Report of the Working Group on

Non Resident Taxation

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WORKING GROUP

Chairman
Shri Vijay Mathur
Director General of Income Tax (International Taxation)
New Delhi

Members
Shri G.C. Srivastava
Joint Secretary (Foreign Tax & Tax Research), CBDT
New Delhi

Shri M.P. Lohia
Commissioner of Income Tax (Appeals)
Mumbai

Shri Rahul Garg
PricewaterhouseCoopers (P) Ltd.
New Delhi

Shri T.V. Mohandas Pai,
Chief Financial Officer
Infosys Technologies Ltd.
Bangalore

Shri Ketan Dalal
RSM & Co.
Chartered Accountants
Mumbai

Shri Bala Swaminathan
Chief Financial Officer
ICICI Bank Ltd
Mumbai

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Preface

The Government appointed a **Task Force on Direct Taxes** under the Chairmanship of Dr. Vijay Kelkar, which presented a "Consultation Paper" in November 2002 and a final report in December 2002, after eliciting responses from the public. In Para 3.15 of the "Consultation Paper" relating to tax treatment of non-residents, the Task Force recommended the creation of a Working Group headed by the Director General of Income Tax (International Taxation) and comprising representatives from trade and industry **to examine various issues pertaining to non-resident's taxation.**

The Working Group for 'Study of Non-Resident Taxation' (Working Group) was constituted by the Ministry of Finance and Company Affairs vide order F. No. 153/221/2002-TPL dated November 14, 2002. (*Appendix-I*)

It was mentioned in the Para 3.15 of the "Consultation Paper" that in the course of discussions with various Chamber of Commerce, Trade and Industry, a large number of issues were raised, including the following:

1. The inability of the Foreign Tax Division (FTD) in the Central Board of Direct Taxes to respond swiftly to the various clarifications sought by trade and industry.

2. The delay in the outcome of the Mutual Agreement Procedure (MAP).

3. The absence of an institutional framework to deal with issues arising out of Foreign Tax Credit (FTC).

4. The absence of the mechanism of Advance Pricing Agreements (APA).

5. The existing procedure for issue of remittance certificate (A large number of representatives expressed concern on the new procedure of remittance without obtaining clearance from the Income Tax Department).

6. The absence of any guideline regarding the database to be used for the purposes of transfer pricing.
7. The high level of penalty on transfer pricing contrary to international practice.

8. The restrictive scope of advance ruling (Representatives suggested that the Indian partner in a Joint Venture with a foreign entity should also be eligible for advance ruling).

The Working Group was to submit this report by the end of December 2002 so that the recommendations could be considered during the forthcoming budget exercise. The time available being too short the Working Group sought and obtained an extension for submitting the report by 10th of January, 2003.

Chapter 1

Approach to Tax Reform

The Working Group deliberated on the approach that it should adopt for suggesting any changes in the taxation of non-residents. The Working Group feels that for a responsive and vibrant tax system the following principles are essential prerequisites:

- **Stability**
- **Certainty**
- **Equality / Neutrality**
- **Efficiency**

The need for adopting global best practices was considered to be of utmost importance and as such in relation to various aspects dealt with in this Report the basis used is available international conventions. This, however, would be subject to the country's economic interest. In this regard the Working Group felt that there should be an open consultative process for obtaining feed back from the taxpayers on proposals for changes contemplated by the Government.

Methodology

The Working Group met at regular intervals. The Group interacted with several organizations in meetings at Mumbai, Delhi, Bangalore and Kolkata. In addition written proposals were also received from many others. The Working Group benefited considerably from the suggestions made.

Chapter – 2

Reform of Tax Administration

The taxation of non residents is governed by the domestic tax law (Income Tax Act, 1961) and by the Double Taxation Avoidance Agreements that India has entered into with other countries. Internationally, treaties have been negotiated under the UN Model Convention or the OECD Model Convention. India being a developing country has largely followed the UN Model Convention. Each of these conventions are explained in official commentaries on various articles dealing mostly with interpretative issues. Wherever countries disagree on any interpretative issue stated in the commentary, these are expressed by way of reservations. India should also state its reservations with regard to the various matters stated in OECD/ UN Commentaries. **For uniformity and certainty of interpretation, the Working Group recommends that a Technical Advisory Group be set up to proactively advise on the reservations that India may have in relation to matters stated in the commentary of the Model Conventions.** The Advisory Group should include members from outside the Government both from professional bodies and from industry who have expertise in international tax. The Advisory Group should adopt a consultative approach building consensus on various issues which impact international tax**. The Working Group recommends that this work should be completed within six months of submission of this Report. It is also suggested that a Chapter on Treaty interpretation be added to the Income-tax Act, which should state India's reservations on the OECD/UN commentaries.**

2.2 In the changing business environment, cross border transactions are throwing up a variety of issues e.g. characterization of payments in electronic commerce transactions, payments for satellite connectivity, existence of a permanent establishment (PE), attribution of profits to the PE, etc. Application of law in respect of these issues is required to be specifically addressed by the tax administration. **Towards this end, the Working Group recommends that an Emerging Issues Task Force on Non-**

resident Taxation (EITF) be set up as a continuing advisory body. The framework of the EITF is recommended as under:

- **The EITF should be constituted under the Chairmanship of a senior officer of the Income Tax Department conversant with International Taxation.**

- **It should be an advisory group with representatives from the Tax Department, Industry and Tax Experts, all having extensive experience and exposure in dealing with cross-border tax issues.**

- **There should be regular meetings of the EITF in relation to emerging issues either as identified by the Chairman or as suggested to him by the members of the EITF or by others.**

- **The EITF should form its views within a period of three months.**

- **The views of the EITF would be intimated to the CBDT who on consideration thereof should issue a circular within a period of one month notifying the Government stand in respect of any class of income or class of cases so that the Non-resident taxpayers have a clear understanding of the Government stand on such emerging issues. The technical clarification could be benevolent to the taxpayers or otherwise. Section 119 of the I.T. Act may have to be amended to allow issue of clarifications, which may be against the taxpayers. Needless to say that the taxpayers would have the right to contest such clarifications in their assessments. This process would lend uniformity of approach by the officers in the Department and make taxpayers aware of their obligation and bring in certainty in a large number of tax issues. This would considerably reduce the compliance cost for the taxpayers and the administrative burden for the Tax Department.**

- **Estimated budget of Rs. one crore for setting up and functioning of the EITF should be provided.**

- **A list of issues which the Working Group recommends for reference to the EITF is given in** *Appendix-II.*

In Para 7.22 of Chapter 7 of the Report of the Task Force on Direct Taxes (December 2002) one of the issues identified was the "inability of the Foreign Tax Division (FTD) in the Central Board of Direct Taxes to respond swiftly to the various clarifications sought by trade and industry". The setting up of the EITF would also provide the necessary inputs for requisite swift response from the Foreign Tax Division (FTD).

2.3 While tax litigation and issues of interpretation are widespread in virtually all countries, the difficulty of uncertainty is compounded where redressal mechanisms are not conducive to timely settlement of disputes. In virtually all representations received by the Working Group, this was a major issue. The Working Group recognizes that while efforts can be made to reduce uncertainty and also to achieve transparency, certain issues will always get litigated. It is, therefore, necessary to address the issue of devising mechanisms for timely settlement of tax disputes. It was recognized by the Working Group that this would need to be done at various levels as under:

- Mutual Agreement Procedure (MAP) which is the competent authority mechanism envisaged in the tax treaties;

- Authority for Advance Rulings;

- Appellate Tribunal level.

