5.1 Introductory

After discussing the basic constituents of international tax regime, namely, international tax agreements and international aspect of domestic legislation, it seems that everything is in place. There are different kinds of international tax agreements like Double Tax Conventions which comprehensively deal with the avoidance of double taxation and prevention of tax evasion, tax information exchange agreements which deal specifically and comprehensively with administrative assistance in tax matters. The domestic statutes and legal framework of different countries support this structure of international tax agreements by recognizing them and giving priority in application over the legislation itself.

Apart from this, there are tax administrations of different countries and various international tax organizations which are playing an active role in curbing the menace of tax evasion. The tax administration is created by the taxing statutes and also has wide powers for computing, assessing and collection of taxes. It has legalized tools to penalize the erring taxpayers and in some cases even to initiate prosecution. The international organizations do not have any direct administrative control over the taxpayers but their contribution towards research and development of tax models is indispensable.
However, despite of the existence of such frameworks, there are disputes relating to international tax evasion and avoidance as regardless of how carefully tax laws have been made, they are unable to eliminate conflict between tax administration and tax payers. This point is evidenced and substantiated by the various case laws incorporating different disputes between the taxpayers or tax evaders on one side and the tax department on other side.

The present chapter deals with some of the selected cases incorporating tax disputes between international tax payers and tax department of India. The cases under discussion have been selected from various journals like Current Tax Reporter, Income Tax Reporter and Taxman Weekly which are published by the leading publishing houses in India. Such disputes have also been analyzed in light of the various methods of international tax evasion and avoidance.

5.2 Methods of International Tax Evasion and Avoidance

A complete and comprehensive list of methods and techniques which can be used by taxpayers in order to affect international tax evasion and avoidance is clearly impossible. The main reasons being great quantity of relevant statutes, other legal sources, continuous changes in law and the impossibility of getting to know all the often used secrets by business houses, tax professionals and tax administrators. These methods may include abuse of tax treaties or these methods may also be grouped under different heads as highlighted by Wisselink. Wisselink has grouped them on basis of movement and non-movement of funds and persons. All these points have been discussed hereunder.

5.2.1 Abuse of Tax Treaties

The term ‘abuse of tax treaties’ may be defined loosely as the use of tax treaties by persons the treaties were not designed to benefit in order to derive benefits the treaties were not designed to give them.\(^{372}\) There are threefold advantages of abusing a tax treaty. Firstly, a person can accumulate tax-free income in a contracting country. Secondly, a person can transmit this accumulated income to the country of residence without paying any taxes and thirdly, the country of residence which is at the end of chain fails to know the exact source from which such income is derived. These points facilitate international tax evasion and tax avoidance. Hence, where it is true that international tax treaties encourage flow of capital into the country, it is more likely that investments are merely re-routed to avail tax benefits.

5.2.2 Movement of Persons

The term ‘person’ includes individuals, corporations, and other legal entities like trusts, partnerships and consortiums. All these entities try to evade or avoid taxes by manipulating place of residence or point of taxability in a particular country.

5.2.2.1 Avoidance of residence by Movement of Individuals

The individuals can be categorized into three broad heads from tax evasion point of view, namely, tax refugees / stateless persons, tax exiles and persons who live in one country but work in another. ‘Tax refugees or stateless persons’ are those individuals who avoid all factual circumstances which qualify them as fiscal residents of one country by travelling from one country to another and staying only for short periods in different hotels or temporary abodes. ‘Tax

exiles’ are those persons who for tax reasons move to another tax jurisdiction. These cases also fall under the category of total emigration or real emigration. For example, real emigration after retirement in another country amounts tax exile. The third category includes those persons who live in one country but work in another country. For example, a person living in Nepal and working in India or vice versa fall under this category.

The scope of taxation in case of individuals is based on residential status of such individuals. Thus the individuals try to evade or avoid taxes by shifting their place of residence through artificial emigration (tax refugees), partial emigration (staying and working in different countries) and real emigration (tax exile). These points must be distinguished from those persons who are assigned to work in another country on temporary basis (for example, an Indian engineer assigned some training duty in America) or provisional immigrants who enjoy some temporary provisional residence before being considered as full residents.

5.2.2.2 Avoidance of Residence of Corporations

There are two criterions to fix residential status in case of companies or body corporate which is followed in different countries, namely, place of incorporation and place of effective management. These corporations try to manipulate these criterions for evading or avoiding taxes in a particular country. In the countries where place of incorporation is the sole criteria for taxing worldwide income, companies try and employ the concept of ‘Letter Box’ companies. Letter Box companies are those companies which consist of only required juridical organization (articles of association etc.) and registration in the chosen country of residence. The commercial or other activities are performed and executed elsewhere. In other cases, where place of effective management is a criteria, the following measures can do the trick.
(i) The shareholders in high tax jurisdiction may avoid performing any managerial activities. Their shares can also be deprived of the rights to influence management and retaining only the financial rights.

(ii) The companies may employ non-resident managing directors who hold all the meetings of board outside the high tax jurisdiction. This fact is further substantiated by maintenance of shareholders record outside such jurisdiction and by avoiding issue of any instruction or telephone from it. The foreign records of meetings contain detailed information on substantial business decisions taken abroad.

(iii) In such cases, any emergency or incidental transaction can be handled by a service company in high tax jurisdiction which may be taxed on a certain profit margin.

Some companies also create holding subsidiary relationships for performing intermediary operations which result in tax saving. The essential point is interposition of an accumulation centre between the source of origin of income or profits and the ultimate recipients. These centers are located in a pure tax haven or a country with special concession and/or double tax treaties with advantageous provisions concerning withholding tax. After accumulation the moneys involved can be reinvested. The accumulation centre has the essential legal rights and the ultimate owner of the diverted income or profits is a resident of high tax jurisdiction. The juridical form is in the tax haven and the economic substance remains in the high tax jurisdiction.

5.2.2.3Avoidance of Residence by Movement of Persons Other than Corporations or Individuals

This category involves those legal persons like partnerships, cooperative agreements and consortiums. Tax advantages in such situations shall depend on the question whether such combinations or ventures have independent tax payer status or not. In case they are not enjoying independent status, the question arises whether advantageous treaty provisions or tax exemptions are
available for the various participants.

### 5.2.3 Non Movement of Persons

The essence of such methods is that the ultimate owner does not move out of his country or actually emigrate but stays there and gives orders to other persons to create for him vehicle in another country in which income can be segregated. For example, a person may enter into contractual ties with bank and the bank may in turn act in fiduciary capacity to collect interest. The bank claims reduction in withholding tax due the double tax convention between that state and bank’s residential state.

