such taxes in the form of productive inefficiencies. Richman (1963) argues that countries may concurrently want to tax the international capital income of domestic residents, implying that any taxes paid to foreign governments should be simply deductible from domestic taxable amount. Governments do not accept policies that are reliable with these forecasts. Corporate income is taxed at high rates by rich countries, and most countries either exempt foreign-source income of domestic multinationals from tax provide credits rather than deductions for taxes paid abroad. Additionally, individual investors can use different methods to avoid domestic taxes on their foreign-source incomes, in the process also avoiding taxes on their domestic-source incomes. Individual and firm behavior also differs from that forecast by simple theories.



In India, the international taxation is more popular among CA's, Company Secretaries and Lawyers. The knowledge of international taxation are based on the factors governing the taxation system of a particular country and being familiar with those factors is the job of an expert on international taxation. The experts must be very experienced with the knowledge on laws

administering the international taxation which plays an important part in the analysis of the international taxation. The objective of International taxation is to manage the cross overs of national tax systems when confronted with international transactions. Its goal is to share the international tax base by assigning tax jurisdiction, prevent tax avoidance, facilitate international trade and finance, and prevent double taxation.

Fundamental Concepts in International Taxation

There are some essential terminologies used in International Taxation. The first concept in international taxation is Income deemed to accrue in India. The Indian Income Tax Act offers for levy of income tax on the earnings of overseas companies and non-residents, but which is restricted to the extent of income accumulated in India. In terms of Section 5 of the Income Tax Act, 1961, a foreign company or any other non-resident individual, is responsible to tax on income which is received or is deemed to be received in India by or on behalf of such person or income which accrues or arises or is deemed to accrue or arise to it in India. Section 9 of the Act specifies certain types of income that are deemed to accrue or arise in India under certain circumstances. No income of a non-resident can be taxed in India unless it falls within the four corners of section 5 read with section 9 of the Income-tax Act.

Two common principles of international taxation and basis of any national tax system are the residence principles and source principles. Country of Residence is significant to determine the liability of a person under the relevant tax laws of any particular country. Income Tax laws of countries are not analogous and it varies. Sometimes, a taxpayer may be a resident of two different countries. In such circumstances, a test has to be applied to determine his residence in terms of double tax avoidance agreement. Another factor in international taxation is source of Income and residential status. In International Taxation field, a country where a person generates income or where the income accrues or arises is very important to decide his tax liability. There has to be a link between the country and its residents as the Government cannot tax foreign sourced income of non-residents.

Other principle of international taxation is associated Enterprises. Section 92A(1) of the Act presents the meaning of Associates Enterprises and specifies the possible situations in which two enterprises will become associated enterprises. Permanent Establishment is another factor in international taxation in which Section 92F describes the term "Permanent Establishment (PE)" which includes fixed place of business through which the business of the enterprise is wholly or partly carried out. OECD and UN model conventions also provide for description of the term permanent establishment as it includes a place of management, a branch, an office, a factory, a workshop etc. There is an international agreement on the acknowledgment of profits earned by Permanent Establishment on the basis of 'Separate Enterprises' concept and the relevance of the 'arm's length principle'. Section 92(1) of the Act also lay down that any income from international taxation shall have to be computed based on the arm's length price. In Business Connection, Section 9 (i) of the Act offers what is business connection in determining tax liability of Non-resident establishments which includes any business activity carried out through a person who acts on behalf of the non-resident who has and usually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident or has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf

of the non-resident or habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident.

Other aspect of international taxation is withholding tax at source. Withholding tax is extra tax imposed by the country of source when various types of remuneration are paid in favor of non-residents of that country. Section 195 of the Income Tax Act, states that any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries" shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force. Provided that in the case of interest payable by the Government or a public sector bank within the meaning of clause (23D) of section 10 or a public financial institution within the meaning of that clause, deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode; Provided further that no such deduction shall be made in respect of any dividends referred to in section 115-O. The withheld tax would be paid into the credit of Central Government and the payee would be getting the balance amount after deduction of tax withheld.

Next factor of international taxation is Double Taxation Avoidance Agreements (DTAA). India entered into Double Taxation Avoidance Agreements with several countries to share the tax between the country of source of income and the country of residence of a taxable entity. Section 90 (1) of the Act provides that Central Government can enter into an agreement with the Government of any country outside India for granting relief in respect of double taxation, promotion of mutual economic relations, trade & investment, for the avoidance of double taxation, for exchange of information & for recovery of taxes. Section 90(2) of the Act states that provisions of Indian Income-tax or DTAA whichever is more beneficial to the assessed will apply. It is pertinent to note that DTAA can even override the provisions of Indian Income Tax Act. Different categories of income such as interest, royalty, fees for technical services, rent, dividend etc. would have different treatment in ascertaining the tax liability in reference to source of income.

Transfer pricing is also important factor in international taxation. Transfer price denotes to the amount used in accounting for transfer of goods or services from one responsibility centre to another or from one company to another which belongs to the same group. Transfer pricing is a means for distributing income between different divisions which jointly develop, manufacture and market products and services. Companies use variations of market-based and cost-based transfer pricing mechanisms to achieve the objective of goal equality. Transfer-pricing system must have in-built mechanisms for smooth negotiation and conflict resolution.

In Authority for Advance Ruling, Section 245N of the Income Tax Act, 1961 defines an Advance Ruling as a determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant; or a determination by the Authority in relation to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident, and such determination shall include the determination of any question of law or of fact specified in the application; a determination or decision by the Authority in respect of an issue relating to computation of total income which is pending before any income-tax authority or the Appellate

Tribunal and such determination or decision shall include the determination or decision of any question of law or of fact relating to such computation of total income. Authority for Advance Ruling is a quasi-judicial authority which helps the non-resident to know his or its tax liability in India in advance.

Crucial Issues in applying International Taxation

International taxation system is highly complicated process. It is an issue which requires modernism in applying settled legal dictum. Even though Indian laws with respect to arbitration and conciliation have been modified which is well-matched with established international trade laws and norms, still it poses difficulty in understanding. In India, economic system is still developing therefore the issue of international taxation have critical role in devising principles of good governance in the domestic as well as international levels. Every nation may develop its principles of governance, in the background of international law, to suit its requirements, policies, priorities and ideals. India has to perform a balancing act for good governance. Tax treaties may create various tax disagreements, which domestic tax forums and courts have to tackle intelligently. The main trouble before such forums and courts would be that there are often no precedents to be followed.

It is found that Parent-country (double) corporate taxation has an independent, strongly negative effect on the probability of foreign subsidiary location in potential host countries, despite the fact that parent country taxation can generally be deferred until income is repatriated. This may reflect that a parent country's taxation is rather discriminatory as it only applies to parent firms residing in the parent country. The high sensitivity of foreign subsidiary location to the parent country tax suggests that this tax is particularly distortive. Paradoxically, the parent country tax may be particularly distortive on account of the foreign credit mechanism - aiming to alleviate international double taxation, as the foreign-tax credit mechanism produces a high variability of the (post credit) parent-country tax across foreign location choices.

To conclude, contemporary considerations for international taxation require smooth administration and revenue adequacy. Developing nations such as India, must consider social justice factor as well in designing International Taxation structure. Main standards of taxation like equity, clarity, economy of a particular country must also be taken in to account while developing international taxation.