In respect of Mutual agreement Procedure (MAP) clear administrative guidelines should be formulated and communicated to the taxpayers regarding how to use the MAP channel. Efforts should be made to reduce the time in resolving disputes in consultation with the other treaty partner countries.

Though the Tax Department has a well-established judicial process, it will be seen as greatly improved if the dispute resolution is speeded up. The Authority for Advance Rulings has only one bench stationed at Delhi**. It is**

therefore recommended that another bench of AAR be constituted at Mumbai, which has a large number of non-resident taxpayers and at any other place where the volume of work so justifies. It is also recommended that the AAR be manned by a full time chairman and members. The Working Group also recommends that dedicated benches of the ITAT are constituted to deal with matters pertaining to Non-resident taxation at least in the bigger cities like Delhi and Mumbai and wherever the volume of work justifies. Department's representatives in these specialised benches should be offices with experience/training in international tax.

2.4 With the opening up of the Indian economy, taxation of Non-residents including foreign companies has increased exponentially. Presently a majority of the tax officers do not have any exposure to Non-resident taxation particularly with regard to the application of treaty law. The human resources in the Directorate of International Taxation requires to be strengthened through good training both in India and abroad. **There should be an earmarked budget available to the CBDT for the purpose of training officers of the I.T. Department abroad. The FTD has an annual budget which should be enhanced to meet this requirement. The Working Group recommends that for training at least 50 officers annually a budget of Rs. 2.5 crores annually be provided.** The OECD, International Bureau of Fiscal Documentation (IBFD) (Amsterdam), as also other international organizations provide training at subsidized cost, which can be availed of. **In order to reap the benefits of such training, the trained Officers should be posted to the Directorate of International Taxation for a minimum period of three years.**

2.5 The Working Group also feels that there is a need for improving awareness in the tax department with regard to what is happening in the field of international taxation in other parts of the world. The need to know the latest in Rulings by Governments as also decisions of foreign Courts is extremely important. This is for the reason that in international taxation reciprocity is pivotal. Furthermore, there are organizations which are carrying on research in various fields of international taxation whose process and results we should be keenly following. Exchange of information

between Governments is enabled through a provision in the DTAAs. There is lack of awareness with regard to tax regime in India which does affect the investment decisions of foreign entrepreneurs. Thus, with the dual objective of giving wider exposure to Tax officials and also to generate awareness among foreign investors about taxation in India, **the Working Group recommends that officers of the Income-tax Department be posted at our missions abroad particularly in the United States Of America, United Kingdom, Belgium (Brussels), Japan, and in the organizations like OECD at Paris and IBFD at Amsterdam. The officers to be posted should be selected from those who have worked or have experience in international taxation and of a level not above that of Commissioner of Income-Tax.**

2.6 Research in relation to International Taxation is of paramount importance. Though tax research is contemplated in the Foreign Tax division of the CBDT, it has neither the manpower nor the resources to undertake the task. **The Working Group, therefore, recommends that the CBDT should be provided with a budget dedicated for research. The research may also be outsourced to institutions like the Institutes of Management and Accountants, Institute of Public Finance and Policy, business schools, etc. in specific areas. A fund of Rs. Three crores may be allocated for this purpose.**

2.7 **The Income Tax Department should create facilities so as to enable taxpayers to correspond with the officers of the Income-tax Department on the Internet.** This may be useful for making the assessment process efficient. **The Working Group also recommends that a legal database including relevant reports of foreign research organisations be compiled in electronic format. For transfer pricing best international and national database on companies, industries and businesses should be made available to the department. The Working Group also recommends to have an intranet for the Tax Department on which useful information including assessment orders can be made available. Tax codes of major countries of the world and journals both domestic and foreign should be available to the Officers to keep them abreast with the latest developments**

in fiscal, economic and business environment. An earmarked budget for all these purposes be made available to the CBDT.

2.8 **In keeping with the need to centralize cases involving cross boarder transactions, the Working Group recommends the extension of the jurisdiction of the International Taxation to extend to the following:**

- **Indian companies which are 100% subsidiaries.**

- **Resident individuals who have foreign income excluding income from business (expatriates).**

2.9 Under the existing dispensation a statement of deduction of tax from interest, dividends or any other sum payable to a non-resident is to be submitted to the tax Department in Form No. 27 quarterly. This form is to be submitted by the person deducting the tax at source. The statement inter alia gives details only in respect of tax deducted at source. No details are made available to the Income Tax Department where payments are made to non-residents and no tax is deducted on the basis of a certificate/undertaking issued by a Chartered Accountant/deductor of tax. Consequently verification as to the liability to deduct tax at source in such cases is not easily possible. **The Working Group, therefore, recommends that Rule 37A of the I.T. Rules along with Form No. 27 be amended to provide for information in respect of payment to non-residents even in cases where no tax has been deducted.**

Chapter – 3

Tax Treaties

3.1 Treaty interpretation

As already stated in Chapter 3 of the Report, it is recommended that a Chapter on interpretation of DTAAs be added in the Income-tax Act. It should provide for interpretation of various terms used in DTAAs, as also the power to frame rules with regard to reservations on treaty interpretation.

3.2 Entitlement to avail DTAA benefit:

Presently a person is entitled to claim application of DTAA if he is 'liable to tax' in the other Contracting State. The scope of liability to tax is not defined. **The term "liable to tax" should be defined to say that there should be tax laws in force in the other State, which provides for taxation of such person, irrespective that such tax laws fully or partly exempts such person from charge of tax on any income in any manner.**

3.3 Applicability of anti-abuse concept in relation to DTAAs:

3.3.1 There is a growing practice amongst certain entities who are not residents of either of the two Contracting States, of trying to access the beneficial provisions of the DTAAs and indulge in what is popularly known as 'Treaty Shopping'. The benefit of the Treaty should be accorded only to persons who are residents of either or both of the Contracting States. It is clear that in relation to taxation, necessity of anti-abuse provisions in tax administration cannot be undermined. This is also supported by the principle of substance over form. While there are a number of decisions from the highest court in the country, which give precedence to substance over form, there is a need to incorporate suitable provisions in the chapter on interpretation of DTAAs, to deal with treaty shopping, conduit companies and thin capitalization. These may be based on UN/OECD model or other best global practices.

