CHAPTER THREE
DOMESTIC TAX LAWS AS A TOOL TO PREVENT INTERNATIONAL TAX EVASION

3.1 Introductory

The Domestic Tax Laws are an indispensable part of the International Tax Regime as the applicability of any International Tax Agreement primarily depends on taxability of a person under domestic laws of the contracting parties. Taxability under domestic law entitles the taxpayer to claim relief under international agreement. The same taxability also empowers the tax administration concerned to take steps for checking and controlling the menace of tax evasion. On the other hand, article on ‘taxes covered’ under the various international tax agreements include a list of those taxes which are levied by the contracting parties and are covered by International Tax Agreements. Usually they apply and cover taxes on income and capital. Therefore, apart from the International Tax Agreements, the Domestic Tax Laws assume importance under the International Tax Regime.

Domestic Tax Laws include statutes, rules, notifications and circulars relating to tax on income and capital in a particular country. From the view of International Tax Regime, the international aspect of such laws is certainly important. The international aspect refers to those provisions which are relevant for taxing world income and capital of domestic taxpayers or domestic income and capital of the non-resident taxpayers. Such domestic laws also recognize the different International Tax Agreements signed by the respective country. This interplay between the International Tax Agreements
and the international aspect of domestic law gives rise to a legal framework in which the cross border transactions take place.

In India, the tax on income is levied by the *Income Tax Act, 1961* and tax on capital is levied by the *Wealth Tax Act, 1957*. The *Income Tax Act, 1961* provides for taxation of the income earned by both the residents and the non-residents. All the aspects relating to the basis of charge, assessment of income, computation of income and collection of taxes on such income are covered in the *Income Tax Act, 1961*. The *Income Tax Act, 1961* also empowers the Central Government to enter into treaties with foreign countries for avoiding double taxation and for preventing tax evasion.\(^{171}\)

However, all the provisions relating to non-resident are unrealistically dealt under different chapters and sometimes under sub sections or clauses which ordinary appear to be applicable to residents. There is no comprehensive chapter or code which can act as guide for non-residents who are doing business in India. A non-resident is expected to know the complex structure of domestic legislation in India to understand his tax liability. Further, the provisions ordinarily applying to residents but having international effect are also scattered throughout the Act. In this chapter, the researcher has compiled all such provisions which are applicable to non-residents or are ordinarily applicable to residents but have international effect. An attempt has been made to highlight specifically those provisions which are helpful in preventing international tax evasion.

### 3.2 The Residential Status and the Scope of Total Income

Almost all the International Tax Agreements have an article on personal scope. Such article specifies the applicability of such agreements on residents of either or of both the contracting parties. Another article on

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\(^{171}\) Chapter IX of the *Income Tax Act, 1961*. 

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‘residents’ leaves it to a contracting party to decide residential status under its respective domestic laws. Only persons falling within this definition are entitled to take benefits under the international tax agreements. Thus, the taxability in a domestic territory and claiming benefits under International Tax Agreements depends on the residential status of a person. One person may be resident in one contracting party and non-resident in another contracting party or a person may become resident in both the contracting parties due to different rules prevailing in two contracting parties.

In India, the residential status of a person is decided by Income Tax Act, 1961 itself which is divided into three heads, namely, non-resident, resident and not ordinary resident. This issue of residential status is a question of fact which is discussed under following sub-heads.

3.2.1 Non-Resident

A non-resident has been defined in section 2(30) of the Income Tax Act, 1961 as a person who is not a “resident”. It does not give the clear constituents of term non-resident but is dependent on the concept of resident as defined under section 2(42) which is discussed in next point. An important point to note in this regard is that a resident person may be ordinary resident India or not ordinary resident in India. A person to come within the definition of non-resident must neither be ordinary resident nor be not ordinary resident in India. The term ‘Person’ includes individuals, hindu undivided family, company, firm, association of persons, body of individuals, local authorities and every other artificial juridical person. Thus, all such persons can be non-resident in India if they are not falling within the term resident.

For the purposes of sections 92 (Special provisions relating to avoidance of

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172 Raja Bahadur Seth Teomal v. CIT, (1963) 48 ITR 170 (Cal).
tax), 93 (Avoidance of income tax by transactions resulting in transfer of income to non residents) and 168 (Executors), non-resident also includes a person who is not ordinary resident. It may also be noticed that assessment as a resident in one year does not preclude contention in subsequent year that he was non-resident because each assessment year is separate and the residential status in each year has to be decided separately. Thus, person may be resident in assessment year 2010-11, non-resident in assessment year 2011-12 and again become resident in assessment year 2012-13.

3.2.2 Resident

As per section 2(42) of the Income Tax Act, 1961 “resident” means a person who is resident in India within meaning of section 6 of the same Act. Section 6 lays down two alternative tests for individuals, two criterions for companies, one each for Hindu undivided family, firm, association of persons and other taxable persons. Both the alternatives for deciding residential status in case of individuals are based on their period of stay in India.

As per the first option, an individual is said to be resident if he is present in India for a period amounting to one hundred and eighty two days or more during a particular previous year. The expression ‘previous year’ means the financial year preceding the assessment year. The assessment year is the year in which the total taxable income is subjected to tax and assessment.

As per the second option, an individual is said to be a resident in India if his period of stay exceeds sixty days in the previous year and further, the period of stay exceeds three hundred sixty five days in four years preceding the previous year. In case of the second option, the period of sixty days is substituted for a period of one hundred eighty two days in case an Indian

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174 CIT v. PL.M.TT Firm, (1973) 87 ITR 260 (Mad).
citizen leaves India for employment purposes or as member of the crew of an Indian ship or being outside comes to India on a visit.\textsuperscript{176} Calculation of physical presence in respect of the broken period is to be made on hourly basis and where such details are not available the day of arrival and the day of leaving India shall be taken as the stay of the individual in India.\textsuperscript{177}

The basis for the residential status for other entities is based on the locale of ‘control and management’ of the entity. A hindu undivided family, association of persons or a firm is said to be resident only if the control is wholly or partially from India. If the control is wholly outside India, then these entities shall be termed as the non-residents.\textsuperscript{178} In a firm, the control is in hands of the active partners, in case of family entities, control may be in hands of Karta or coparcener(s) or both, and in case of association of persons, the control is in hands of the principal officer.

A company is said to be resident in India if it is an Indian company or if the control and management of its affairs is situated wholly in India.\textsuperscript{179} Indian company means a company formed and registered under the Companies Act, 1956.\textsuperscript{180} Thus, an Indian company is always resident in India even if its control and management abides abroad.

\textbf{3.2.3 Not Ordinary Resident}

The status of not ordinary resident is applicable only to individuals and to hindu undivided families. A Hindu undivided family is treated as not ordinary resident if its manager is not ordinary resident in India. The two conditions prescribed for status of not ordinary are as follows:

\begin{itemize}
  \item \textsuperscript{176} Section 6 of the \textit{Income Tax Act}, 1961.
  \item \textsuperscript{177} In Re ABC (Application No. P. 7 of 1995), (1997) 90 Taxman 62 (AAR New Delhi).
  \item \textsuperscript{178} Section 6(2) of the \textit{Income Tax Act}, 1961.
  \item \textsuperscript{179} Section 6(3) of the \textit{Income Tax Act}, 1961.
  \item \textsuperscript{180} Section 2(26) of the \textit{Income Tax Act}, 1961.
\end{itemize}
(i) he was non-resident in India for at least 9 out of 10 previous years immediately preceding the relevant previous year; or
(ii) he has not been in India for a period of 730 days or more during 7 years immediately preceding the relevant previous year.

On a plain reading of the sub section 6 of section 6 of the Income Tax Act, 1961 it is clear that if an individual comes within the mischief of either of the two conditions, he will be treated as “not ordinary resident”. The residential qualifications prescribed by section 6 of the Income Tax Act, 1961 do not cover state or the government. Therefore it would be incorrect to contend that the government can be considered to be a person capable of being a resident in India.

3.2.4 Scope of Total Income

The income which is taxable in the hands of non-resident includes all income from whatever source they may be derived from India and which is either received or deemed to have been received in India or income which accrues or arises or is deemed to accrue or arise in India. Therefore, all incomes which accrue or arise outside India and are received outside India by such non-resident have been excluded from taxation in case of non resident Indians. The position of not ordinary residents is similar to that of non residents but the only difference is that the income which accrues or arises outside India and received outside India from a business controlled from India is also taxable in India. As far as residents are concerned, they are taxed on all incomes earned by them either globally or from an Indian source.