### 5.2.4 Movement of Funds, Goods or Services

There are two principles of taxing business transactions of the non-residents, namely, permanent establishment and force attractive. The principle of ‘force attractive’ is a wide concept than ‘permanent establishment’ in which taxation is made on all gains of the relevant taxpayer including dividends and interest even if they are not derived from the establishment in that country. This concept is losing its importance and most countries are following the principle of ‘permanent establishment’. The business houses try to evade or avoid payment of taxes by manipulating transfers between such establishments, intercompany pricing, movement of funds to tax haven etc. All these methods fall under the head movement of funds, goods or services are further discussed here under.

#### 5.2.4.1 Transfer Between Permanent Establishments

The main manipulations which are done in relation to dealings between permanent establishments are allocation of head office costs, payments relating to interest and royalties, pricing of goods, and entering into fictitious
transactions. There are two methods of allocating head office cost incurred by a business in its home country among its permanent establishments in other countries, namely, direct and indirect method. Under the direct method, each permanent establishment is considered to be an independent unit and the profit is split amongst them as if they were dealing with each other at arm’s length. Under the indirect method, all the permanent establishments and the head office of the business is treated as single unit. The profits are computed for this single unit and then it is split amongst the head office and other permanent establishments on the basis of some keys or elements.

There are some other payments like interest, royalty and service charges which are paid by the permanent establishments to the head office or other permanent establishments and sometimes to third parties. A distinction has to be made between the real payments made to third parties, head office and permanent establishments and fictitious payments made to head office and permanent establishments. These fictitious payments may act as a tool to shift profits or gains from one jurisdiction to other jurisdiction and thus, evade taxes.

These permanent establishments and head office also tend to shift profits amongst them by manipulating the pricing of goods which otherwise is expected to be at arm’s length. Then there are manipulations through fictitious lease of assets to other permanent establishments or head office. Similar manipulations also arise in case of intercompany dealings which do have separate legal entity but are related to each other like holding subsidiery companies or subsidiaries of same holding company.

5.2.4.2 Movement of Funds to Tax Havens

The main purpose of moving funds to the tax havens is to enjoy tax free or low
taxed income. This process is facilitated through base companies, letter box companies or by performing intermediary operations. In all these methods, an entity is created in tax haven having no or low rate of tax. This entity has separate legal entity and accumulates all the funds generated from an income source in other high tax jurisdiction. The transfer of such accumulated funds is then facilitated to the residential state of the ultimate owner in form of dividends, interest and tax free loans.

The main point which is exploited by the tax evaders in this process is that such tax havens provide fiscal recognition to the base and letter box companies. The position is further shifted in favor of tax evasion as such tax havens have double tax conventions with the country from which income is sourced and the country to which income is ultimately transferred. It may be highlighted here that in some cases the country of source and the country of residence of ultimate owner is same but still the accumulation and movement of funds is done to evade or avoid payment of taxes.

5.2.5 Non-Movement of Funds, Goods or Services

Another method adopted by the tax evaders for their selfish interest is non-movement of funds, goods or services. This is also known as ‘accumulation’ which is usually made in a low tax jurisdiction or tax haven. As already discussed above, under the heading ‘movement of funds’, the tax evaders move funds from high tax jurisdiction to low tax state and accumulate there before finally transmitting them to the state where ultimate owner resides. The time period for accumulation depends on scope which tax legislation allows for deferral in remittance of income to home state.

5.2.6 Combinations of Movements and Non-Movements

It may be observed that the international tax evasion or avoidance may
involve combinations of movement and non-movement of persons and/or funds, goods and services. This gives four possibilities, namely, movement of persons and movement of funds; movement of persons and non-movement of funds; non-movement of persons and movement of funds; and non-movement of persons clubbed with non-movement of funds. For example, when a person goes in tax exile, he or she emigrates along with all or part of their income sources and/or assets. Any income sources or assets left behind are generally subject in state of emigration to the provisions of double tax conventions. This involves movement of both persons and funds.

One can find the case of movement of persons and non-movement of funds where a natural person lives in one country and works in another. The scope of taxation in the country of emigration is affected by the question that whether the person continues to have assets and income in country of emigration. If yes, then it involves movement of persons and non-movement of funds. If no, then it is a case for movement of both persons and funds.

The most exploited form in International taxation that has received maximum attention is non-movement of persons but movement of funds. This is typically done by either shifting of profits and income or through establishments called base companies.

The situations relating to non-movement of persons and non-movement of funds actually involve earlier movement. This earlier movement may not have been motivated by tax evasion or avoidance and may originally have been regarded as temporary. For example, the taxpayer may have worked temporarily abroad and been paid abroad and at the end of assignment, tax advantages may be obtained by not returning to his country of residence and/or repatriating his funds until after the end of a fiscal year or until this source of income is deemed to have ceased and to be therefore no longer taxable in the country of residence.
5.3 Reported Disputes Involving International Transactions

The tax evaders may adopt different methods for evasion or avoidance but once such activity is detected by the tax department, a dispute originates between such tax evader on one side and tax department on other side. These disputes then land up in tax courts or other adjudicatory channels. The outcome may be in favor of the department or it may give a clean chit to the tax evader as an honest tax planner. These tax disputes have been discussed under following heads.

5.3.1 Disputes Relating to Classification of Income

An important aspect relating to International tax avoidance or evasion dispute is classification of income under various heads. Quite often the courts are faced with the problem that whether a particular income is either royalty or business income or fee for technical services. The main reason behind such controversies is that is the payments are termed to be business profits and there is no business establishment in India, then income is not taxable under the *Income Tax Act*, 1961. Whereas royalty income and income from fee for technical services are taxable even if there is no business connection or permanent establishment in India. Where a person in India was making payments to a UK company for providing international leg of the service in transmitting voice data to places outside India using its international infrastructure and equipment was held to be neither royalty not fee for technical services. Payments were held to be in nature of business profits but in absence of any permanent establishment in India, the same were not taxable here.\(^{373}\)

\(^{373}\) *In re Cable & Wireless Networks India (P) Ltd.*, (2009) 224 CTR 463 (AAR); Also see: *In re Dell International Services India (P) Ltd.*, (2008) 218 CTR 209 (AAR); *In re Ernest & Young (P) Ltd.*, (2010) 230 CTR 355 (AAR); *In re Real Resourcing Ltd.*, (2010) 230 CTR 120 (AAR) and *In re Cushman & Wakefield (S) Pte. Ltd.*, (2008) 218 CTR 238 (AAR).
5.3.2 Salary Income Deemed to Accrue or Arise in India

There are not much disputes reported on salary income deemed to accrue or arise in India. In S.G. Pgnatale Case the main issue before the court was that whether salary paid to foreign technicians outside India fell within the phrase ‘earned in India’ occurring in clause (ii) of sub section (1) of section 9. The Gujarat High Court while relying on the observations made by Apex court held that word ‘earned’ has two meanings. One meaning is the narrower meaning in the sense of rendering of services, et cetera and the wider meaning in the sense of equating it with ‘accrued’ and treating only that income as earned by the assessee to which the assessee has contributed to its accruing or arising by rendering services or otherwise but that must have created debt in his favor. A comparison between the terminologies used in clause (ii): ‘earned in India’ and clause (iii): ‘services rendered outside India’ clearly reveals the intention of legislature in favor of wider meaning to be adopted. Thus, the phrase ‘earned in India’ must be interpreted as ‘accruing or arising in India’ and not earned from ‘services rendered in India’.