3.3.2 The increase in outbound investments has brought significant challenges in the context of ability of companies to park profits outside in low or no tax jurisdictions and deferring taxes in India. Tax deferral is an unjustifiable loss of revenue. It also militates against the neutrality between overseas and domestic investment. Broadly Controlled Foreign Corporation (CFC) Regulations provide for recognising income and creditable tax in the hands of the parent company. Many countries have adopted CFC Regulations, for example USA, UK, Germany and twenty-five more countries. Introduction of CFC regulations would safeguard the interest of the revenue and prevent companies from accumulating profits in low tax jurisdiction. A note giving an overview of CFC Regulations and a comparative chart of their working in USA, UK, and Finland is as per *Appendix-III.* **Presently enterprises have the ability to classify their equity as loans, so as enable them to claim a deduction of interest from their profits whereas if the same was classified as equity, no deduction would have been available in respect of dividend payout. The Working Group, therefore, recommends introduction of anti-abuse provisions in the domestic law, enacting of CFC regulations and the law relating to thin capitalization.**

3.3.3 **The Working Group recommends that in future negotiations, provisions relating to anti-abuse/limitation of benefit may be incorporated in the DTAAs also.**

3.4 Surcharge – Need for clarification vis-à-vis Treaty rates

Surcharge has not been applicable to non-residents till recently. The Finance Act, 2002 has made surcharge applicable to non-residents. The DTAAs provide for withholding tax in the case of payments made to non-residents in respect of interest, dividends, royalty and fees for technical services. The DTAAs also provide that the tax withheld should not exceed a particular percentage, say 10%. In such circumstances the tax to be deducted at source should be 10% and no surcharge should be levied additionally. This would also apply in a case where a taxpayer opts to be assessed on a gross basis. **The CBDT may issue necessary guidelines to provide that in case a specific rate of tax is mentioned in DTAA no surcharge be levied except where the assessee opts for taxation on a net basis.**

3.5 Interpretation of the term "may be taxable"

Tax treaties provide for either sharing of taxes between the country of residence and the source country or the absolute right to tax to the country of residence of the taxpayer. Where taxes are payable in both countries the same is eliminated through either the credit or exemption method. The Karnataka High Court in the case of *CIT Vs. R.R. Muthaiah* reported in *202 ITR 508* held that in the case of an individual owning an immovable property in Malaysia, the Govt. of India did not have any power to levy tax on income from immovable property arising in Malaysia even though such individual is a resident of India. Similar decisions in respect of share income *[211 ITR 368 (Madras)]* and income from a Permanent Establishment in Malaysia *[CIT vs. SRM Firm 208 ITR 400 (Madras)]* have been given. On account of these decisions some of the Tribunals in other parts of the country e.g. Delhi have also applied the principle laid down by the Karnataka and Madras High Courts. While Special Leave Petition has been filed in both the aforementioned cases it would take time to get a decision from the highest court. Meanwhile loss of revenue is expected on this account. Both the UN and OECD models interpret the words "may be taxable" to mean that the specified income would be taxable in the source country and the credit would be given in the country of residence. Where the words "shall be taxable only" are used in the treaties it is taken to mean that a specified income shall be taxable only in the country of residence. The High Courts and the Tribunals are interpreting the words "may be taxable" to mean that the income from immovable property or the income of a PE is taxable only in the country of source, with the country of residence exempting such income completely from the computation of total income. **The Working Group recommends that a suitable amendment be carried out to give the interpretation to the words "may be taxable" in line with OECD/UN Model conventions.**

Chapter – 4

Domestic Law

4.1 Definition of India

The definition of India as appearing in the domestic law and that appearing in various DTAAs is not the same. The domestic law, infact, is narrower in its scope. The Working Group is of the view that **the definition of India provided for in the DTAAs should be introduced in the Income Tax Act, 1961 also for the sake of uniformity.** The Treaties Division in the Ministry of External Affairs may be consulted in this regard.

4.2 Rate of tax

4.2.1 Foreign companies are taxed at a higher rate as compared to domestic companies. Presently a foreign company is taxed @ 40% + surcharge as against the tax rate of 35% + surcharge, applicable to domestic companies. The rationale for the difference in tax rates is that a domestic company distributes dividends and tax is payable by the shareholder too on the receipt of such dividend. The Working Group examined this differential in tax rates and is of the view that in case dividend is not taxed at all as per the recommendation of the Task Force on Direct Taxes then the rationale for having a higher tax rate would not hold good in the case of foreign companies. **The Group therefore recommends parity in the tax rates between domestic and foreign companies.**

4.2.2 If however the dividend is taxed either in the hands of the shareholder or by way of distribution tax, then **the Group still recommends parity in tax rates however with the introduction of Branch Profit Distribution tax to act as an equaliser.** The rate of tax for such branch profits should be decided to ensure that the economic burden of taxes is the same.

4.3 Status of "not ordinarily resident" (NOR)

The existing tax law provides that a person is said to be "not ordinarily

resident" if he has not been a resident in India in nine out of the last ten previous years preceding the year under consideration or has not been in India for 730 days or more out of the last seven years. Such a person enjoys the benefit of not being taxable in respect of his income accruing or arising outside India unless it is derived from a business controlled in or a profession set up in India. Such a provision acts against the grain of 'residence based taxation', which provides for taxation of a resident of a country in respect of income from any source wherever situated. India follows the concept of 'residence based taxation'. India also is a signatory to more than 65 DTAAs. A person availing of the status of 'not ordinarily resident' in India is not taxed on his overseas income but only on the income earned in India. The overseas income particularly the passive income is taxed at more beneficial rates in the source countries as provided for in the DTAAs. A resident in India escapes taxation on his passive income in India because of the NOR provision and is required to pay tax only at very concessional rates in the other jurisdiction because of DTAA provisions. Such a resident is not paying tax at full rate in either country. There is no rationale for continuing with the status of 'not ordinarily resident' for the reason that it militates against the concept of taxation on global basis in the case of a resident. By doing away with the status of NOR an individual would be taxable in India on global basis if he becomes a resident and the Tax Department would thereafter have to give credit for the taxes payable in the foreign country in respect of the same income. The individual would therefore not be taxed twice on the same income and the Government would get its share of revenue. **The Working Group recommends deletion of the provision regarding NOR.**

4.4 Amendments to section 9 of the I.T. Act

4.4.1 The term 'business connection' has been the subject of interpretation by various courts leading to watering down of the original intent of taxing the non-residents on the basis of their business connection in India. **It is, therefore, recommended that the term business connection should be amended to also mean an agency PE, a concept provided for in many of our tax treaties. In other words the meaning of the term 'business connection' should include a person acting on behalf of the non-resident who:**

a) **has and habitually 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**

b) **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**

c) **habitually secures orders in India, wholly or almost 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.**

The agency PE, however, should not be held to be established in cases where the non-resident carries on business through a broker, general commission agent or any other agent of an independent status, provided that such a person is acting in the ordinary course of his business.