From the above discussion it is clear that the primary aspect to determine the scope of taxable income is through the residential status of the person and

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other aspect is the basis of charge that is, receipts, accrual, deemed receipt and deemed accrual. This position can be highlighted through the following table:

<table>
<thead>
<tr>
<th>S. No.</th>
<th>RESIDENTIAL STATUS</th>
<th>SCOPE OF TOTAL INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Resident</td>
<td>(i) Income received or deemed to be received in India by or on behalf of such person</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Income accruing or arising in India or deemed to accrue or arise in India</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(iii) Income accruing or arising outside India</td>
</tr>
<tr>
<td>2</td>
<td>Not Ordinary Resident</td>
<td>(i) Income received or deemed to be received in India by or on behalf of such person</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Income accruing or arising in India or deemed to accrue or arise in India</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(iii) Income accruing or arising outside India only if it is derived from a business controlled in or a profession set up in India</td>
</tr>
<tr>
<td>3</td>
<td>Non Resident</td>
<td>(i) Income received or deemed to be received in India by or on behalf of such person</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Income accruing or arising in India or deemed to accrue or arise in India</td>
</tr>
</tbody>
</table>

The remittances made to India of an income received in earlier previous years are not taxable in any of the three cases. Therefore, this section makes a difference between remittances of income and receipt of income.

3.2.4.1 Receipt of Income
The receipt of income refers to the first occasion when the recipient gets the money under his own control. Once an amount is received as income, any remittance or transmission of amount to another place does not result in receipt, within the meaning of this clause at the other place.\textsuperscript{184} The expression “deemed to be received” means deemed by the provisions of the Act to be received. The phrase ‘statutory receipt’ might be conveniently employed to cover income which is “deemed to be received”. In a landmark case the Supreme court gave instances of sections 18(4), 58E, 58J(3), 7(2), 16(1)(c), 19(2)(vii) and 16(2) of 1922 Act.\textsuperscript{185} What is taxable is income receipt only. All receipts do not constitute income and do not come within the ambit of the Act. Where the receipt in India was in nature of advance and sale of goods was taking place outside India it was held that there is no receipt of profits which shall be taxable in India.\textsuperscript{186} Mere promise to pay does not falls within the ambit of receipt.\textsuperscript{187}

3.2.4.2 Income Accruing or Arising in India

The three expressions ‘accrues’, ‘arises’ and ‘received’ have been used in section 5 of Income Tax Act, 1961. Strictly speaking, the expression ‘accrues’ should not be taken as synonymous with the expression ‘arising’ as the former connotes the idea of growth or accumulation and latter connotes growth or accumulation in tangible shape so as to be receivable. It is difficult to say that this distinction has been throughout maintained in the Act and perhaps the two words seem to denote the same idea.\textsuperscript{188} In any taxation law place where the income is accruing or arising is very important and differs from

\textsuperscript{184}Pondicherry Railway Co. v. CIT, (1931) 5 ITC 363; CIT v. S. L. Mathias, (1939) 7 ITR 48 (PC).
\textsuperscript{185}Keshav Mills Ltd. v. CIT, (1953) 23 ITR 230 (SC).
\textsuperscript{186}CIT v. Mysore Chromite Ltd, (1955) 27 ITR 128 (SC).
transaction to transaction. As rightly pointed by the decision of the Privy Council, it is impossible to lay down any general test to determine the place where the profits of business accrue.\footnote{189} For example, import entitlements which are relatable export performance accrue where such export performance took place. The precise quantification done from some other place does not alter the picture.\footnote{190} In speculative forward contracts, where the assessee earned profits from speculative forward contracts with a firm in other state who acted on telegraphic instructions of the assessee, it was held that the profits arose in other state.\footnote{191} In high seas trade, the profits accrue at the place where title in goods passes.\footnote{192} Whether a certain income accrued or arose in India within meaning of s. 5(2) of the Income Tax Act, 1961 is a question of fact which should be looked at and decided in the light of common sense and plain thinking.\footnote{193} Section 9 of the Income Tax Act, 1961 relates to various classifications of income which is deemed to have arisen or accrued in India.\footnote{194} This section is a deeming provision and has been discussed under various headings of this chapter.

\section*{3.3 The Exempted Incomes}

The incomes which fall within the scope of total income are taxable unless expressly exempt under the Income Tax Act, 1961. Section 10 of this Act deals with exempted incomes in case of all taxpayers, that is, residents, non residents and not ordinary residents. The following list highlights the exempted incomes which have a transnational character:

(i) Income by way of interest on securities or bonds and income by way

\footnote{189} \textit{CIT v. Chunnilal B. Mehta}, (1938) 6 ITR 521 (PC).
\footnote{190} \textit{CIT v. Anglo French Textiles}, (1993) 199 ITR 785 (Mad).
\footnote{191} \textit{Rupajee Ratnachand and Others v. CIT}, (1955) 28 ITR 282 (AP).
\footnote{192} \textit{Chhaganlal Savchand v. CIT}, (1966) 62 ITR 133 (Bom).
\footnote{194} \textit{Anglo-French Textile Co. Ltd. v. CIT}, (1954) 25 ITR 27 (SC).
of premium on redemption of bonds as may be notified by the Central Government in the official gazette.\textsuperscript{195} The Finance Act, 2002 mandates that Central Government shall not notify after June 1, 2002.

(ii) Income by way of interest on moneys deposited in the Non Resident (External) Account.\textsuperscript{196}

(iii) Income by way of interest on notified savings certificate issued before June 1, 2002 and subscribed to by an individual in foreign exchange.\textsuperscript{197}

(iv) Income by way of interest, premium on redemption or other payments on such securities, bonds, annuity certificates, savings certificates, other certificates issued by the Central Government and deposits as may be notified by the Central Government.\textsuperscript{198} Income by way of interest on deposits accruing to non-residents in the Non-resident (Non-repatriable) Rupee Deposit Scheme has also been specified by the Central Government.\textsuperscript{199}

(v) Income by way of interest on NRI Bonds, 1988 and NRI Bonds (Second Series) issued by the State Bank of India.\textsuperscript{200}

(vi) Income by way of interest on deposits in foreign currency under a scheme approved by Reserve Bank of India.\textsuperscript{201}

(vii) Income by way of interest payable by government, financial institutions, industrial undertakings on debts incurred by them outside

\begin{footnotesize}


\textsuperscript{199} Notification No. S.O. 653(E), dated 31 August 1992.


\textsuperscript{201} Section 10(15)(iv)(fa) of the Income Tax Act, 1961.
\end{footnotesize}
India in some cases.\textsuperscript{202}

(viii) Remunerations received by foreign citizens in certain specified cases like diplomats and employees for foreign state.\textsuperscript{203}

(ix) Income by way of salary received by a non resident for services rendered in connection with his employment on foreign ship and his total stay in India does not exceed in aggregate a total of ninety days in previous year.\textsuperscript{204}

(x) Income by way of royalty or fee for technical services received by notified foreign company under an agreement with the Government for providing services on a project connecting security of India.\textsuperscript{205}

(xi) Any income received by an individual under a cooperative technical assistance programme between the Central Government and government of a foreign state.\textsuperscript{206}

(xii) Income received by foreign consultants, their employees and family members in cases specified under section 10(8A), (8B) and (9) of the \textit{Income Tax Act}, 1961.

(xiii) Income by way of interest, dividend and capital gains from investments made out of funds belonging to European Economic Community.\textsuperscript{207}

(xiv) Income of the SAARC Fund for regional projects set up by the Colombo Declaration issued on December 21, 1991.\textsuperscript{208}

\subsection*{3.4 Taxability of Incomes Earned from Different Sources}

\textsuperscript{202} Sections 10(15)(iii) and (iv) of the \textit{Income Tax Act}, 1961.

\textsuperscript{203} Sections 10(6)(ii), (vi) and (ix) of the \textit{Income Tax Act}, 1961.

\textsuperscript{204} Section 10(6)(viii) of the \textit{Income Tax Act}, 1961.

\textsuperscript{205} Section 10(6C) of the \textit{Income Tax Act}, 1961.

\textsuperscript{206} Section 10(8) of the \textit{Income Tax Act}, 1961.

\textsuperscript{207} Section 10(23BBB) of the \textit{Income Tax Act}, 1961.