An explanation was introduced by the Finance Act, 1983 to overcome the interpretation given by Gujarat High Court in S.G. Pgnatale Case retrospectively with effect from 1 April 1979. This explanation made clear the income shall be chargeable to tax even if it is paid for services rendered in India. The Finance Act, 1999 has further amended and inserted second explanation to clause (ii) of sub section (1) of section 9 which clarifies that any income under the head salaries payable for rest period or leave period which is preceded and succeeded by services rendered in India and forms part of the service contract of employment shall be regarded as income earned in India.

In the *Halliburton Offshore Services Incorporation* Case the issue relating to taxability of salary for off period arose before Uttaranchal High Court.\(^{376}\) The High Court while deciding the dispute in favor of tax department held where the off period was preceded and succeeded by on period and the assessee had to undergo training abroad during this period, the income was chargeable to tax in India. The court reasoned that it was not possible to give separate treatments to on periods and off period salaries. Moreover, all these periods had direct nexus with the services which he had to render in India. Similar observations have also been made by same high court in other cases which are in line with the amendments introduced by the *Finance Act, 1999*.\(^{377}\) However, the Supreme Court of India has restricted this view by ruling that the explanation substituted by this Act is applicable prospectively.\(^{378}\) That is why in two cases which related back to prior assessment years, a contradictory view was taken by Allahabad High Court from what Uttaranchal High Court had contended.\(^{379}\)

There is only one reported dispute relating to salaries payable by the government under clause (iii) of sub section (1) of section 9.\(^{380}\) This case is related to the Government of Sikkim and for the Assessment year 1983-84. The Calcutta High Court had, while resolving the issue relating to payment made by Government of Sikkim under the head ‘Advocate General Fee’, held that as the *Income Tax Act, 1961* had not been extended and made applicable to this state for relevant assessment year, the payment was to be governed

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\(^{378}\) *Sedco Forex International Drilling Co. Ltd. & Ors. v. CIT & Anr.*, (2005) 199 CTR 320 (SC).


\(^{380}\) *D. P. Choudhury v. Union of India & Ors.*, (1990) 186 ITR 329 (Cal).
by the Sikkim Income Tax Manual. The tax department’s plea that as this manual exempted the fee in Sikkim, the same could be made taxable under deeming provision of section 9 was rejected by the court.

5.3.3 Disputes Relating to Business Income

The situs of business income is connected with the permanent establishment or business connection in India. Where a Russian company shipped certain material outside India which was to be received by National Thermal Power Corporation in India for execution of offshore supply contract, it was held that the title to goods passed outside India on high seas and thus, it was not taxable in India.\(^{381}\) The Authority for Advance Ruling held that no income was taxable in India where the commission was payable to the South African company abroad and there no fixed place or agent in India.\(^{382}\)

5.3.3.1 Concept of Business Connection

Business connection is the most litigated aspect under section 9 of the Income Tax Act, 1961. It is a linking pin between income and its taxability in India. Many disputes have resulted in courts defining the concept of ‘business connection’.\(^{383}\) The key element to be present while terming an activity as


\(^{382}\) In re Spahi Projects (P) Ltd., (2009) 225 CTR 133 (AAR).

\(^{383}\) CIT v. Currimbhoy Ebrahim & Sons Ltd., (1935) 3 ITR 395 (PC) affirming CIT v. Currimbhoy Ebrahim & Sons Ltd., (1933) 1 ITR 341 (Bom); CIT v. R. D. Aggarwal & Co. & Anr., (1965) 56 ITR 20 (SC) affirming R. D. Aggarwal & Co. & Anr. v. CIT, (1961) 42 ITR 155 (Pun); Abdullahbai Abdul Kadar v. CIT, (1952) 22 ITR 241 (Bom); Jethabhai Javeribhai v. CIT, (1951) 20 ITR 331 (Nag); Commissioner of Income Tax v. Bombay Trust Corporation Ltd., (1936) 4 ITR 323 (PC); Remington Typewriter Company’s Case, (1931) ILR 55 (Bom) 243; Bank of Chettinad Ltd. v. Commissioner of Income Tax, (1940) 8 ITR 522 (PC); In re Nandial Bhandari Mills Ltd., (1939) 7 ITR 452 (All); CIT v. Evans Medical Supplier Ltd., (1959) 36 ITR 418 (Bom); In re Speciality Magazines (P)
business connection is that there must be some continuity between the person in India who helps to make profits and the person outside India who receives or realizes the profits.\textsuperscript{384} An isolated transaction between a non-resident and a resident without any course of dealing does not result in business connection.\textsuperscript{385} Rangoon High Court\textsuperscript{386} took a narrow view to include isolated and casual dealings within the purview of business connection but this view has been rejected and doubted by Bombay and Allahabad High Courts.\textsuperscript{387} Some courts have laid stress on commonness of interest, real and intimate connection between the non-resident and resident.\textsuperscript{388} In Barendra Prasad Ray’s Case it was held that this concept also includes ‘professional connection’.\textsuperscript{389}

The courts have also given an idea of how the ‘business connection’ can

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\textsuperscript{385} Bikaner Textile Merchants Syndicate Ltd. v. CIT, (1965) 58 ITR 169 (Raj).

\textsuperscript{386} CIT v. Steel Brothers, (1926) 3 Rang 614.

\textsuperscript{387} CIT v. National Mutual Association of Australia, (1933) 1 ITR 350 (Bom); Hira mills Ltd. v. ITO, (1946) 14 ITR 417 (All).