4.4.2 Presently a non-resident sportsman etc. may be taxable u/s 115BBA in respect of his participation in India in any game etc. However, sportspersons/entertainers may remain in India for a very short period of time. Consequently they cannot be treated as residents and taxed in respect of the activities performed here. The DTAAs largely provide for the taxation of artistes and sportspersons in the country where their activities are exercised. To align the domestic law with the DTAAs **it is recommended that section 9 be amended to deem that the income in respect of artistes and sportspersons shall accrue in India if the income earned is in respect of personal activities performed in India.** Where, however, the income accrues to another person in respect of the personal activities of the artistes or the sportspersons, such income may notwithstanding any thing contained in sections 28 to 44C should be taxed in India u/s 115BBA in the hands of the other person only. **In this connection the provisions of section 115BBA should also be amended to include the term artistes/entertainers in addition to sportspersons. Consequential amendments may also be required in section 194E and Part II of the First Schedule. The expression artistes/sportspersons should be defined in line with DTAAs.**

4.5 Withdrawal of certain exemptions:

4.5.1 Section 10(4)(ii) excludes, in the case of an individual, from computation of income, interest accruing in a Non-Resident (External) Account. The exemption from tax is available only to non-resident Indians (NRIs). Under the existing tax regime, non-residents do not pay any tax in India on the interest on such deposits. They may ordinarily be paying tax in the country where they are resident on such interest income. In this manner tax in any case is being paid in the country of residence. The Working Group is of the view that with more than 65 DTAAs in place, there is no need for India to forgo any tax in respect of non-residents. In the current scenario the benefit of exemption does not really flow to the taxpayer but to the other country's treasury. The interest accruing on such deposits should be taxed at source in India at the DTAA rate and credit for the taxes paid can be claimed in the country of residence by the NRIs as provided in DTAAs. In this manner double taxation in respect of the same income in the hands of the same individual would be avoided. There is no need for filing of any return in India by the NRI. He would continue to file his return in the country of residence along with his claim for credit of tax payable in India. The deposits in Non-Resident (External) Accounts are substantial and without any loss to the NRIs, India would get its share of revenue. The Working Group, therefore, recommends that the provisions of section 10(4)(ii) be omitted.

4.5.2 In line with the above, the Working Group also recommends that the provisions of section 10(15)(iv)(fa) and section 10(15)(iv)(g) be deleted which relate to interest on foreign currency deposits by banks and interest on foreign currency loan taken by housing companies respectively.

4.5.3 For the same reasons, the provisions of sub-sections (8), (8A) and (8B) of section 10 exempting individuals and consultants who perform duties in India in connection with technical assistance programmes are not required. The tax paid in India would be credited by the country of residence. The Working group recommends the deletion of the aforesaid sub-sections of section 10 of the I.T. Act.

4.5.4 On the same analogy, the provisions of sub-section (15A) of section 10 are recommended for deletion. This provision relates to exemption of any cross border payment for aircraft lease.

4.6 Benefit of deductions to foreign banks

4.6.1 The banking sector in India has implemented various VRS packages to reduce the employee cost in the wake of increased competition and introduction of technology. In the event of business reorganization by way of amalgamation, demerger, acquisition, or succession of business, the successor of such business is entitled to the deduction under the said section in respect of the proportionate amounts of VRS payments for the balance period as prescribed. Section 35DDA(2) makes the benefit available only to amalgamating and amalgamated Indian companies. Foreign banks lose the unabsorbed benefit on amalgamation. This seems to be an anomaly as section 35DDA(1) extends the benefit of amortization of VRS expenditure to all assesses. **The Working Group, therefore, recommends that the benefit of amortization of unabsorbed VRS expenditure under section 35DDA should be extended to all assessees in all schemes of business reorganization like amalgamation, demerger, etc.**

4.6.2 The scheduled banks and non-scheduled banks are allowed deduction under section 36(1)(viia) of the Act on provision for doubtful debts at 7.5% of total income (computed before making Chapter VIA deductions) and 10% of aggregate rural advances. Further such banks also have an option to claim deduction upto 10% of the doubtful assets/ loss assets as on the last day of the previous year as per the guidelines of the Reserve Bank of India. Banks incorporated outside India are eligible for deduction at 5% of total income (before chapter VIA deductions) for provision for bad and doubtful debts under section 36(1)(viia)(b). **In keeping with the Report of the Task Force on Direct Taxes foreign banks should also be allowed deduction in accordance with the prudential guidelines issued by the Reserve Bank of India.**

4.7 Business deductions

4.7.1 Under section 40(a)(i) of the Act, no deduction is allowed in the computation of profits and gains of business or profession if the tax has not been paid or deducted on any payment of interest, royalty, etc. outside India. For deductions made in any month of a previous year, the statutory date for deposit of tax to the Government account is in accordance with Rule 30 of

the I.T. Rules, 1962. The due date for deposit of the tax varies from seven days to two months from the last day of the month in which the deduction is made. The difficulty arises where deduction of tax is made in one financial year and the due date for deposit falls in the next financial year. Consequently the taxpayer is unable to take the benefit of deduction of the payment in the year in which it is charged to the profit and loss account. **The Working Group recommends that in case the tax deducted at source is deposited by the due date falling in the next financial year, the payment to which such TDS relates shall be allowed as a deduction from the profits in the year in which it is charged to the profit and loss account.**

4.7.2 The provisions of section 40(a)(i) presently covers only payments made outside India. **It is recommended that it should be extended to cover payments made to a non-resident including a foreign company even when such payments are made within India.**

4.7.3 On similar lines, **the Working Group recommends that section 40(a)(iii) dealing with the restrictions on deductibility of salary payable outside India should be aligned with the recommendations in connection with section 40(a)(i) above.**

4.8 Amendment of section 44D

4.8.1 Section 44D does not allow any deduction for any expenditure from payments of royalties and "fees for technical services" made to a foreign company only. There is no reason for the exclusion of non-corporate entities from its ambit. **The Working Group, therefore, recommends that section 44D should be amended to apply equally to foreign companies as well as non-corporate non-residents.**

4.8.2 To tax real income in the hands of non-residents as in the case of residents it is important that expenditure incurred on "fees for technical services" be allowed as deduction. **The Working Group, therefore, recommends that in the case of a non-resident carrying on business in India through a PE or a "fixed base" as understood in the relevant DTAA, deduction in respect of any expenditure incurred should be allowed in computing the income by way of "fees for technical services".** Such expenditure, wherever

incurred, should be allowed if it is incurred wholly and exclusively for the purposes of the business and is verifiable. Expenditure should be so allowed only if the accounts are maintained and produced for verification before the Tax Authorities. Where the taxpayer opts to be assessed on a gross basis then the provisions of section 115A and/or the DTAA shall apply. However, no deduction should be allowed in respect of amounts paid or charged by the PE to the Head Office or any of its other offices except for the expenditure allowable under section 44C of the I.T. Act. However the payments made to the Head Office by a PE which are incurred by Head Office wholly and exclusively for the business of PE should be allowed if these are paid to the third parties by Head Office.

4.8.3 **The Working Group recommends that the position in respect of deductibility of expenses on royalty payments to non-residents should remain unchanged.**

4.9 Presumptive Tax and gross basis of taxation

4.9.1 The Working Group is of the view that presumptive taxation for certain classes of income as provided in the Act may continue. **However, it recommends that a study be carried out to evaluate as to whether the presumptive rates prescribed are economically justifiable**. Till a study is made, there is no justifiable basis to extend the scope of presumptive taxation.

4.9.2 **In line with the provisions of presumptive tax regime for residents, the Working Group recommends that the non-resident taxpayer may be allowed the option of following the net basis of taxation provided that the accounts are maintained and produced for verification. This option can be exercised at the time of filing the tax return. Once exercised, the net basis of taxation shall be regularly followed for all succeeding years in respect of the same business.**

4.9.3 **In cases where the presumptive or gross basis of taxation u/s 115A / DTAAs apply, the working Group recommends that the minimum alternate tax (MAT) provisions and provisions relating to tax audit u/s 44AB should**

not be made applicable. Further, the transfer pricing requirements to maintain documentation and furnishing of report should apply only in respect of receipts, which form the basis for computing the tax liability under presumptive or gross basis of taxation. In case the assessee opts for taxation on net basis at the time of filing of return, the provisions of minimum alternate tax and of section 44AB and the documentation requirement in relation to transfer pricing in respect of all international transactions should continue to apply. The rationale for this suggestion is that it simplifies the taxation as also does not subject to MAT or tax audit, cases where the tax liability is to be determined on the basis of gross receipts irrespective of the expenses.