\textsuperscript{208} Section 10(23BBC) of the \textit{Income Tax Act}, 1961.
The rules relating to taxation of income having transnational character are scattered under different chapters and provisions of the *Income Tax Act, 1961*. The international tax agreements discuss taxability of different incomes under certain predefined heads which are universally accepted as most of them are based on model conventions. This is why the present researcher has discussed the provisions relating to taxability of income having transnational character under the following heads which are in tune with the various international tax agreements.

3.4.1 **Income from Immovable Property**

The primary jurisdiction which has the right for taxing income from immovable property under various international tax agreements is the source state. Charge and computation of such income is left on the source state to be determined through its domestic statute. Therefore all the incomes which are earned from any immovable property situated in India are taxable in India under the international tax regime.

The *Income Tax Act, 1961* contains provisions for determining income from immovable property / house property under sections 22 to 27 of the chapter IV. These provisions do not make any difference between residents and non residents while computing income under the head “income from house property”. The charge is made on the ‘annual value’ of the property consisting of any buildings or lands appurtenant thereto of which the assessee is owner.\(^\text{209}\) Annual value is considered to be the inherent capacity of the property to earn income. The three important conditions which are required to be satisfied for computing taxable income under this head are as follows:

(i) The property must consist of buildings and lands appurtenant thereto;
(ii) The assessee must be the owner of such house property;

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\(^{209}\) Section 22 of the *Income Tax Act, 1961*. 

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(iii) The property may be used for any purpose, but it should not be used by the owner for purpose of any business or profession carried on by him, the profits of which are chargeable to tax.

Section 23 of the Income Tax Act, 1961 provides for the rules relating to computation of annual value of the property which is subject to tax. There are different rules for computing gross value in house property which is let out throughout year, partly let out, partly self occupied, lying vacant and self occupied. The most important aspect of this income is that the owner can claim exemption for any one house property which is self occupied by treating its gross value as nil.

The value which computed under this head is subject to certain deductions. The municipal taxes paid by the owner on the property owned by him are deductible from the annual value itself. Apart from such municipal taxes, other deductions which are available to the owner are standard deduction (a sum equal to thirty percent of the net annual value) and interest on the borrowed capital.

3.4.2 Business Profits

Under the international tax agreements, taxability of business profits is dependent on existence of permanent establishment, that is, the source state has the right to tax in case the permanent establishment exists in such state but in other cases where no permanent establishment exists in other state, the residence state has the right to tax. This rule has two fold effects when it is considered from India’s perspective. Firstly, India’s domestic statute is going to tax income earned by non residents from a permanent establishment in India. Secondly, tax is going to be levied on residents for business income earned by them in other jurisdictions when no permanent establishment is established in such other jurisdiction. In other cases, where the income is earned by residents through a permanent establishment in other states or non residents of other states do not have any permanent
establishment in India, then such other state is going to levy tax.

3.4.2.1 Permanent Establishment and Business Connection

The international tax agreements use the word ‘permanent establishment’ whereas the *Income Tax Act, 1961* uses the word ‘business connection’. They may be different in purport but the purpose of both these concepts is to secure a tax base and levy a tax. It is generally felt that term business connection is wider in coverage than permanent establishment as permanent establishment is defined under the international tax agreements and its meaning is thus confined to such terms. On the other hand, *Income Tax Act, 1961* does not define ‘business connection’ which makes it elastic in import.\(^{210}\) Thus, business connection may be wide enough to include permanent establishment and other incomes. The Apex Court in *Barendra Prasad Ray’s Case* has held that ‘business connection’ is wide enough to include a professional connection whereas international tax agreements treat business incomes and professional incomes under different articles.\(^{211}\) In other cases business connection concept may yield to other incomes like royalties and fees for technical services dealt under section 9(1)(vi) and 9(1)(vii) of the *Income Tax Act, 1961* whereas under the treaties if the royalties or fees for technical services are attributable to a permanent establishment, then article of business income becomes applicable. Whateover it may be, the golden rule to be kept in mind is that the taxpayer charged under any provision of *Income Tax Act, 1961* like business connection or royalty or technical services can claim relief under any article of international tax agreements like permanent establishment or royalty or professional income because such taxpayer is given an option to choose amongst the

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The concept of business connection can be found in section 9 of the Income Tax Act, 1961 which deals with income deemed to accrue or arise in India. Section 9(1)(i) provides that the incomes which accrue or arise directly or indirectly through a business connection in India shall be deemed to accrue or arise in India. A business connection involves relation between business carried on by non-resident which yields profits or gains and some activity in India which contributes directly or indirectly to the earnings of those profits or gains. This relation must be real and intimate between trading activity carried on outside India and trading activities within India. The Apex court has also upheld the principle of territorial nexus for taxing income relating to business connection.

This provision is further substantiated by three explanations. The first explanation clarifies the circumstances in which part of the income can be attributed to business connection and circumstances where no income shall be deemed to accrue or arise in India like purchase or sale of goods, collection of news and views in India and shooting of cinematography films by certain specified taxpayers. The second and third explanations were added the Finance Act, 2003 with effect from April 1, 2004. The memorandum explaining the provisions of finance bill highlights that these two provisions are inserted to clarify the expression ‘business connection’ as it is not defined under the Act. The second explanation is inclusive in nature and specifies following three categories under business connection:

(i) Person who has an authority to conclude contracts on behalf of non residents and such authority is habitually exercised;

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(ii) Person who does not have such authority but habitually maintains stock of goods and merchandise in India from which he regularly delivers goods or merchandise;

(iii) Person who habitually secures orders in India, mainly or wholly for non residents.

This explanation excludes brokers, general commission agents or other persons having independent status acting in ordinary course of business. The third explanation clarifies that where a person is termed as business connection in India under explanation 2, then only so much of income as is attributable to the operations carried out by such person shall be deemed to accrue or arise in India.

3.4.2.2 Computation of Business Profits

All those business profits made by the non-residents which are attributable to business connection in India and all those business profits which are made by residents in other states where they have no permanent establishment are subjected to tax which is calculated on income computed in accordance with sections 28 to 44-D and 68 to 69-D of the Income Tax Act, 1961. The same provisions apply for residents earning business income from within India. Thus, once the situs of taxation is decided to be India in international taxation, there is no difference in computation of tax liability between domestic and international taxation.

3.4.3 Income from Shipping, Inland Waterways Transport and Air Transport

The international tax agreements grant primary right of taxation to the state where effective management of the person engaged in shipping, inland waterways or air transport is located. The computation of income of such business has to be made in accordance with the domestic statute of such country. In India the Income Tax Act, 1961 provides for special provision for
computing profits and gains of the business operation of aircraft in case of non residents.\textsuperscript{216} This provision has an overriding effect over the provisions of sections 28 to 43A. Therefore, non-residents can compute their income from aircraft operations under this special provision and they need not follow the procedure for computing income like any other ordinary business under sections 28 to 43A. The residents have to follow the procedure under the ordinary sections 28 to 43A. The special provision which is meant for non residents provides that a sum equal to five percent of the aggregate of the amounts mentioned below shall be deemed to be the profits or gains of such business.

(i) Amount paid or payable as carriage of passengers, livestock, mail or goods from any place in India.

(ii) Amount received or receivable on account of carriage of passengers, livestock, mail or goods from any place outside India.

This special provision was inserted with effect from April 1, 1988 to simplify the computation of income in respect of foreign airlines.\textsuperscript{217} Similarly, a non-resident who is engaged in shipping business can also take benefit of another special provision wherein a sum equal to seven and a half percent of the aggregate amounts as specified above shall be deemed to be the profits and gains of such business.\textsuperscript{218} However, both these special provisions are applicable only if the situs of taxation is in India.\textsuperscript{219}

### 3.4.4 Income of Associated Enterprises or Transfer Pricing

Shifting of profits to a jurisdiction having lower rate of taxes is a common problem in International Tax Regime. This practice is rampant when the international transactions take place between two or more associated enterprises. Even the international tax agreements provide for financial

\textsuperscript{216} Section 44BBA of the Income Tax Act, 1961.

\textsuperscript{217} Circular No. 495, 22 September 1987 issued by the Central Board of Direct Taxes.