\textsuperscript{388} CIT v. P. V. R. M. Vishalakshi Achi, (1937) 5 ITR 448 (Rang); CIT v. Metro Goldwyn Mayer (India) Ltd., (1939) 7 ITR 176 (Bom); Hira mills Ltd. v. ITO, (1946) 14 ITR 417 (All); Bangalore Woolen Cotton and Silk Mills Co. Ltd. v. CIT, (1950) 18 ITR 423 (Mad); Anglo French Textile Co. Ltd. v. CIT, (1953) 23 ITR 101 (SC) and Mazagaon Dock Ltd. v. CIT, (1958) 34 ITR 368 (SC).

arise. Although there cannot be any exhaustive list for the same but these cases are important as they throw light on the same. In many disputes, agency relationship has been termed as ‘business connection’ particularly when it is not irregular or mere casual. In other cases, business connection has also said to arise when an Indian company enters into an agreement for rendering of technical assistance by the non-resident company. However, where the foreign company sold machinery to the Indian company and for installation of the same supplied some technicians until the machinery started production and functioning, it was held that the foreign company had no business connection in India.

5.3.3.2 Disputes Relating to Transfer Pricing

The present scheme of transfer pricing which is incorporated in sections 92 to 92F primarily aims at avoiding international tax evasion through dealing between the associated enterprises. They are also helpful in determining the arm’s length pricing for business income. An important feature of these provisions is that they apply to not ordinary residents as section 2(30) makes it clear that for purposes of section 92 and 93, non residents include not ordinary residents.

The Delhi High Court has held that before determining the arm’s length price, the transfer pricing officer needs to give appropriate notice to the assessee but no opportunity is required to be given to the assessee before referring the matter to such officer by the assessing officer. Such transfer pricing officer

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393 Coca Cola India Inc. v. Asst. CIT & Ors., (2009) 221 CTR 225 (P&H).
then has to provide an oral hearing to the assessee at very initial stage before determining arm’s length price.\footnote{Moser Baer India Ltd. & Ors. v. Addl. CIT & Anr., (2009) 221 CTR 97 (Del).} In an another case, the Punjab and Haryana High Court held that while computing the arm’s length price the allowance of depreciation may be made by the transfer pricing officer.\footnote{CIT v. Rakhra Technologies (P) Ltd., (2011) 243 CTR 505 (P&H).} Once the price had been determined, the assessing officer is not bound to accept the arm’s length price as determined by the transfer pricing officer and he can consider not only the report of the transfer pricing officer but any other material that may be placed before him.\footnote{Sony India (P) Ltd. v. CBDT & Anr., (2006) 206 CTR 157 (Del).}

The Supreme Court has held that once the transfer pricing analysis is undertaken, there is no further need to attribute profits to permanent establishment which is an associated enterprise and has been remunerated on an arm’s length basis taking into account all risk taking functions of the multinational enterprise.\footnote{Director of IT (International Taxation) v. Morgan Stanley & Co. Inc., (2007) 210 CTR 419 (SC).} The objections to determinations made by transfer pricing officer can be made before the dispute resolution panel constituted under section 144C of the \textit{Income Tax Act}, 1961. It is an alternative remedy and thus, the writ petitions filed by the taxpayers in this regard have been dismissed in some cases.\footnote{Messe Dusseldorf India (P) Ltd. v. Dy. CIT and Anr., (2010) 231 CTR 176 (Del) and Intimate Fashions (India) (P) Ltd. v. Jt. CIT and Ors., (2010) 232 CTR 36 (Mad).}

\subsection*{5.3.4 \textit{Income from Transfer of Capital Assets}}

The disputes relating to transfer of capital assets mainly revolves around the fact that whether a particular transaction involves transfer of capital asset situated in India or not. It seems that all the courts have given an unequivocal voice that there must be a relation between the capital asset transferred and the boundaries of India. Thus, where a non resident carrying on worldwide air
transport business had sold some capital assets outside India, the Delhi High Court held that profits arising to non-resident company from sale of capital assets located outside India were not part of income proportionately assessable in terms of the provisions of the *Income Tax Act, 1961* as the income in question had not arisen from any business connection in India or from any asset or source of income in India or through transfer of capital asset situated in India.\(^{399}\) Similar position has also been upheld by other courts.\(^{400}\) On the other hand where the shares in Indian company were transferred by a non-resident to another non-resident, it was held that the transaction was taxable in India as shares are situated in India and the transferee can be agent of the non-resident transferor.\(^{401}\)

This principle of taxing transactions whose assets fulfill the criterion of *situs* in India is equally applicable for intangible assets like technical know-how and information. Where a company incorporated in and tax resident of Panama received some income from Danish company by transfer of certain documents containing technical know-how and information, it was held that *situs* of technical know-how and information was outside India.\(^{402}\)

### 5.3.4.1 Indirect Transfer of Capital Assets

The recent controversy of *Vodafone International Holdings BV* requires special emphasis in disputes relating to indirect transfer of capital assets.\(^{403}\) There has been a much hype of this controversy in media. In this case, Hutchison Essar Limited was a company located in India (Capital Asset in India). There was a controlling stake in this company which was held by CGP

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\(^{399}\) *CIT v. Quantas Airways Ltd.*, (2002) 175 CTR 98 (Del).

\(^{400}\) *CIT v. Assam Consolidated Tea Estates Ltd.*, (1987) 61 CTR 208 (Cal) and *In re Citicorp Trustee Company Ltd.*, (2005) 197 CTR 211 (AAR).


\(^{403}\) *Vodafone International Holdings BV v. Union of India*, (2011) 198 Taxman 418.
Company (Cayman Island) through eight entities located in Mauritius. The CGP Company was further a subsidiary of HTI (BVI) Holdings Ltd. (British Virgin Island). This HTI (BVI) Holdings Ltd. (British Virgin Island) transferred the shares in CGP (Cayman Island) to Vodafone NL (Netherlands). This transaction gave a controlling stake in Hutchison Essar Limited (Capital Asset in India) to Vodafone NL (Netherlands) and hence, an indirect transfer of capital asset located in India. The tax department alleged that the wording of section 9 (before amendment) was wide enough to tax this indirect transfer of capital asset. The relevant part of section 9 which deals with the income deemed to accrue or arise in India read as: “income accruing or arising whether directly or indirectly through transfer of a capital asset situated in India”. The assessee contended that the words ‘directly or indirectly’ were connected to income and not capital asset in India. Apart from this, there were many other contentions which were raised in a long drawn battle at various levels of tax authorities, the Bombay High Court and the Supreme Court of India. The Supreme Court finally decided the controversy in favor of the assessee by holding that:

(i) Unless the capital asset itself were actually transferred which was situated in India, section 9 was not attracted. Therefore, the Supreme Court refused to read section 9 to connect the words “directly or indirectly” with capital asset in India.