4.10 Removal of Chapter XII-A

Chapter XII-A of the I.T. Act deals with special provisions relating to certain incomes of NRIs. Income from long term capital gains or investment income from specified assets are taxable on a gross basis at the rate of ten or twenty per cent respectively. With regard to such income they ordinarily should be paying full tax in the country of residence and getting credit for taxes paid in India. The tax should be neutral to the residential status of a person. In addition the DTAAs take care that the NRIs would not be taxed twice on the same income. On the basis of the above, **the Working Group recommends the abolition of Chapter XII-A in the I.T. Act.**

4.11 Rationalization of section 115A

4.11.1 Currently, section 115A provides that Royalties/FTS received by non-residents are taxed at a concessional rate of 20% only if the agreement under which these Royalties/FTS are received is approved by the Central Government or relates to a matter that is covered under the Industrial Policy. After the enactment of the Foreign Exchange Management Act, 1999 the Government has liberalised the exchange control regulations and currently every payment to a non-resident on current account is allowed unless specifically made subject to approval either by the Central Government or by the Reserve Bank of India. The Reserve Bank of India has also in certain cases, granted ‘automatic approval’ for payments upto a certain monetary limit. The denial

of tax at a concessional rate in respect of payments on account of royalty and fees for technical services to non-residents on the ground of approval by Central Government not being there, would not be rational. **It is therefore recommended that section 115A should be amended to clarify that payments of Royalties/FTS to non-residents under agreements in accordance with FEMA be taxed in accordance with section 115A.**

4.11.2 The DTAAs provide that where royalty, fees for technical services, dividend and interest are paid to a non—resident, tax shall be withheld at the rate prescribed therein on a gross basis. In case the payments of the nature referred to above are relatable or connected to a PE then such income is taxable as 'Business profits' and the provisions prescribing the rate of tax in the respective Articles of the treaty do not apply. In this situation the rates of tax specified in section 115A of the I.T. Act become applicable which may be more than the rate in the relevant DTAA. At the stage of withholding tax the rate of profit has to be determined for computing the tax deductible. This creates difficulties in the issue of orders u/s 195/197. **It is recommended that section 115A be amended to state that where there is a PE (as understood under the relevant DTAA) then the rate of tax applicable should be the rate as per the treaty on the gross basis without allowing any deduction for expenses in respect of the different types of payments for the purpose of tax deduction at source.**

4.11.3 Section 115A(3) provides that no deduction in respect of any expenditure or allowance is to be allowed in computing income inter alia from royalties and "fees for technical services". In respect of "fees for technical services" **the Working Group recommends that similar amendment as suggested in respect of section 44D be made to give the option of being taxed on net basis.**

4.12 Removal of provisions from Chapter-XII relating to Determination of Tax in Certain Special Cases

The Working Group holds that the principle of neutrality and equality in tax treatment between resident and non-resident taxpayers should apply. In the case of non-residents, dividends and interest is taxable in accordance

with the rates specified in the DTAAs. No further beneficial tax dispensation should be extended to them. This is again for the reason that whatever tax is collected in India the same can be taken as credit in the country of residence of the non-resident. Based on this, **the Working Group recommends that the provisions of sections 115AB, 115AC and 115AD should be omitted. Consequently sections 196B, 196C and 196D relating to TDS in respect of income referred to in sections 115AB, 115AC and 115AD should also be omitted. However, the provisions of sub-section (2) of section 196D which provide that no tax should be deducted at source on capital gains on transfer of securities accruing or arising to FIIs, should continue to apply.**

4.13 Withholding Tax

4.13.1 Under the provisions of section 195 of the Act, any sum payable to a non-resident and chargeable to tax under the Act requires tax withholding by the payer. The deductor or recipient can apply for a No Objection Certificate under section 195/197 of the Act. Large-scale complaints against the delay in issue of these certificates were made both in written submissions as also in the meetings with trade, industry and professional bodies. These complaints have infact been received by the Tax department in the past too. While attempts have been made to speed up the process of issue of these certificates delays still occur. In some cases where payments have to be made by a particular date to a non-resident the delay impacts the business adversely**. The Working group, therefore, recommends that an option be provided to the deductor to remit 80% of the amount sought to be remitted and furnish a certificate from the bank for holding 20% of the balance amount as 'good for payment' towards the tax liability to be determined pursuant to the order u/s 195/197. The Assessing Officer would thereafter determine the tax required to be deducted u/s 195 on receipt of application alongwith bankers certificate for 20% amount being good for payment. The deductor would, thereafter, present this order along with a challan to the bank to deposit the tax quantified in that order. The bank would, thereafter, remit the tax to the Tax Department and release the balance to the deductor. The rate of 20% for withholding from the amount sought to be remitted is being suggested, as it is not expected that ordinarily the tax liability would exceed this percentage. The Working Group also**

recommends that administrative instructions be issued by the CBDT to the field formation that the order u/s 195/197 be issued not later than twenty one days from the date of receipt of application.

4.13.2 Non-residents having Branch Office/Project Office in India and performing work covered u/s 194C should be considered at par with the residents for withholding tax purposes and as such the same rate of withholding tax should apply to payments made to them. **The Working Group recommends that suitable amendment should be made for this purpose.**

4.13.3 There are certain provisions in the Act viz. section 194H, 194I, 194J etc., which require tax to be deducted in respect of payments to any person (including non-residents) for payments of the nature of commission, rent, professional fees, etc. Section 195 deals with all payments except interest on securities and salary payable to non-residents. **The Working Group recommends that the payments referred to in section 194H, 194I, 194J etc should exclude payments made to non-residents because they are covered by the provisions of section 195.** This would obviate avoidable overlapping of the provisions.