\textsuperscript{219} Circular No. 732, dated 20 December 1995 issued by the Central Board of Direct Taxes.
adjustments to be made by the respective tax authorities of the contracting countries in case any manipulation is detected. In India, the *Income Tax Act, 1961* contains special provisions relating to avoidance of tax.\textsuperscript{220}

The present scheme of transfer pricing was introduced by the *Finance Act, 2001* with effect from April 1, 2002 by substituting existing section 92 and inserting sections 92A to 92F. These provisions lay down that income arising from an international transaction between associated enterprises shall be computed having regard to the arm’s length price. The term ‘associated enterprise’ has been defined in section 92A. Section 92B defines an ‘international transaction’ between two or more associated enterprises. The provisions contained in section 92C provide for methods to determine the arm’s length price in relation to an international transaction, and the most appropriate method to be followed out of specified methods. While the primary responsibility of determining and applying an arm’s length price is on the assessee, sub section (3) of section 92C empowers the Assessing officer to determine the arm’s length price and compute the total income of the assessee accordingly, subject to conditions provided therein. Section 92D provides for certain information and documents required to be maintained by persons entering into international transactions, and section 92E provides for a report of an accountant to be furnished along with the return of income.\textsuperscript{221}

### 3.4.4.1 Methods for Determining Arm’s Length Price

Apart from the above mentioned provisions, the Central Board of Direct Taxes has also prescribed rules 10A to 10E in the Income Tax Rules, 1962 which provides for manner and circumstances in which different methods would be applied in determining arm’s length price and factors governing the selection

\textsuperscript{220} Chapter X of the *Income Tax Act, 1961*.

\textsuperscript{221} Circular No. 12 of 2001, dated 23 August 2001 issued by the Central Board of Direct Taxes.
of most appropriate method.\textsuperscript{222}

Comparable Uncontrolled Price Method involves a three-fold process. Firstly, price charged or paid by the business entity in a comparable uncontrolled transaction or number of transactions is identified. Secondly, such price is adjusted to account for differences between international transaction and comparable uncontrolled transaction. Lastly, the adjusted price is taken to be an arm’s length price in respect of the property transferred or services provided.

The Resale Price Method involves a five fold process. In the first place, a transaction is identified where the business entity has made resale of the property purchased or services obtained to an unrelated enterprise. Secondly, the resale price is reduced by the gross profit margin which is earned by such business entity while making resale to an uncontrolled and unrelated enterprise. Thirdly, this reduced price is further reduced by the expenses incurred by the business entity in obtaining services or purchase of property. Fourthly, adjustment is made for any variations which may have crept due to difference in accounting treatment. Lastly, this adjusted price is taken to be an arm’s length price in respect of purchase or property or obtaining of services.

The Cost Plus Method involves a five fold process. In the first place, the direct and indirect costs incurred by the business entity in respect of property transferred or services provided are determined. Secondly, the gross profit mark up for such transaction in cases involving uncontrolled and non related enterprises is determined. Thirdly, adjustments to this gross profit mark up due to functional differences are made. Fourthly, the cost which is determined in the first step is increased by the adjusted gross profit mark up as determined in third step. Lastly, the sum so arrived is taken to be the arm’s length price in

\textsuperscript{222} Notification No. 250/S.O. 808E, dated 21 August 2001.
the international transaction.

The Profit Split Method involves a four fold process. In the first place, the combined net profit of the associated enterprise arising from the international transaction in which they are engaged is determined. Secondly, the relative contribution made by each associated enterprise to earnings of such combined net profit is evaluated. This evaluation is done on basis of the functions performed, assets employed and risks assumed by each enterprise. Thirdly, the net profit as determined in first step is then split amongst associated enterprise in proportion of the relative contribution made by each of them. Lastly, the profit so determined is taken into consideration while determining arm’s length price.

The Transactional Net Margin Method involves a five fold process. In the first place, the net profit margin realized by the business entity from a transaction entered into with associated enterprise is computed in relation to costs incurred or sales effected or assets employed by such enterprise. Secondly, net profit margin realized by such business entity while dealing with unrelated comparable uncontrolled enterprise is determined. Thirdly, the net profit margin determined in second step is adjusted for any functional differences. Fourthly, the net profit margin realized by the business entity as determined in first step is established to be same as net profit margin determined in third step. Lastly, the net profit margin thus established is then taken into account to arrive at arm’s length price.

Apart from these methods, Rule 10 AB of the Income Tax Rules, 1962 prescribes a residuary rule for determination of arm’s length price under clause (f) of sub section (1) of section 92C. It states that such method shall be any method which takes into the price which is charged or paid for same uncontrolled transaction considering all the relevant facts.
3.4.4.2 Choice of Appropriate Method

Rule 10C of the *Income Tax Act*, 1961 prescribes that most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction. In addition, the following factors must be taken into consideration:

(i) The nature and class of international transaction;

(ii) The class or classes of associated enterprises entering into the transaction and the functions performed by them taking into consideration the assets employed and risks assumed by such enterprise;

(iii) The availability, coverage and reliability of data necessary for the application of method;

(iv) The degree of comparability existing between the international transaction and the controlled transaction and between the enterprises entering into such transaction;

(v) The extent to which reliable and accurate adjustments can be made to account for differences; and

(vi) The nature, extent and reliability of assumptions required to be made in the application of a method being identified or adopted.

3.4.5 Dividend Income

The principal systems of corporate taxation are, namely, classical system, imputation system and two rate system.\(^{223}\) Under the classical system, both company and the shareholder who receives the dividend are taxed. Thus, the distributed profits are taxed at a higher rate than the undistributed profits. This system is followed by the countries which promote retention of dividends by the company.

Under the imputation system, like classical system, both company and shareholder are taxed but the shareholder gets a credit for part of the tax paid by company. This system reduces the discrimination between retained and distributed profits but cannot eliminate it. Under the two tier system, different rates of tax are assigned for company and shareholder. The shareholder is usually taxed at a lower rate as compared to the company. It may be noticed that both imputation and two tier systems provide some relief to the shareholder by giving credit for the tax paid by company or by taxing shareholder at a lower rate.

Under the *Income Tax Act*, 1961 dividend means any dividend defined under section 2(22) which is declared, distributed and paid by a company. Income from dividends is chargeable under head ‘Income from Other Sources’ under section 56(2)(i) subject to the deductions available under section 57, until or unless it is specifically exempt. Some deductions are also available under Chapter VIA in respect of dividend income. However, treatment of dividend is not same in all kinds of assesses. Some of them are given special treatment in form of incentives and low rate of taxation.\(^{224}\) The different rules relating to taxability of dividend income in India are highlighted as under:

(i) A dividend income paid by an Indian company outside India is deemed to accrue or arise in India.\(^{225}\)

(ii) The income from dividends from all domestic companies where provisions of dividend distribution tax under section 115-O applies are exempt in the hands of shareholders.\(^{226}\)

(iii) Dividend income of recognized provident funds, approved superannuation funds, approved gratuity funds and registered trade unions are exempt.\(^{227}\)

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(iv) Dividend income received by foreign companies and non-corporate non resident assessee is taxable at a lower rate of twenty percent.\textsuperscript{228} No deduction under sections 28 to 44C, 57 or Chapter VIA is allowed. If the investment is made in specified units through foreign exchange then the rate applicable is ten percent only.\textsuperscript{229}

### 3.4.6 Interest Income

Interest income is taxable in the hands of a non resident depending upon the use of the funds bought by the payer of interest.\textsuperscript{230} If the interest is paid / payable by the Government of India to a non resident it is always taxable in India. If interest is paid / payable by a person resident of India to a non resident and where the funds borrowed are used for carrying out business or profession outside India or for making or earning any income from any source outside India, then in such a situation the interest is not deemed to accrue or arise in India and therefore not taxable in India. Thus, if the funds, for which interest is paid / is payable, are used for the purpose of carrying out business or profession in India or for making or earning any income from any source in India, then in such a situation the interest is deemed to accrue or arise in India and therefore taxable in India. If interest is paid / payable by a non resident to a non resident and where the funds borrowed are used for carrying out business or profession in India or for making or earning any income from any source within India, then in such a situation the interest is deemed to accrue or arise in India and therefore taxable in India.\textsuperscript{231}

\textsuperscript{228} Sections 115A of the \textit{Income Tax Act}, 1961.

\textsuperscript{229} Section 115AC of the \textit{Income Tax Act}, 1961.


\textsuperscript{231} Section 9(1)(v) of the \textit{Income Tax Act}, 1961.
3.4.7 **Royalty Income**

‘Royalty’ generally means a share of the profit reserved by the owner for permitting another to use the property of the owner. It includes consideration received for exploitation of what are called intellectual properties and for information concerning industrial, commercial or scientific experience. Such properties are intangible and having no physical existence. The *Income Tax Act, 1961* defines ‘Royalty’ in Explanation 2 to S. 9(1)(vi). It defines royalty as consideration for:

(i) The transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;

(ii) The imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;

(iii) The use of any patent, invention, model, design, secret formula or process or trade mark or similar property;

(iv) The imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(iva) The use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;

(v) The transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) The rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

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The rules relating to taxability of royalty income, when it is deemed to accrue or arise in India, are similar to interest income. Royalty is taxable in India in all cases when it is paid by government and if it is paid by resident one exception is made out in favor of a business or profession which is carried on by such resident from outside India. In cases involving non residents, the royalty is taxable only if it is payable for purposes of making or earning any income from any source in India.