(ii) The wordings of section 9 do not permit a “look through” approach but rather “look at” approach should be adopted.

Similar position has also been upheld by other courts. However, refusing to settle with the interpretation given by Supreme Court, the Government immediately introduced various amendments with retrospective effect. Two explanations have been added to section 9 which states that a capital asset being a share or interest in a company or entity incorporated outside India shall be deemed to have been situated in India if the shares or interest

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derives, directly or indirectly, its value “substantially” from assets located in India. Other explanations have been added to the definition of term “capital asset” in order to clarify that the term includes right of management and to definition of term “transfer” to clarify that the term includes transferring or creating any interest in any asset notwithstanding that such creation or transfer flowed from transfer of a share of a company incorporated outside India. Another explanation to section 195 provides that the provisions relating to withholding tax applied equally to both residents and non residents even if non residents do not have any place of business in India.405

5.3.4.2 Issue of Shares by an Indian Company to Non-Resident Associated Enterprise

After the Vodafone controversy, the next in line is the tax demand raised by tax department against few Indian companies like Shell India, Vodafone India, Bharati Airtel, Havell India, HSBC Securities for alleged undervaluation of shares issued by them to their foreign located associated enterprises. The case of Shell India involves the highest tax demand from issue of eighty seven crores shares at par in 2009 to its parent Shell Gas BV (Netherlands) for the purpose of raising capital to fund the operating loss of Shell India.406 The allegations leveled by the tax department is that the fair value of shares at that time was Rupees one hundred eighty five whereas they were issued at par, that is, Rupees ten and thus causing an undervaluation of Rupees one hundred seventy five. The Shell India has filed a writ petition against this alleged demand. Similarly, other companies have also been issued tax demands but as the matters are sub judice, facts are not available in public domain.


Such controversies highlight that the ability of taxman to see income where others fail to see never ceases to exist and amaze. No one would have ever expected that such a simple transaction of issuing shares to the non-resident parent would have resulted in taxman getting involved and raising a tax demand. The proceedings of this controversy shall be eagerly watched and awaited (position as on 31 July 2013).

5.3.4.3 Tax on Buy Back of Shares by Indian Companies

Buy back is an option which is exercised by the Indian companies whereby they return the capital investment made by the shareholders and in return the shareholders surrender all their rights in relation to the shares held by them. This is usually done when the company is having excess cash without any intention to employ the same in near future. The shareholders get benefited as they can employ this money in other remunerative investments. From a tax angle, this transaction of returning the shares to the company is regarded as transfer of shares at a price and thus resulting in ‘capital gains’ in hands of such shareholder.\textsuperscript{407} Now, there are two ways of taxing this transaction, firstly, in the hands of shareholder and secondly, in hands of the company. Prior to the passing of the \textit{Finance Act}, 2013 such transactions were taxed in the hands of shareholder but now there is a simultaneous introduction of two provisions\textsuperscript{408} which shall impose tax in hands of company and exempt such transaction in hands of shareholder.

This tax is just like the dividend distribution tax and seems to have far reaching implications where the recipient shareholder is a non-resident. The controversies have already begun even prior to the introduction of this buy

\textsuperscript{408} Sections 10(34A) and 115QA of the \textit{Income Tax} Act, 1961.
back tax. Interestingly, the Authority for Advance Ruling had an opportunity to deal with such set of facts and it was held that the buyback transaction was a colorable device and thus, the payment for buying back the shares should be re-characterized as dividend income. The transaction was completely legitimate but the tax department took it as an avoidance of payment on account of dividend distribution tax. Now, with passing of the Finance Act, 2013, the tax department has got a license to impose tax on such international transactions in India without bothering for the nature of payment, that is, may be dividend or may be payment for buying back of shares. They may not re-characterize the transaction for payment in buy back transaction as dividend.

5.3.5 Apportionment of Income

Section 9 seems to exclude income from those operations which are not carried out in India. According to the explanation appended to clause (i) of subsection (1) of this section where a business has some operations carried out in India and some outside India, the income of the business deemed to accrue shall be only such part as is reasonably attributable to the operations carried out in India. Many disputes have terminated in highlighting this principle. However, the question whether a particular part of income arose or accrued within taxable territories or without the taxable territories would have to be decided having regard to the general principles as to where the income could be said to accrue or arise and section 9 does not come to the rescue. Rule 10 of the Income Tax Rules, 1962 provides for three basis of apportionment, namely, turnover basis, receipt basis and any other suitable basis as the assessing officer may deem fit. The courts have observed that

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whatever may be the basis of apportionment but it must be rational.\textsuperscript{411} It must include losses also.\textsuperscript{412}

**5.3.6 Disputes Relating to Royalty Income**

An unsettled question over the dispute relating to royalty income is that whether the consideration for transfer of software programme is taxable as royalty income under *Income Tax Act*, 1961. In a case relating to *Andhra Pradesh General Sales Tax*, 1957 the Andhra Pradesh High Court held that the term ‘goods’ is very wide and includes all types of movable property.\textsuperscript{413} Admittedly, both canned, that is, off the shelf software and uncanned, that is, custom made software, are capable of abstraction, consumption and use. They can be transmitted, transferred, delivered, stored, possessed, etc. Hence, even an intellectual property, once it is put on media, whether it may be in the form of books or canvas or computer disc or cassettes, and marketed would become goods. What the buyer purchases and pays for is not the disc or CD but intellectual property. Software and media cannot be split and thus, the transaction of sale of software is clearly within sale of ‘goods’.

While relying on this judgment, the Authority for Advance Ruling held that the payment received by the foreign company from value added resellers in India on account of supplies of software products to the end-customer (from whom license fee was collected and appropriated by value added resellers) does not result in income in the nature of royalty to the applicant company.\textsuperscript{414} However, the same Authority for Advance Ruling has


\textsuperscript{412} Harakchand Makanji & Co. v. CIT, (1952) 22 ITR 33 (Bom).


\textsuperscript{414} In re Dassault Systems K. K., (2010) 229 CTR 105 (AAR).
distinguished this decision in other case and held that consideration for
transfer of software programme may be termed as royalty income.415

5.3.7 Dividend paid by Foreign Companies

The provisions relating to taxing dividend income which is deemed to accrue
or arise in India are clear in approach as it specifically includes all the
dividends which are paid by Indian companies in or outside India and all
dividends which are paid by foreign companies in India but exclude only
those dividends which are paid by foreign companies outside India.416 Prior to
the amendment by the Finance Act, 1958, Explanation 3 to section 4(1) of
the Income Tax Act, 1922 which is pari materia to the current provisions,
contained the words “to the extent to which it (the dividends) has been paid
out of the profits subjected to income tax in the taxable territories”. Thus, the
dividends declared by foreign companies outside India out of profits earned
in India was held to be taxable by the Bombay High Court.417 This decision
does not hold good law after deletion of these words.