4.13.4 Requiring non-residents, especially if they do not have any presence in India, to deduct tax from payments to residents of India, depositing tax in the Government treasury within the prescribed time frame, filing TDS returns, etc. unnecessarily burdens them. It becomes practically very difficult for them to comply with such obligations. **It is recommended that a provision be introduced to the effect that if the recipient undertakes to pay the withholding tax and completes all formalities including filing of TDS return on behalf of the non-resident payer then the non-resident payer shall be relieved of his obligation of deduction of tax at source. The undertaking and the deposit of the tax in such cases shall be made in non-resident tax circles. This will also safeguard revenue's interest.**

4.13.5 Section 2(37A) of the Act, defines the term 'rate or rates in force' to mean the rate or rates of income-tax specified in the Finance Act of the relevant year or the rates provided in the relevant DTAA. Section 2(37A)(iii) does not have any reference of section 193 and consequently the treaty rate may not apply in cases where payments of interest on securities are made to

non- residents. The Act also provides for lower tax rate in the case of dividends u/s 115A. However, Part II of the First Schedule presently does not provide for the lower rate of TDS for dividends as a result of which tax is required to be deducted @40% under clause (vii) of item 2 (b) of Part II of the First Schedule. **To remove these anomalies, it is recommended that suitable amendments be carried out.**

4.14 Appeal by person denying liability to deduct tax

Under section 248 of the Act, any person may deny his liability for having deducted and paid tax at source u/s 195 by filing an appeal with the Commissioner of Income Tax (Appeals). The Commissioner may declare that the deductor had no liability to deduct tax at source. If the Commissioner holds so and a certificate for deduction of tax at source has already been issued by the deductor, the claim for refund may be made by both. **The Working Group recommends that appeal by the deductor should not lie if the certificate for TDS has been issued.**

4.15 E-commerce

Cross border transactions in e-commerce pose considerable difficulties in their taxation. Many countries have expressed their position with regard to the question as to whether business conducted through a server situated in a country would constitute a PE. Further, clarifications regarding characterization of payments and deliveries over the Internet have also been given by many countries. The Govt. of India had constituted a High Power Committee to examine the taxability of transactions in e-commerce. The Committee submitted its reports in 2001. Since then much work, which has been published, has been done internationally particularly by the OECD. There are many reports and research papers now available. **The Working Group recommends that the Government must state its position with regard to both the aspects of existence of PE and characterization of payments and deliveries in electronic commerce environment.** The Working Group felt that to comprehensively deal with the taxation under e-commerce environment, it is also important to address the aspect of attribution of profits to the permanent establishment. **The Group, therefore,**

recommends that while the Government states its position with regard to permanent establishment and characterization, it should simultaneously deal with and state its position with regard to attribution of profits. The Group is of the view that these issues can be effectively dealt with if Tax Advisory Group as suggested in Para 1 of Chapter 2 is constituted and asked to undertake this work as well on a priority.

4.16 **Transfer pricing**

4.16.1 Transfer Pricing Regulations (TPR) have been introduced in the statute book in the form of new sections 92 to 92F in Chapter X by the Finance Act, 2001 with effect from Assessment Year 2002-03. Rules 10A to 10E have also been incorporated in the Income-tax Rules. The Working Group received several representations for amendments in relation to various issues including the definition of the term "Associated Enterprises" (AE), applicability of TPR to foreign companies in respect of receipts from India, nil cost transactions, domestic correlative adjustments, clarification on methods for determination of arm's length price, etc. The Working Group has taken cognizance of all these issues and after considerable deliberation has come to the conclusion that the TPR introduced in India has yet to be tested and therefore amendments are being recommended only in a few areas where it is considered to be essential. Other issues can be addressed by issuing suitable guidelines.

4.16.2 **The Working group recommends that the guidelines on TPR should cover the following:**

- **Scope of work of the Transfer Pricing Officer (TPO).**
- **Cost sharing, reimbursement of expenses and contribution arrangements that are not expressly dealt with by the TPR.**
- **Services/goods provided at concessional or nil value by a foreign enterprise to its Indian AE**
- **Applicability or otherwise of TPR to non-taxable transactions such as exports by a foreign company to India without a PE in India.**

- **Applicability or otherwise of TPR to transactions pursuant to contracts entered into prior to TPR.**

- **Applicability of various methods for determination of arm's length price.**

- **Guidelines on levy of various penalties for violation of TPR.**

- **Application of TPR in respect of transactions subject to withholding tax where corresponding deduction is claimed by Indian entity.**

4.16.3 Section 92A lays down as to when an enterprise shall be held to be an associated enterprise in relation to another enterprise. The criterion prescribed is participation directly or indirectly in the management or control or capital of the other enterprise. Sub-section (2) of section 92A further deems situations as to when two enterprises shall be deemed to be associated enterprises. Situations specified in this sub-section may or may not ipso facto result in a relationship of associated enterprise as envisaged in sub-section (1). Sub-section (2) actually waters down the concept laid down in sub-section (1) and the two are inconsistent. For example there may be control exercised by one enterprise over the other even in cases where the shareholding is only 5%. The qualitative conditions laid down in sub-section (1) should always prevail. Further, the provisions under most of the DTAAs that India has entered into are similar to the provisions of sub-section (1). **The Working Group, therefore, recommends that sub-section (2) be omitted.**

4.16.4 The Working Group also considered the issue of setting up of Advance Pricing Mechanism for TPR. However, the Group is of the view that while the need for having such mechanism can not be understated, the Department should wait till adequate database is generated and some experience is gathered in transfer pricing matters.

4.17 Representative assessee u/s 163

4.17.1 Section 163 of the Act provides that any person in India can be treated as representative assessee of a non-resident if such person is employed, or

has a business connection or has made payments to non-resident or is the trustee of the non-resident. Under section 161 assessment or reassessment proceedings can be initiated against such representative assessee for the income of the non-resident. However, section 149(3) provides that no notice u/s 148 can be served on such representative assessee after the expiry of a period of two years from the end of the relevant assessment year. Thus, though in a normal case, the Act provides time upto six years from the end of the relevant assessment year for reopening/reassessment but in the case of a representative assessee, the time allowed is only two years on account of limitation of treating a person as agent u/s 163.

4.17.2 Sometimes during the course of assessment proceedings of a resident it is found that certain payments made by the resident to a non-resident have not been subjected to tax. In such cases, the resident is required to be treated as a representative assessee u/s 163. Many a times the fact that resident has not deducted tax on payment to non-resident comes to the knowledge of the A.O. only at last stage when the assessment is getting time barred. At that time, the A.O. of the resident assessee informs the Assessing Officer having jurisdiction over the non-resident, who then has to pass an order u/s 163 treating the resident as representative assessee and to issue a notice u/s 148 asking for filing of return. The time available for all these proceedings is too short to give adequate opportunity to the resident to be heard. **The Working Group, therefore, recommends that time limit for issue of notice u/s 149(3) should be increased to six years so as to align it with the time available for reopening of an assessment.**

4.17.3 Banks provide a channel to the non-residents for the payment of income to the non-resident by way of credit to the bank accounts or by way of remittance. The use of the words "from or through whom the non-resident is in receipt of any income" in section 163 may result in a bank being treated as an agent of the non-resident. This would create unintended hardship for the banks who are facilitating the receipt of income by the non-resident in the course of their ordinary banking business. **It is, therefore, recommended that section 163 be amended to provide that where the bank merely allows remittance it will not be treated as an agent.**

4.18 Requirement of PAN in the case of non-residents

The provisions of rule 114C as presently worded exclude the application of section 139A of the Act in the case of non-residents all together. A large number of non-residents are assessed to tax and are involved in the transactions with residents. **Therefore, the Group recommends that the non-residents doing business in India should be required to obtain PAN. However, to obviate the hardship in the cases of such non-residents who have no physical presence in this country, we may provide for necessary exclusion in the requirement of quoting of PAN.**

4.19 Filing of return by a Liaison Office (LO) or Representative Offices (RO)

4.19.1 Presently, u/s 139(1) every company is required to file a return in respect of its income or loss in every previous year. During the course of the interactive meetings between trade and industry an issue was raised as to whether LO/RO is required to file the return in India. Whereas the LOs are not supposed to carry out any trade or business activity, there is no mechanism for Income-tax Department to examine and ascertain as to whether infact the activities taken by LO/RO result in any taxable income in India. In many countries there is a compulsory registration requirement for LO/RO with the Revenue Authorities.