3.4.8 Fee for Technical Services

It may be noticed that the term ‘royalty’ as defined under section 9 of the Income Tax Act, 1961 includes any services in connection with use or right to use of any industrial, commercial or scientific equipment. All other clauses under the term ‘royalty’ deal with consideration for use of intangible property or/and services in connection with such properties. This clause on industrial, commercial or scientific equipment and services in connection thereof was added by an amendment with effect from April 1, 2002. After its inclusion a major portion of fee for technical services already stands included in royalty income. Even most of the double tax conventions deal with royalty and fee for technical services under same article. Some treaties which differentiate between royalty and fee for technical services include consideration for use or right to use of intangible property and industrial, commercial or scientific equipment under royalty and consideration for services ancillary or subsidiary to such properties under fee for technical services.233

Under section 9 of Income Tax Act, 1961 income by way of fee for technical services will be deemed to accrue or arise in India if they are payable:

(i) By Government: In all cases;

(ii) By a Resident: In all cases except where the fees are payable in respect of technical services utilized in a business or profession carried on by the person outside India or for purpose of making or carrying

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233 Article 12 of the Agreement Between India-USA, 1990.
any income from source outside India;

(iii) By a Non-Resident: Only where the fee are payable in respect of services utilized in a business or profession carried on by a non-resident in India or where such services are utilized for the purpose of making or earning income from a source in India.

3.4.9 Capital Gains

Capital gains arising in case of non residents are dealt under special provisions of the *Income Tax Act, 1961*. Capital gains which are not covered by these provisions are to be dealt under general provisions of the Act. All these provisions come into play only when the situs of taxation under the International Tax Regime is India. This situs is decided in accordance with the provisions of double tax conventions and the *Income Tax Act, 1961*.

In case of non residents, unless the place of accrual of income is within India, it cannot be subjected to tax. Income which accrues directly or indirectly outside India may be fictionally deemed to accrue or arise in India if such income accrues or arises as a sequel to the transfer of a capital asset situated in India. This is the main purpose behind enactment of section 9(1)(i) of the *Income Tax Act, 1961*. It may be highlighted that it is only the income which may be directly or indirectly accruing from the transfer of capital asset in India but the transfer as such has to be in India. Therefore, indirect transfers of capital asset are not covered by section 9(1)(i) of the *Income Tax Act, 1961*. As such this provision is not a “look through” provision.

The law relating to taxation of capital gains for non resident Indians for investment in specified assets is laid down in the Chapter XIIA of the *Income Tax Act, 1961*. This chapter is applicable to only those non-resident Indians who are individuals and being citizen of India or a person of Indian origin do

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not fall within the definition of resident. The investment by such non resident Indians must be made in specified assets which refers to share in Indian company, debentures or deposits in company which is not private company or any security of the Central Government covered by clause (2) of section 2 of the Public Debt Act, 1944 or any other notified asset. Such specified asset must have been acquired by such non-resident Indian in foreign exchange. If these conditions are satisfied, then the investment income is taxed at a lower rate of twenty percent and long term capital gain is taxed at ten percent. The investment income means any income other than dividend under section 115O of the Income Tax Act, 1961 from a foreign exchange specified asset. Long term capital gain means income chargeable under the head capital gains relating to a capital asset, being a foreign exchange asset, which is not a short term capital asset.

The general provisions relating to taxation of capital gains is contained under sections 45 to 55A of the Income Tax Act, 1961. These provisions are applicable if following conditions are satisfied:

(i) There is a capital asset;
(ii) This capital asset has been transferred;
(iii) The transfer must have been affected in previous year;
(iv) There must be gain arising on such transfer of a capital asset.

Gains from assets held for more than three years (one year for listed securities or mutual fund units) are treated long term capital gains and are taxed at lower rate as compared to short term capital gains. These gains are subject to certain exemptions provided under sections 54, 54B, 54D, 54EA, 54EB, 54F, 54G and 54H.

### 3.4.10 Income from Independent Personal Services

Some of the international double tax conventions contain an article on

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Independent personal services which decides the *situs* of taxation in such cases. The independent personal services include professional services rendered by physicians, lawyers, engineers, architects, dentist and accountants which are of independent nature and not ancillary or subsidiary to sale of any property. If the services are dependent on sale of some property, then it is dealt as either royalty income or fee from technical services.

The *Income Tax Act*, 1961 deals with income from rendering of independent personal services as professional income under the head “Income from business or profession”. This head has common rules for taxability of business profits and professional gains. The rules which are applicable for deciding business profits which are deemed to accrue or arise in India under section 9 also apply to the income from rendering of professional services. Thus the *Income Tax Act*, 1961 does not differentiates between business profits and income from professional services. Even the OECD model convention has deleted this clause relating to independent personal services and merged it with the article on business profits but the UN convention and some of the India’s treaties still retain this article.

### 3.4.11 Income from Dependent Personal Services or Employment

The international tax agreements deal with income from employment The OECD model convention) or income from dependent services (UN model convention) under four articles including director’s fee, pension and social security payments, and government service. The *Income Tax Act*, 1961 deals with all such incomes under a common head namely, “Income from Salary”. The general provisions relating to salary are contained in chapter IV of the *Income Tax Act*, 1961. The general guidelines in regard to salary income are as follows:

(i) Income from salary, if earned in India is deemed to accrue or arise in
India.

(ii) In case of citizens, income from salary is taxable even if it is paid outside India. However, perquisites paid to such person outside India are exempt.

(iii) In case of non-citizens, income paid outside India for services rendered outside India is not taxable.

3.4.12 Other Incomes

All the residuary incomes which are not covered by any specific clause of the domestic legislation or international tax agreements are dealt under the head other incomes. International tax agreements decide the country of residence as the situs of taxation for such incomes but do not lay down any rules for computing income from other sources. Part F of Chapter IV of the Income Tax Act, 1961 deals with income from other sources. Section 56 lays down a general and inclusive definition for income from other sources. Generally, it includes all incomes which are not taxable under any other heads as specified under section 14. Particularly, it gives an inclusive list of incomes which can be included under this head. Section 57 provides for certain deductions admissible under this head.

3.4.13 Reconciliation of Different Heads under International Tax Agreements and Domestic Law

It may be noticed that the researcher has discussed the provisions relating to international aspect of the Income Tax Act, 1961 under the heads which are there in international tax agreements. However, the Income Tax Act, 1961 recognizes only five heads of taxing any income. That is why a reconciliation of heads under the Income Tax Act, 1961 and international tax agreements is made in following table.
<table>
<thead>
<tr>
<th>S. No.</th>
<th>HEADS UNDER The INCOME TAX ACT, 1961</th>
<th>HEADS UNDER INTERNATIONAL TAX AGREEMENTS</th>
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</thead>
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<tr>
<td>1.</td>
<td>Salary Income</td>
<td>(i) Dependent Personal Services</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Remuneration of Managerial Persons</td>
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<td></td>
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<td>(iii) Pensions</td>
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<td>(iv) Income from Government Service</td>
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<td>2.</td>
<td>Income from House Property</td>
<td>(i) Income from Immovable Property</td>
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<td>3.</td>
<td>Income From Business and Profession</td>
<td>(i) Business Profits</td>
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<td></td>
<td>(ii) Income from Shipping, Inland Waterways Transport and Air Transport</td>
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<td>(iii) Income of Associated Enterprises</td>
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<td></td>
<td></td>
<td>(iv) Royalty Income*</td>
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<td></td>
<td></td>
<td>(v) Dividend Income*</td>
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<td>(vi) Interest Income*</td>
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<td></td>
<td></td>
<td>(vii) Independent Personal Services</td>
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<td>4.</td>
<td>Capital Gains</td>
<td>(i) Capital Gains</td>
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<td>5.</td>
<td>Other Sources</td>
<td>(i) Royalty Income**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(ii) Dividend Income**</td>
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<tr>
<td></td>
<td></td>
<td>(iii) Interest Income**</td>
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<tr>
<td></td>
<td></td>
<td>(iv) Other Incomes</td>
</tr>
</tbody>
</table>

Notes:
* If such incomes are earned by business establishments
** If such incomes are earned by individuals or other persons and not linked with any permanent/business establishment

### 3.5 Tax on Capital

In India, tax on capital is levied by the Wealth Tax Act, 1957. This Act contains...
provisions relating to charge, computation, assessment and collection of wealth tax. The charge is made on all assets falling within the definition of asset as contained in section 2(ea) of this Act. The tax is computed at a flat rate of one percent on the value of net assets as calculated in accordance with the rules contained in Schedule III. The charge is made only if the net assets value exceeds rupees thirty lakhs on a valuation date. Certain exemptions have also been provided which include one residential property, agricultural land etc.