After the enactment of the Income Tax Act, 1961 there is one dispute
decided by the Calcutta High Court in which the company shifted its office
to Pakistan due to which its status was changed from resident to non-resident
in India.418 The Calcutta High Court held that the material date was the date
of the annual general meeting in which the deemed dividend was declared.
Since, on that date the company had become a foreign company by shifted
its office to Pakistan and the dividend was paid outside India, the recipient
non-resident shareholder was not assessable in respect of the same.

415 In re Millennium IT Software Ltd., (2011) 244 CTR 233 (AAR); Also see: In re Lanka Hydraulic
417 Caltex India Ltd. v. CIT, (1952) 21 ITR 278 (Bom).
418 M.A. Isphani v. CIT, (1968) 70 ITR 141 (Cal).
5.3.8 Interest Income of Non-Residents

The disputes relating to interest income can be analyzed under two time frames, namely, prior to 1 June 1976 and post amendment period. Prior to 1 June 1976, the taxability of interest income was dealt under clause (i) of section 9(1) but by an amendment through the Finance Act, 1976, which became effective from 1 June 1976, clause (v) was inserted in section 9(1) to specifically deal with the subject. This amendment simultaneously deleted the words “through or from any money lent at interest and brought into India in cash or kind” which appeared under clause (i).

There were many disputes prior to 1 June 1976 as the judiciary had laid a test of taxability for interest income. This test was satisfied only if lending of money abroad and bringing it into India formed part of same composite contract and it was within the knowledge of lender. In cases where money was borrowed abroad and brought into India without the knowledge of lender, courts took a view that the interest paid on such money by the Indian concern was not taxable in the hands of non-resident lender as he had no knowledge regarding the situs where money had to be used. While explaining the meaning of phrase “money lent”, the Gujarat High Court held that unpaid price in respect of sale of goods could never be said to be a loan advanced by the non-resident company to the assessee-company. Since the non-resident company could not be said to have lent the amount of unpaid price either in cash or kind, there was no question of interest payable or any income accruing or arising in India. Lord Lindley while elaborating the concept ‘money lent in kind’ alleged that a sum of money may be received in more ways than one, for example, transfer of a coin or


420 Salzgitter Industries Bau GmbH v. CIT, (1990) 82 CTR 284 (Bom) and A. H. Wadia v. CIT, (1949) 17 ITR 63 (FC).

negotiable instrument or other document. Even settlement in account may be equivalent to receipt of a sum of money although no money passes in such case.422

After the amendment which was brought into effect from 1 June 1976, the source rule has been upheld by the legislature in case of interest income. The exceptions have been clearly specified and there are not much disputes after this change.

5.3.9 Income from Shipping Business

There are two provisions dealing with income from shipping operations in cases pertaining to non-resident assessee.423 Section 44B is not applicable to all non residents, but only to a non resident assessee engaged in business of operation of ships. In other words, the assessee should have regularity of business of operating ships as a condition to attract section 44B.424 Non residents who are engaged in occasional shipping activities would come within the purview of Section 172.425

An important controversy relating to shipping income of non residents is the taxability of certain type of incomes which are incidental to the said business but nevertheless not covered by section 44B(2). For example, hire charges paid by time charterer of a ship would not be a receipt by the ship owner on account of carriage of goods, but mere receipt of his charges only426; Dead

422 Gresham Life Assurance Society Ltd. v. Bishop, (1902) AC 287; Also see: CIT v. Ahmadabad Advance Mills Ltd., (1938) 6 ITR 31 (Bom).
426 Union of India v. Gosalia Shipping (P) Ltd., (1978) 113 ITR 307 (SC): It is not receipt of freight
Freight is not freight but damages for loss of freight and hence compensatory.\textsuperscript{427} Although section 44B starts with a non-obstante clause but the provisions excluded are section 28 to 43A only. All other provisions of the Act apply. Section 44B is not a complete code in itself and can operate only subject to the main charging section, that is, section 4 of the \textit{Income Tax Act, 1961}. Therefore, it can be summed up that where non-resident engaged in the business of operation of ships, derives any income which prima facie would fall under section 28 to 43A, but is not covered by section 44B, the same would not be taxable at all. However, if such non-resident is in receipt of any other income not covered by sections 28 to 43A, the same would be subjected to tax. It is noteworthy to highlight the ratio of the Supreme Court’s decision that a receipt arising from exercise of business or profession should be capable of being charged under the head relating to income from business or profession and that in absence of any provision (whether specific or deeming) making it taxable under the head, it cannot be taxed under the residuary head ‘income from other sources’.\textsuperscript{428}

The position is quite different in case of section 172 which is relating to occasional shipping business. This section is a complete code in itself and the levy and collection of tax is to be made only in manner provided therein. Thus, in case of non-resident covered by section 172, hire charges received from time charter of ship, not being a receipt on account of carriage of goods, will not be covered by section 172. Consequently, such receipt cannot be taxed in hands of the non-resident at all.\textsuperscript{429}

\textbf{5.3.10 Liability of Agents of Non-Residents}


An agent of the non-resident is a representative assessee who is vicariously liable for the tax liabilities pending against the non-residents. For a person to be treated as an agent of non-resident, section 163 requires that the non-resident should receive income directly or indirectly from or through any person in India. The substantive liability of the non-resident is fixed under other provisions of the *Income Tax Act, 1961* and the provisions of charging income upon an agent are merely machinery.\(^{430}\) Under the *Income Tax Act* of 1922, it was not necessary that an order should be passed declaring a person to be agent of non-resident but the 1961 Act has made it mandatory to pass such order and a right of appeal has also been provided against such order.\(^{431}\) The various disputes relating to such persons have been discussed under following subheads:

**5.3.10.1 Protective Assessment or Alternative Assessment**

In *Cochin Co. Case*,\(^{432}\) the assessee company was exporter of sea foods on consignment basis. It had appointed ‘A’ (New York) as its sole selling agent and exclusive consignees. Financial assistance was required by the assessee to expand its business. The assessee’s Swiss friends ‘L’ were willing to extend financial help but only through ‘A’ and not directly. ‘A’ received the loan from ‘L’ and extended it on same terms to the assessee. The dispute arose for taxability of the interest payments made by the Assessee to non-residents ‘L’ (Switzerland) through its sole selling agent ‘A’ (New York). The tax department made a nil assessment in hands of assessee as an agent of ‘A’ at first instance. Thereafter, the assessing officer passed a subsequent order under section 163 treating the assessee as an agent of ‘L’. This was disputed by assessee before Kerala high court.