4.19.2 **The Working Group, therefore, recommends that the LO/RO be required to file a tax return to the Income-tax Department giving necessary disclosures regarding their activities in India. In respect of companies it should be provided that the requirement to file the return of income shall arise if the company has any income or loss chargeable to tax in India irrespective whether such company is partly or fully exempted from charge of income-tax under any provision of the I.T. Act 1961/DTAA or the income earned by such company is subjected to tax deduction at source.**

4.20 Foreign tax credits

Due to increased globalilsation of Indian businesses more and more transactions are being undertaken where the residents need to claim the tax credit of the income-tax paid in other countries. During the interactive

session with trade and industry practical difficulties in regard to applying the foreign tax credit provisions under Income-tax Act 1961/DTAA were highlighted. **With a view to streamline the process in this regard the working group recommends the following to be provided:**

- **That the credit for taxes paid overseas shall be allowed in the year in which the foreign taxed income is assessable in India,**

- **That liability towards advance tax shall be computed after taking into account the overseas taxes paid.**

4.21 Underlying Tax Credit

4.21.1 Outbound investment from India is on the increase. Some domestic companies have setup subsidiaries in other countries that are generating profits. Normally dividends should flow back to the parent company in India as and when declared. The dividends are, however, flowing to lesser tax jurisdictions where holding companies are being set up. The income in such jurisdictions accumulates and may be remitted to India at a later date. There is, therefore, a deferment of tax as also a lack of flow back of the funds at an early date. To induce these Indian companies not to structure their affairs in the above manner but to remit the dividend funds to India as also to relieve the economic double taxation on foreign dividend income, **the Working Group recommends that a mechanism known as the allowance of underlying tax credit for the stream of dividend income be adopted.** In this scheme, credit is given by the country where the parent company is a resident, not only for the tax withheld at source on the dividend payout by the overseas subsidiary but also in respect of the tax suffered on distributable profits. **[Underlying tax = Gross Dividend/Distributable Profits x Actual Tax Paid on those profits] This in the case of an Indian parent company receiving dividend from more than one tax jurisdiction by aggregating the gross dividend, distributable profits and actual taxes suffered on those profits in all such jurisdiction.** This would give an incentive for the flow of funds to the parent Indian company and it would also make them more competitive. Larger availability of funds may generate increased investments by these Indian companies and a source of more

taxes for the country. The underlying tax credit would be granted on dividends paid by a company whose 25% or more shares are held by an Indian company.

4.22 Maintenance allowance paid overseas

During the course of interactive discussion with the trade and industry, it was pointed out that due to increased outbound mobility of Indian professionals and technical manpower, the situation demands payment of maintenance allowance to the employees who go overseas for work undertaken by the employer. Such maintenance allowance is granted to meet the additional cost of living of such employee and his family. Under the present law such allowance or a part thereof may be treated as exempt u/s 10(14). However, the application of Sec. 10(14) requires it to be demonstrated that the expenses are actually incurred. Considering the nature of the allowance that is used to meet inter alia day-to-day expenses, it causes genuine hardship in documenting the same. **The Working Group, therefore, recommends that the maintenance allowance paid to the employees for the period of their stay outside India for work of the employer be exempted from tax in India provided that allowance has been taxed in the overseas country. Further, to safeguard the interest of revenue, it should be provided that if any employee brings back any amount to India after the tenure of his overseas assignment, such amount should be treated as income by way of salary earned overseas in the year in which he returns. Also, it should be provided that such exemption would be allowed to an employee only for six months in any 12 months period.**

Chapter – 5

Recommendations

5.1 For a responsive and vibrant tax system the following principles are essential prerequisites:

i) Stability

ii) Certainty

iii) Equality/Neutrality

iv) Efficiency

Tax administration to adopt global best practices.

(Paragraph 1)

5.2 Technical Advisory Group be set up to advise on reservations that India may have in relation to matters stated in the OECD/UN Model Commentaries. Chapter on Treaty interpretation be introduced in the Income-tax Act, 1961.

(Paragraph 2.1)

5.3 The Government should constitute an Emerging Issues Task Force on non-resident taxation (EITF) as a continuing advisory body.

(Paragraph 2.2)

5.4 Constitution of another bench of AAR and dedicated benches of ITAT to deal with non-resident taxation

(Paragraph 2.3)

5.5 Allocation of budget for purposes of training of the Officers abroad, posting of Officers of the Income Tax department abroad, dedicated budget for outsourcing of research in non-resident taxation, purchase of journals etc.

(Paragraphs 2.4, 2.5 & 2.6)

5.6 Use of Internet for interface between taxpayers and the Department.

(Paragraph 2.7)

5.7 Extension of jurisdiction of Directorate of International Taxation to centralise cases involving cross border transactions.

(Paragraph 2.8)

5.8 Introduction of Chapter on treaty interpretation in domestic law.

(Paragraph 3.1)

5.9 Define scope of the term "liable to tax".

(Paragraph 3.2)

5.10 Introduction of anti abuse rules for treaty shopping and thin capitalization and Controlled Foreign Corporation (CFC) Regulations in domestic law.

(Paragraph 3.3)

5.11 Clarification to be issued with regard to levy of surcharge where tax rates are prescribed in treaties.

(Paragraph 3.4)

5.12 Clarification on interpretation of the term "may be taxable" used in DTAAs.

(Paragraph 3.5)

5.13 Align definition of "India" in domestic law with definition in DTAAs.

(Paragraph 4.1)

5.14 Domestic and foreign corporate tax rates should be same in case dividend is not taxed. In case dividends continue to be taxed there should be parity in tax rates between domestic and foreign companies. However in the latter circumstance a Branch Profits Tax should be introduced to act as an equaliser.

(Paragraph 4.2)

5.15 Status of Not-ordinarily Resident (NOR) to be done away with.

(Paragraph 4.3)

5.16 Concept of "business connection" in section 9 of I.T. Act to be strengthened.

(Paragraph 4.4)

5.17 Withdrawal of certain exemptions presently available in the I.T. Act.

(Paragraph 4.5)

5.18 Extension of benefits to foreign banks which are available to domestic banks.

(Paragraph 4.6)

5.19 Rationalization of certain business deductions including in respect of fees for technical services.

(Paragraphs 4.7 & 4.8)

5.20 Option to follow net basis of taxation even where presumptive rate of taxation specified in the Act.

(Paragraph 4.9)

5.21 Removal of Chapter XII-A from the I.T. Act-taxation of NRIs to be aligned with Indian residents.

(Paragraph 4.10)

5.22 Rationalization of the provisions of section 115A and removal of certain provisions in Chapter XII of the I.T. Act.

(Paragraphs 4.11 & 4.12)

5.23 Scheme for resolution of bottlenecks in foreign remittance.

(Paragraph 4.13)

5.24 Guidelines to be issued for implementation of Transfer Pricing Regulations.

(Paragraph 4.16)

5.25 Non-residents doing business in India and having physical presence in India should obtain PAN.

(Paragraph 4.18)

5.26 Filing of return of income by liaison office/representative office to be made mandatory.

(Paragraph 4.19)

5.27 Foreign tax credit to be allowed in the year in which foreign income is assessable in India. Dividends from Indian subsidiaries abroad to be eligible for underlying tax credit in India.