The international aspect of the Wealth Tax Act, 1957 is dealt under section 6, namely, ‘Exclusion of Assets and Debts outside India’. This section excludes the following items while computing net assets value in case of non resident Indians:

(i) the value of assets and debts located outside India
(ii) the value of assets in India represented by any loans or debts owing to the assessee in any case where the interest, if any, payable on such loans or debts is not to be included in the total income of the assessee under section 10 of the Income-tax Act, 1961.

The term ‘non-resident' has the same meaning as assigned to it under the Income Tax Act, 1961. By virtue of section 8 of the Wealth Tax Act, 1957 the jurisdiction to administer provisions of this Act vests with the income tax authorities appointed under Income Tax Act, 1961. The provisions of the Wealth Tax Act, 1957 are in consonance with the provision relating to tax on capital under the international tax agreements.

3.6 Assessment of Non-Residents under the Income Tax Act, 1961

The international tax agreements resolve the problem relating to double taxation by deciding the situs of taxation but the provisions relating to computation and assessment are contained in domestic laws of the jurisdiction which has the right to tax.
All persons having taxable income above the prescribed threshold limit subject to tax are liable to file income tax return under section 139(1). Such return must be filed along with the payment of self assessment tax (if payable, after payment of advance tax and deductions on account of tax deduction at source). Delay in filing of return attracts liability to pay interest and non filing of return attracts various civil and penal liabilities. This system of filing the return on your own account is termed as self assessment.

The Assessing Officer may also require the non-resident to file his return of income if there is a failure. He may require the non-resident to substantiate his claims made in the return by leading appropriate evidence. This happens in case of a scrutiny assessment. The assessing officer also has the power to make best judgment assessment in case the assessee fails to cooperate. Any income escaping assessment can be put to tax by exercising power to make re-assessment within a stipulated period of six years.

The non-residents are absolved from the liability to file income tax return in cases where the income is computed under the special provisions of the Chapter XII-A. They are also exempt from filing the return under the one by six criteria of ownership of telephone, car or subscription to a phone or membership of a club, travel to foreign country or being holder of a credit card (one by six category has been deleted with effect from assessment year 2006-07).

A non resident who has a business connection in India and income accrues to him as a result of the business connection, may be assessed to tax in India either directly or through agents. Persons in India who may be treated as agent of non-resident include any person

(i) Employed on behalf of or trustee of the non resident;
(ii) Person who has any business connection with the non-resident;
(iii) Person from or through whom the non-resident is in receipt of any
income;
(iv) Person who has acquired a capital asset in India from the non-resident.

These provisions may result in great difficulty as the agent may not be holding the income on behalf of non-resident. That is why an opportunity of being heard is provided to such person before treating him as an agent by serving a notice.

The general provisions of the Chapter XVII-B dealing with recovery and collection of tax apply to non-residents also. A responsibility is fixed on the person paying to a non-resident, any sum chargeable under this Act, to deduct tax at source. This tax is to be deducted at prescribed rate. Reference has to be made to the provisions of relevant Finance Act and the Double Tax Avoidance Agreement to decide the prescribed rate. Apart from the tax deductions made at source, the tax is also collected by way of advance tax payments made by the non-resident assessees. Any arrears of tax which are not paid or collected from the non-residents may be recovered under the provisions of this Act from any assets of the non-resident which are or may at any time come within India.

It may be noticed that the income tax department may dispute the tax liability assessed by the non-resident himself in his return even at a later stage. The department has such inherent powers while making scrutiny assessment, best judgment assessment and re-assessment which may be done up to six years after the filing of returns. Thus, there is always a risk factor involved as there is no certainty of self assessment and the result may be a long drawn litigation. To avoid such situations, the Income Tax Act, 1961 provides non-resident assessees to obtain a binding ruling on the issues which could arise in determination of their tax liability. This ruling can be obtained from a quasi-judicial body known as the Authority for Advance Ruling. Such rulings are binding on both parties, namely, non-resident applicant and the income tax
department. The non-residents are benefited from such rulings as they can plan their affairs well in advance and it brings certainty to their tax liability. Moreover, it avoids post facto litigation, is inexpensive and expeditious. Some issues on which advance ruling may be sought are, for example, application of international tax agreements, conflict between them and domestic statute, problems relating to tax deduction at source and consequences of international acquisitions etc.

3.7 Provisions Relating to Evasion and Avoidance of Tax

Tax avoidance is the practice which takes benefit of the loopholes in law to reduce tax liability. It does not violate law in letter but in spirit. Tax avoidance is considered to be legal as the transaction is legal in form but not in substance. Thus, there must be a specific provision in the statute to prevent assessee from entering into a transaction which aims at tax avoidance. Such provisions may be the Specific Anti Avoidance Rule (SAAR) or the General Anti Avoidance Rule (GAAR). These provisions empower the income tax department to peep into the transaction and ascertain its true character. The department is restrained from discarding any tax avoidance transaction in absence of such specific or general anti avoidance rules.

Tax evasion is illegal method of reducing tax liability and violates law in both letter and spirit. The *Income Tax Act, 1961* contains a number of provisions relating to prevention of tax avoidance and checking of tax evasion. They are discussed under following sub heads.

3.7.1 Provisions to Counter Taxpayers Taking Advantage of Loopholes in Law

There can be two methods to counter those taxpayers who take advantage of loopholes in law. The first one is to give wide interpretation to a provision by
court and the second one is to enact or amend provisions to plug loopholes. The judiciary has its own restraints and cannot import words into the statute. Thus, the government takes shelter of amending old provisions or enacting new provisions in the Act.

3.7.1.1 Definitions

The definition of person is very important under any taxing statute as tax is imposed on a legal person. Legal person includes individuals, companies, association of persons, body of individuals, societies, limited liability partnerships etc. The provision defining person must be finely drafted to include all kinds of legal persons so that the assessee may not take shelter of a loophole by constituting those legal persons which are not covered by the provision. The Income Tax Act, 1922, initially defined person as “includes a Hindu undivided family and a local authority”. The definition was inclusive in nature and there was no clarity as to the status of companies, firms and other legal entities. Thus, the Act was amended twice in the years 1924 and 1939 to broaden the definition of person.

The Income Tax Act, 1961 is very comprehensive in defining the term person as clause (vii) of sub section (31) of section 2 includes every artificial juridical person not falling within any of the preceding clauses (i) to (vi). The Finance Act, 2002 further broadened the definition by inserting an explanation to this definition which states that the legal person is included even if it is not be formed for deriving income.

Initially, the Income Tax Act, 1961 defined not ordinary resident as a person who “has not been resident in India in nine out of the ten previous years.

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236 Section 2(9) of the Income Tax Act, 1922.
237 The Income Tax (Amendment) Act, 1924 added the words “other association of individuals”.
238 The Income Tax (Amendment) Act, 1939 added the words “a local authority”.
preceding that year”. This provision was interpreted in a manner that any person who was non resident for two consecutive years was treated as not ordinary resident for next nine years. The mischief was avoided by amending the provisions so as to use the words “has been a non-resident” instead of words “not been resident”. The amended provision defined not ordinary resident as person who “has been non resident for nine previous years”. Thus, now the benefit of not ordinary resident status which excludes the global income to be taxed in India can be granted only if the person was non-resident for nine consecutive previous years.

It has been mentioned earlier in this chapter that the income accruing or arising from a business connection in India are taxable in India. The provision relating to definition of term “business connection” is an anti tax avoidance measure as it draws a framework for situations which can be termed as business connection. This definition was added by Finance Act, 2003 by inserting Explanation 2 to section 9(1) of the Income Tax Act, 1961.