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\(^{430}\) *Maharaja of Patiala v. CIT*, (1943) 11 ITR 202 (Bom).


\(^{432}\) *Commissioner of Income Tax v. Cochin Company (P) Ltd.*, (1976) 104 ITR 655 (Ker).
In light of these facts, the Kerala High Court explained law relating to protective or alternative assessment in case of non-residents. It observed that in cases where the department has any doubts as to the person who is or will be deemed to be in receipt of the income, protective or alternative assessment are permitted. This method is quite sensible as the revenue needs to be protected against bar of limitation. If the tax authorities are precluded, then by the time disputes are over the real assessment would be barred. However, protective assessment is permitted but protective recovery is not allowed. Lastly, the court held that assessee could be treated as “representative assessee” of both the non-residents and assessed separately in the respective representative capacities. In such circumstances protective assessment can be made so that income may not escape taxation altogether.\textsuperscript{433}

5.3.10.2 Liability for Payment of Advance Tax

Various disputes have arisen regarding the liability of such agents for payment of advance tax which is actually to be paid by their nonresident counterparts. Two questions which are important to resolve this issue are, firstly, whether the agent can be appointed prior to the assessment year and secondly, whether the agent appointed for one year can be fixed with the liability for payment of advance tax in subsequent year.

To answer first question, the observations made by the High Court of Bombay presumes importance.\textsuperscript{434} This High Court has categorically laid down that in several (but not all) cases, persons cannot be appointed agents under section 163 and made vicariously liable as representative assessee prior to

\textsuperscript{433} Lalji Haridas v. Income Tax Officer & Anr., (1961) 43 ITR 387 (SC) and Jagannath Hanumanbux v. Income Tax Officer, (1957) 31 ITR 603 (Cal).

\textsuperscript{434} Premier Automobiles Limited v. Income Tax Officer & Ors., (1966) 59 ITR 656 (Bom).
the closure of accounting year. It may also be, that in several such cases the period of the accounting year may synchronize with the commencement of the assessment year, with the result that such agents cannot be called upon to pay advance income tax as representative assessee. The liability cannot be saddled retrospectively for any past financial year.\textsuperscript{435} However, it is not possible to preclude from the scheme of Act that the agent cannot be appointed prior to the commencement of assessment year and the liability can be fixed for advance tax.\textsuperscript{436}

As far as second question is concerned, it may be noticed that the agent is appointed for one assessment year. The vicarious liability imposed by such appointment only extends to the liability for the self contained assessment for which appointment is made. The expression “for all purposes” used in section 163 of the \textit{Income Tax Act}, 1961 does not extend liability to any other assessment year. Thus, in order to impose liability of advance tax on a person as agent of non-resident there should be a fresh order for each year notwithstanding the fact that the assessee was liable as agent in the preceding year.\textsuperscript{437}

\textbf{5.3.11 Persons Liable to Tax as Non-Resident}

An interesting question which sometimes arises in International Tax disputes is that whether joint ventures are liable to tax as association of persons or the members forming such joint ventures can be assessed separately having separate legal entity. In \textit{Re Van Oord Acz. BV},\textsuperscript{438} there was a joint venture

\textsuperscript{435} \textit{Commissioner of Income Tax v. T. I. & M. Sales Ltd.}, (1978) 114 ITR 59 (Cal).

\textsuperscript{436} \textit{Sections 160, 161 and 209 of the Income Tax Act, 1961.}


between foreign company and Indian company. The foreign company undertook a construction contract in India in joint venture with HCC, an Indian company. It was mutually agreed between the parties that they were to bear their own loss and retain their profits separately. Each party further agreed to execute specific part of the job according to its technical skill and for specified consideration. They rules out any constitution of partnership between them. The main purpose for association with HCC was to coordinate execution of the contract. Department alleged that both the companies were liable to tax as association of persons.

While rejecting the contentions made by tax department, the Authority for Advance Ruling held that foreign company was liable to be assessed as separate and independent entity as each party agreed to execute specific part of the job according to its technical skill capacity for specified consideration. It may be noticed that in such cases the Indian company cannot be regarded as agent of the foreign company and the tax department has to fix liability of the person giving them the contract.

5.3.12 Authority for Advance Ruling

The scheme of Authority for Advance Ruling enables non-residents to obtain, in advance, a binding ruling from the Authority for Advance Rulings on issues arising in the determination of their tax liabilities. This system of Advance Ruling is nothing novel as it functions in the United States, Canada, Australia, New Zealand and Sweden. The Authority for Advance Ruling is a good alternative to the court system where speedy resolution of disputes is conspicuous by its absence, given the current delays and the tier upon tier lingering low commotion of litigation.\footnote{B.C. Natarajan, “Authority for Advance Ruling - Boon to Non Residents,” Current Tax Reporter, Vol. 140, 1997, pp. 7-12 at p. 10.} However, it is not free from controversies and disputes.
There are contrary views relating to rectification powers of the Authority for advance Ruling. M.S. Prasad alleges that when a limited question is raised before authority for advance ruling, a high authority, we can expect the applicant and Authority for Advance Ruling to be circumspect and responsible as not to deal with a matter in a slipshod manner. For the Authority for Advance Rulings speed and accuracy without entering into legal hair splitting is the essence of the matter. Thus, providing for rectification of mistakes in the order for the Authority for Advance Rulings does not appear to be necessary. On the other hand, R. Santhanam treats introduction of rule which provides for rectification of orders by Authority for Advance Ruling as a welcome step. He further writes that such a provision ought to have been explicitly provided in section 245R of the Income Tax Act, 1961 itself and absence of such express provisions were felt by all concerned.

The Authority for Advance Ruling being a creation of statute, obviously, cannot determine the constitutional validity of the provision. Therefore, it may not be considered to be an appropriate forum for challenging the retrospective amendments effecting non-resident taxation while making an application for advance ruling. The non-residents are left with an alternative remedy that is to first approach high court under its writ jurisdiction and then file an application before Authority for Advance Ruling in case they want to get relief by challenging the constitutional vires of the provision.

The Income Tax Act, 1961 envisaged an efficacious and speedy remedy due to which a short time limit of three months was fixed for deciding applications.

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before them. However, the spirit of this provision seems to be defeated as the advance ruling is subject to an extended, expensive and sophisticated legal sparing before the High Court and the Supreme Court which may take around three years for final decision.