(Paragraphs 4.20 & 4.21)

5.28 Exemption on maintenance allowance paid to employees of Indian companies for overseas work.

(Paragraph 4.22)

Appendix-I

F.No. 153/221/2002-TPL
Government of India
Ministry of Finance & Company Affairs
Department of Revenue
Central Board of Direct Taxes

New Delhi, the 14th November, 2002

ORDER

Subject : Constitution of Working Group for study of Non-resident Taxation.

Ministry of Finance and Company Affairs has decided to set up a Working Group for study of Non-resident Taxation. The objective is to examine issues relating to taxation of non-resident individual and foreign companies. Accordingly, the Working Group is constituted as under:

1.	Shri Vijay Mathur, Director General of Income-tax (International Taxation), New Delhi.	Chairman
2.	Shri G.C. Srivastava, Joint Secretary (Foreign Tax & Tax Research), CBDT, New Delhi	Member
3.	Shri M.P. Lohia, Commissioner of Income-tax (Appeals), Mumbai.	Member
4.	Shri Rahul Garg, Price WaterhouseCoopers, Chartered Accountant, New Delhi.	Member
5.	Shri T.V. Mohandas Pai, Chief Financial Officer, Infosys Technologies Ltd., Bangalore	Member
6.	Shri Ketan Dalal, RSM & Company, Chartered Accountant, Mumbai.	Member
7.	Shri Balaswaminathan, Chief Financial Officer, ICICI Bank Ltd., Mumbai.	Member

Foreign Taxation Division of Central Board of Direct Taxes, Department of Revenue will serve as the Secretariat of the Working Group.

2. The terms of Reference of the Working Group are as follows :

(i) Identifying the legal and procedural aspect of non-resident taxation, including those mentioned in para 3.15 of the Consultation Paper of Task Force on Direct Taxes, which need to be addressed with a view to simplify and rationalize such laws and procedures.

(ii) Making recommendations on the issues mentioned in point (i) above.

3. The terms and conditions of the Working Group will be as follows :

(a) The Working Group must furnish to the Government its report by 31.12.2002.

(b) The Working Group is empowered to interact with departmental officials, trade interests and individuals and visit field formations as it may choose.

Sd/-
(DEEPIKA MITTAL)
Under Secretary to the Government of India

Appendix-II

Issues for reference to EITF

- E-commerce Characterization
- Economic evaluation of presumptive tax/withholding tax rates.
- Issues relating to Transfer Pricing.
- Withholding tax application when the payer and the payee both are Non-Residents.
- Taxation of partnerships and consortiums of non-residents.
- Pass Through Certificates (PTCs)

Appendix-III

1. AN OVERVIEW OF CFC REGULATIONS IN OTHER COUNTRIES –

1. BACKGROUND

Basically the ability to transfer capital and defer tax is at the heart of CFC regulations in various countries. US was the first country to adopt CFC rules in 1962 and as of January 1, 2001, most of OECD have adopted or are examining the possibility of adopting CFC rules. It appears that around 25 countries have adopted CFC regulations.

2. STRUCTURE – SCOPE, EXEMPTIONS, TAX CREDITS, ETC.

2.1 Foreign companies controlled directly or indirectly by residents are usually covered in the ambit of CFC rules. The test of 'control' is complemented by a policy that facilitates identification of CFCs in line with certain philosophies. Many countries apply 'legal control tests' which provides for a threshold of percentage to qualify as a CFC. The threshold varies significantly – for example, in US more than 50% voting rights/value of the shares is the trigger whereas for France, it just 10%. The definition of 'control' may also extend to factors other than legal control (such as 'constructive ownership test' and 'indirect ownership test', to supplement the concept of legal control).

2.2 For identification of CFCs, either of the following two alternative approaches are adopted:

- Transactional approach – wherein no target jurisdiction is defined – CFC rules apply to specific types of incomes – usually passive income.

- Jurisdictional approach - where CFC rules apply to controlled corporations resident of an identified foreign low tax jurisdiction specially designated by the relevant countries.

It is also possible to follow a hybrid approach i.e. a mix of Transactional and Jurisdictional approaches.

2.3 There are usually exemptions in CFC regulations. Most countries provide one or more of the following:

(i) Exemptions for CFC that distributes certain percentage of income in a year.

(ii) Exemptions for CFC engaged in genuine business activities.

(iii) A 'motive' exemption for CFCs which are not established for the purpose of avoiding domestic tax.

(iv) Exemptions for CFCs whose shares are listed on the recognised stock exchanges.

(v) A de-minimis exemption where the total income of the CFCs does not exceed a particular threshold amount.

U.K. allows all 5 exemptions whereas US provides only for (iii) and (iv).

2.4 Since CFC regime attributes income to shareholders before actual distribution of income, relief provisions are ordinarily built in to prevent double taxation of CFC's income and subsequently distributed. Such relief provisions may be:

- Relief on account of foreign taxes paid.

- Relief on account of dividend paid out of the previously attributed income.

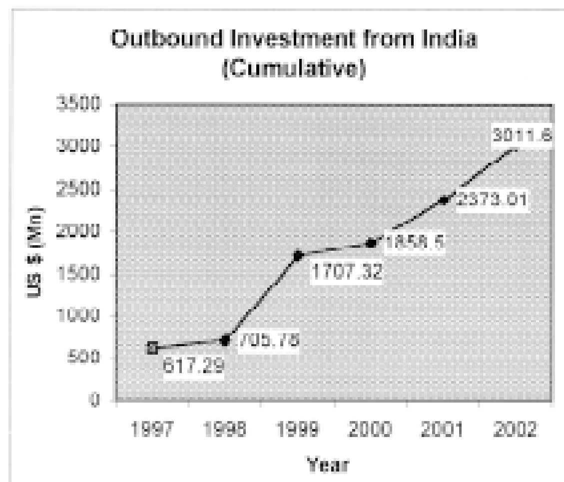
- Relief in respect of losses incurred.

- Relief from double taxation on subsequent capital gains arising from disposition of shares arising out of CFC by the shareholder, where the shareholders have been previously taxed on the undistributed income of CFC.

3. AN INDIAN PERSPECTIVE

3.1 India still does not have full capital account convertibility and the quantum of outbound investment is still not comparable to the levels in relation to countries where there is a free foreign exchange regime.

3.2 The chart below outlines the amount of the outbound investment as on 31st March, 2002 on a cumulative basis. As would be seen, it is currently to the tune of around USD 3 Billion.



4. CFC REGULATIONS IN CERTAIN COUNTRIES

4.1 In order to understand the framework of CFC regulations better, 3 countries namely U.S., U.K. and Finland have been identified for the purpose of a broad review.

4.2 Annexed is a chart which contains the framework of CFC regulations in these countries broken up into certain boxes in order to facilitate appreciation.

- Background
- Definition of CFC
- Key Elements – control, etc.
- What income is included
- Key exclusions
- Tax Credits

Notes

Notes