3.7.1.2 Incentives Under the Export Policy

The Central Government has promoted various incentives and concessions to boost exports from India like cash compensatory scheme, drawback of duty, import entitlements et cetera. Such schemes are intrinsically connected to exports and give different rights to the exporter. Cash compensatory scheme entitles the exporter to receive cash support, import entitlements authorize the exporter to import goods and duty drawback provides relief from payment of duty. These rights are transferable to other persons on which the exporter may earn income. There was conflict of tax treatment on income derived from transfer of such incentives as income relating to cash compensatory scheme was considered to be capital receipt where as the income relating to other schemes were considered to be revenue receipt.
and thus taxable under *Income Tax Act*, 1961.\(^{239}\) This controversy was put to rest by an anti tax avoidance measure which amended sections 2(24)(va), 28(iiiia), 2(24)(vb), 28(iiib), 2(24)(vc) and 28(iiic) so as to clarify that income from transfer of any of the export incentives would be taxable in future. The *Taxation Laws (Amendment) Act*, 2005 further inserted clauses (iiid) and (iiie) under section 28 to include other schemes like duty entitlement pass book and duty remission scheme.

3.7.1.3 *Insertion of Source Rule in Income Deemed to Accrue or Arise in India*

Section 9(1) of the *Income Tax Act*, 1961 recognized the source rule of taxation for the first time by insertion of clauses (v), (vi) and (vii) relating to interest income, royalty income and fee for technical services respectively.\(^{240}\) These clauses provide that the non-resident is liable to be taxed on fee or income payable to them in respect of services utilized in a business or profession carried on by such person in India, or for the purpose of making or earning any income from any source in India. However, while interpreting these provisions, the Apex Court held that for taxing such income or fee two conditions must be fulfilled simultaneously.\(^{241}\) These are: (i) Services must be utilized in India and (ii) Services must be rendered in India.

With a view to get round of this interpretation which might have resulted in tax evasion of interest income, royalty income or fee technical services, the Act was further amended and an Explanation was added to section 9 with a retrospective effect from April 1, 1976. This explanation clarified that the abovementioned incomes were taxable in India without reference to the place of residence or business connection in India. Thus, this provision clarified that the *situs* of utilization was important rather than the *situs* of


rendering the service.

3.7.1.4 Salary Income Earned Before Employment or After Cessation of Employment

The non-residents are liable to tax for salaries earned in India.\textsuperscript{242} The Gujarat High Court in a judgment held that if the liability to pay salaries arises outside India, the same cannot be deemed to accrue or arise in India even if the services are rendered in India.\textsuperscript{243} This interpretation excluded the cases where payments were made prior to starting of employment or after the cessation of employment but related to the services rendered in India. An Explanation was inserted in this section to stop the abuse of not paying the tax in respect of such payments made prior to or after the employment.

3.7.1.5 Provisions Relating to Minimum Alternative Tax

Prior to the insertion of provisions relating to minimum alternative tax, there were companies which were making huge profits and also declaring substantial dividends but were managing their affairs in such a way that there was avoidance of tax. Section 115J was inserted in the Income Tax Act, 1961 with a view to curb this malpractice.\textsuperscript{244} This section incorporates the concept of minimum alternative tax. These provisions are in accordance with an accepted canon of taxation to levy tax on the basis of ability to pay.

Under the concept of minimum alternative tax a company is required to compute its profit in two manners. Firstly, as per the provisions of Income Tax Act, 1961 (after claiming all deductions, concessions and exemptions) and secondly, book profits are computed as the provisions of the Companies Act,

\textsuperscript{242} Section 9(1)(ii) of the Income Tax Act, 1961.

\textsuperscript{243} CIT v. S. G. Pgnatale, (1980) 124 ITR 391 (Guj).

\textsuperscript{244} Circular No. 495, dated 22 September 1987 issued by the Central Board of Direct Taxes.
1956 (after taking into account only specified things as mentioned in section 115J of the *Income Tax Act, 1961*). Tax is imposed on specified percentage of income if the former income is less than a specified limit of latter book profits. The assessee company is given credit for such tax on presumed income in the following years when such income actually becomes taxable.

The researcher has discussed above only some of the provisions which were either amended or inserted by the legislature to plug loopholes in law. There are many provisions which fall under this category but keeping in mind the scope of this thesis, the researcher has taken up only those provisions which have international character. Therefore, the above mentioned list is only inclusive and not exhaustive.

### 3.7.2 Specific Provisions Relating to Avoidance of Tax (SAAR)

This section shall deal with the specific provisions which are there on the statute book for prevention of tax avoidance. These provisions were there on the *Income Tax Act, 1922* and now have been incorporated in the *Income Tax Act, 1961*. The researcher has picked only those provisions which fall within the scope of this thesis and discussed under following sub heads.

#### 3.7.2.1 Provisions Relating to Income of Associated Enterprises or Transfer Pricing

The provisions relating to transfer pricing contained from section 92A to 92F of the *Income Tax Act, 1961* is an example of specific anti avoidance provision. The main purpose of these provisions is to curb the practice of shifting profits to other jurisdictions which have lower rate of tax or no tax at all. This is done by manipulating the prices charged by the closely related enterprises. The concept has already been discussed earlier in this chapter (please refer to 3.4.4 - Income of Associated Enterprises or Transfer Pricing).
3.7.2.2 Avoidance of Tax by Transferring Foreign Assets to Non Residents

It is a settled principle that the residents are taxed on their global income while non residents are exempted from paying taxes on their foreign income. This principle implies that there shall be a differential treatment of income on a foreign asset in hands of residents and non residents. The residents are liable to be taxed on such income. They may try to avoid payment of Indian tax by transferring foreign to a non resident while retain some power to enjoy the income in future. Section 44D of the *Income Tax Act*, 1922 and now section 93 of the *Income Tax Act*, 1961 curb this mal practice by fixing the liability of resident to pay tax on such income. The Apex court while explaining the object of this section held that as disclosed by the provisions of this section, the purpose is to prevent residents of India from evading the payment of income tax by transferring their assets to non residents while enjoying the income by adopting devious methods.245

3.7.2.3 Provisions Relating to Bond Washing and Dividend Stripping

Bond washing is a practice where by the original owner sells his securities on which interest have to accrue on a particular date. The buyer becomes the legal owner and receives the interest in his own capacity. After this transaction the original owner once again purchases the shares from buyer at a price which is ex-interest. The benefit which accrues to the original owner is that his interest income becomes short term capital gain (difference between the price at which he sold the securities and the price at which he purchased the security). This change in nomenclature of income lowers the tax burden of original owner as short term capital gains is taxable at a lower rate that interest income. Similarly, in dividend stripping, the original owner makes a short sale of securities on which dividend has been declared on a

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245 Chidambaram Chettiar v. CIT, (1966) 60 ITR 28 (SC).
record date. Here his dividend income gets converted into short term capital gain.

The provisions of section 94 relating to bond washing and dividend stripping are special provisions for avoidance of tax as the interest income which accrues to the short time buyer is deemed to be the income of original owner. Similar provisions were also there in Income Tax Act, 1922.\textsuperscript{246}

It may be noticed that the short term buyer who receives interest income or dividend income during his holding period adjusts this income against the short term capital loss on sale of securities. Sub section 7 of section 94 further provides that the loss which arises in hands of such short term buyer shall be ignored while computing his taxable income.

3.7.2.4 Provisions Relating to Presumptive Tax

Presumptive basis of taxation was first introduced in 1976 which became effective from April 1, 1976.\textsuperscript{247} At present, there are number of sections relating to presumptive tax.\textsuperscript{248} The term 'presumptive tax' refers to the determination of taxable income and tax on such income on estimate basis. No reference is made to the actual expenses incurred by the business. Total income is estimated on a fixed percentage of the gross receipts and no deductions are allowed thereon. The object behind introduction of presumptive taxation as highlighted by the Central Board of Direct Taxes is to overcome the problems being faced in assessing the income of and recovering the taxes in cases of persons who do not maintain any books of account or the books maintained are irregular and incomplete. The presumptive tax provisions exist in relation to shipping business, aircraft operations and oil exploration business for cases involving non residents.

\textsuperscript{246} Sections 44E and 44F of the Income Tax Act, 1922.


3.7.3 **Provisions for Countering Tax Evasion**

It may be noticed from the above discussion that to curb the practices of taking advantage of loopholes in law and avoidance of tax, the tax administration requires specific provisions or amendments in law. In absence of any such provision tax avoidance has the nod of judiciary. On the contrary, tax evasion is pertinent illegal and both law administrator and judiciary come down heavily on such illegal mode of tax evasion. This section shall deal with the provisions under the *Income Tax Act, 1961* whose main object is to counter tax evasion.

### 3.7.3.1 Provisions Relating to Compulsory Audit

A taxpayer may try to evade tax by not maintaining his books of account due to which the tax department is forced to make assessment on estimated basis which may be less than what is actually taxable under the *Income Tax Act, 1961*. In case where the estimated income is more than the actual income, the tax payer may take the matter in appeal where relief is granted and the income may be reduced to a comfortable level. This mal practice is curbed by section 44AB of the *Income Tax Act, 1961* which provides for compulsory audit.\(^{249}\) A proper audit ensures that the books of account and other records are properly maintained and they faithfully reflect the income of taxpayer. It also helps in checking fraudulent practices.\(^{250}\)

### 3.7.3.2 Furnishing of Information About Foreign Travel

Under section 230(1A) of the *Income Tax Act, 1961* every person who is domiciled in India and leaving India on a foreign tour is required to furnish

\(^{249}\) The *Finance Act, 1984*, w.e.f. 1 April 1985.

\(^{250}\) Circular No. 387, dated 6 July 1984 issued by the Central Board of Direct Taxes.
certain information regarding his foreign travel to the income tax authorities. This section acts as a check on any tax evasion by such person and induces him to disclose his source of money for foreign travel. The authorities are empowered to issue tax clearance certificates if the person leaving India gives a statement that he has no liability under the Act. In cases where it appears to the income authorities that the individual has no present intention of returning back to India, they are empowered to make assessment for a part of the previous year in which he has stayed in India.251

3.7.3.3 Procedural Requirements Relating to Filing of Return and Permanent Account Number

Every country has its own database for taxpayers through which they can track their financial activities. United States has its own social security number, United Kingdom has its national insurance number and India has permanent account number. Quoting of permanent account number is mandatory in India to enter into various financial transactions, for purchasing of property and to liaison with income tax department. The banks, registrar of land and various other authorities are required to file an annual information return where they disclose the permanent account numbers of the taxpayers who have entered into financial transaction beyond prescribed limit. This helps the tax department to monitor returns of such taxpayers and making assessment for unaccounted incomes.

3.7.3.4 Administrative Powers to Counter Tax Evasion

There are various general powers of administration vested in income tax authorities which can be specifically used for countering tax evasion. They can be enumerated as follows:

(i) The income tax authorities have a power to call for information from a

firm, Hindu undivided family, trustees, dealers, brokers, agents, banking companies, taxpayers or other functionaries under different Acts for determination of chargeable income.252

(ii) Subject to the checks and measures of section 133A of the Income Tax Act, 1961, the authorities have broad powers of survey which is an effective tool for checking tax evasion.

(iii) In addition to the power of survey, the income tax authorities can also conduct search and seizure operation under section 132 of the Income Tax Act, 1961.

(iv) There are powers relating to discovery and inspection, enforcing attendance of witnesses, compellng production of books and issuing commissions which vest in both administrative and appellate authorities under the Income Tax Act, 1961.253

(v) The income tax authorities can also inspect register of companies.254

(vi) The assessing officers have the power to bring to tax any undisclosed or concealed income by making re-assessment.255

The structural hierarchy and the powers of the tax authorities have been discussed in detail in next chapter relating to organizational mechanisms as a tool to prevent tax evasion.

3.7.3.5 Taxation of Unexplained Transactions

The unaccounted money may be introduced in the books of account by the taxpayers by taking a plea that it is their own capital contribution or deposits received from third parties. This malpractice of tax evasion and then laundering their black money into proper books of account is checked by various sections relating to taxation of unexplained cash credits256, taxation of

unexplained investments\textsuperscript{257}, taxation of unexplained money, bullion or other valuable articles\textsuperscript{258}, and taxation of unexplained expenditure.\textsuperscript{259} These sections empower the assessing officer to trace the source of such transaction. An addition can be made at time of assessment in case assesseee fails to prove there source.

3.7.3.6 Penal Provisions Countering Tax Evasion

Kautilya in his \textit{Arthashatra} has considered “dhanda” as one of the measure for countering tax evasion.\textsuperscript{260} The “dhanda” refers to those methods which are taken to enforce law through punishment to counter tax evasion.\textsuperscript{261} \textit{Income Tax Act, 1961} contains various provisions relating to penalties and prosecution which counter tax evasion.

(i) Penalty up to three times the tax sought to be evaded can be imposed on an assessee under clause (c) of sub section (1) of section 271 of \textit{Income Tax Act, 1961}. The phrase ‘tax sought to be evaded’ has been given wide interpretation by Explanation 4 to this section. Similar, penal provisions also exist for concealment detected while making assessment in cases of search and seizure.\textsuperscript{262}

(ii) Penalty up to three times the tax sought to be evaded can be imposed in case addition is made due transfer pricing between two associated enterprises.\textsuperscript{263} The concealment of income is deemed to be made in such cases where income tax authorities adjust price under transfer pricing.

\begin{itemize}
\item \textsuperscript{257} Section 69 of the \textit{Income Tax Act, 1961}.
\item \textsuperscript{258} Section 69A of the \textit{Income Tax Act, 1961}.
\item \textsuperscript{259} Section 69C of the \textit{Income Tax Act, 1961}.
\item \textsuperscript{260} \textit{Kautilya’s Arthashatra: Its Contemporary Relevance}, Indian Merchant Chamber and Hinduja Foundation, Mumbai, pp. 118-119.
\item \textsuperscript{262} Section 271AAA of the \textit{Income Tax Act, 1961}.
\item \textsuperscript{263} Section 271 of the \textit{Income Tax Act, 1961}.
\end{itemize}
(iii) Section 271A prescribes a penalty up to Rupees twenty five thousand in cases where an assessee fails to maintain or retain books of account and other documents as prescribed under Section 44AA or rules made there under. Similarly, section 271AA prescribes penalty up to two percent of the value of each international transaction in cases where assessee fails to maintain information and documents in respect of international transaction.

(iv) Failure to get accounts audited in prescribed cases attracts a penalty up to rupees one hundred thousand. Similar, provision is there for failing to furnish audit report in case on international transactions.

(v) In cases where the person fails to obtain or quote his permanent account number a penalty to the tune of rupees ten thousand can be imposed.

(vi) Penalty up to ten thousand can be imposed if a person fails to answer, sign statements, furnish information, returns or statements and allow inspection.

Apart from the above mentioned penal provisions where the income tax authorities can impose penalty, there are provisions where they can initiate prosecution in criminal courts by filing complaints under section 190 of Criminal Procedure Code.

3.8 Conclusion

A structural analysis of entire gamut of domestic law on taxation of income and capital reveals that the Income Tax Act, 1961 is a comprehensive statute. It covers all the aspects of taxation, namely, basis of charge, computation of taxable income, different kinds of assessment and collection

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of taxes. It has comprehensive legal framework in relation to taxation of global income in hands of residents and domestic income in hands of non-residents. The international tax agreements are duly recognized and assessee can chose to apply which ever provision is more beneficial to him. It is this interplay between the domestic law and international tax agreements which is important for international tax regime.

The taxability of various incomes like fee for technical services, independent personal services, dividends, interest, capital gains, business profits as discussed under international tax agreements is dealt under five heads of income in Income Tax Act, 1961. This Act also has special provisions for making assessments in cases involving non-resident assesseees. The collection of taxes is ensured by various methods like payment of advance tax and tax deduction at source. One of the most important features of Income Tax Act, 1961 is the vast gamut of provisions which are brought on the statute book for plugging the loopholes, preventing tax avoidance and countering tax evasion.

The Wealth Tax Act, 1957 which imposes tax on capital is not so comprehensive and dependent on Income Tax Act, 1961 for its assessments and administrative machinery. It covers only the aspect relating to basis of charge and computation of tax. Still it is an important constituent of international tax regime as the international tax agreements cover both tax on income and capital.

This chapter tries to compile the scattered provisions relating to taxation of non-residents and provisions relating to residents having international effect. The headings which have been chosen are similar to headings under international tax agreements. Further, a reconciliation chart has been prepared to reconcile the headings used in International Tax Agreements and Income Tax act, 1961. The special emphasis has been laid on those
provisions which deal with tax evasion and tax avoidance which are applicable to international tax regime. In the next chapter, the researcher shall deal with another important aspect of international tax regime, that is, the domestic tax administration. An emphasis shall also be laid on the international organizations which are contributing towards the development of jurisprudence relating to international taxation.