It may be highlighted that Authority for Advance Ruling is not available in respect of cases involving transfer pricing.\textsuperscript{443} This position has been criticized by R. Santhanam on the ground that the very purpose of bringing Authority for Advance Ruling on the statute book shall be frustrated and tax department shall be inclined to invoke sections 92 to 92F in almost every case of transaction between a resident and non-resident.\textsuperscript{444} He further contends that a mere averment by the tax department that the transaction value is either inadequate or excessive would result in endless litigation as to proper consideration. The residents and non-residents would be placed in great uncertainty as to the financial, legal and tax implication of each transaction and the more exposure, proceedings, interaction and dealings with revenue authorities at various levels. This would facilitate collusive corruption, harassment and hardship to taxpayers.

\section*{5.4 Disputes Relating to International Tax Agreements}

There are many disputes relating to the taxability of income which is specifically exempt in one state by the tax agreements and made taxable in other state. While deciding such a dispute, the Karnataka High Court explained the three fold effect of agreements entered into by virtue of section 90 of the \textit{Income Tax Act}, 1961 as follows:\textsuperscript{445}

1. If no tax liability is imposed under this Act, the question of resorting to the agreement would not arise. No provision of the agreement can

\textsuperscript{443} \textit{In re Instrumentarium Corporation}, (2005) 193 CTR 347 (AAR).


possibly fasten a tax liability where tax liability is not imposed by this Act.

(ii) In case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of the Act.

(iii) If a tax liability is imposed by this Act, the agreement may be resorted to for reducing or diminishing such liability.\(^{446}\)

While highlighting the difference between international tax agreements and other treaties, the Court of Appeal in England held that an ordinary treaty should be distinguished from international tax agreement entered into by a nation consequent to the authority conferred to the Government of two nations by virtue of a specific provision in their respective tax laws. In a case involving ordinary treaty, a conflict between the terms of treaty and express wording of the statute cannot be resolved in favour of treaty whereas in case of tax agreement, the provisions of agreement prevail.\(^{447}\)

### 5.4.1 Method of Eliminating International Double Taxation under Tax Treaties

In VR.S.R.M. (F)firm (C)case, the Madras High Court was faced with a question that whether the income which is made taxable in other state under a double tax convention can be included for rate purposes in India.\(^{448}\) This dispute highlights the method to be adopted by tax authorities for eliminating double taxation under relevant clause of tax agreement. The court held that there may be two situations under any clause of the tax agreement, firstly,


\(^{447}\) IRC v. Colco Dealings Ltd., (1961) 43 ITR 125 (CA).

\(^{448}\) CIT v. VR. S. R. M. Firm & Ors., (1994) 120 CTR 427 (Mad); (1994) 208 ITR 400 (Mad).
the income may be taxable in both states and secondly, the income is taxable only in one particular state. In first case, the tax authorities may include income for computing taxes in one state and thereafter the tax payer is free to get tax relief under exemption or credit method in other state. The other state may also include such income while computing tax relief. In second case, the income is included for tax purposes only in that particular state where it is made taxable and is totally excluded in other state as no relief is required to be admitted in that other state.

It may be highlighted that the first case falls under the concept of tax relief against double taxation and the second case falls under avoidance of double taxation. This differentiation has been highlighted by the Calcutta High Court. The court held that in cases involving tax relief, tax is levied by both the countries and after that the right to apply for refund or deduction arises. In avoidance of double taxation, provision is made to exclude levy in one of the countries.

The fluctuation in foreign currency rates also play an important role for deciding tax relief in cases involving foreign nationals and non-residents. The observation made by the Chancery Division in an English Case assumes importance in this regard. The taxpayer in this case was entitled to double taxation relief in respect of her earnings in United States. The relief was in form of tax credit, to the extent of tax charged in United States. The taxpayer had paid her taxes by deduction at source initially in the years 1946 and 1948 against which she was able to claim refund in 1950. The tax department contended that for working out the double taxation relief in 1946, the

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451 Shell Co. of India v. CIT, (1964) 51 ITR 669 (Cal).

452 Greig (Inspector of Taxes) v. Asnton, (1957) 31 ITR 538 (CHD).
alteration in rate of exchange when the taxpayer was repaid her credit in 1950 should be taken into account. The court rejected this contention and held that the credit should be granted at the rate of exchange prevailing in 1946, the subsequent gain at the time of actual refund due to fluctuation in rate of exchange being purely accidental and an altogether different transaction.

5.4.2 Genuineness of Foreign Company Where Tax Agreement is in Existence

The problem which sometimes arises in making tax assessment of foreign company which is tax resident of other country and claiming benefit under double tax convention is that whether such company is genuine or not. Similar question was answered by the Gujarat High Court in a dispute which arose between the Arabian Express Line Ltd., a tax resident of United Kingdom and tax department. The company produced a certificate issued by tax department of United Kingdom to the effect that it was tax resident there, a certificate to the effect that the company was incorporated there and a certificate to the effect that company had already deposited advance tax there. Keeping in view the documents produced by such company, the court held that order passed by assessing officer under section 172 of the Income Tax Act, 1961 illegal and contrary to the circular issued by the CBDT and convention between government of United Kingdom and India. The fact that whether the company is genuine or not cannot be questioned by tax department.

5.4.3 Appeal against Refund Claims Involving Tax Agreements

The provisions of tax agreements do not replace the provisions of the income

\footnote{Arabian Express Line Ltd. of United Kingdom & Ors. v. Union of India, (1994) 120 CTR 377 (Guj).}
tax law of the contracting state. It is well settled that taxpayer can apply provisions of agreement if they are more beneficial to him though the same might be contradictory to income tax law of the country. The other side of the aspect is that taxpayer may also apply statutory provisions in lieu of tax agreements. Now the question which arises is that whether the taxpayer can take remedies available under the Act if his refund is reduced or negated in terms of tax agreement. The Andhra Pradesh High Court has categorically held that the mutual agreement procedure itself is in addition to the remedies available to an assessee under the Act.\textsuperscript{454} Keeping in view the ratio of this case, it may be observed that the assessee can well within his rights take recourse on either or both grounds, firstly, filing of objections under section 246(1)(a) and secondly, right of appeal under section 246(1)(k).\textsuperscript{455}

The above observations are equally applicable in a case involving abatement. Where the benefit of abatement was improperly given or denied, it was held that the assessee can agitate the matter in appeal.\textsuperscript{456} However, where the claim was made at a stage when it could not be granted at all, the Calcutta High Court held that the order of Income Tax Officer rejecting the claim for abatement is not appealable.\textsuperscript{457}

\textbf{5.4.4 Applicability of International Tax Agreements}

Despite of the Central Board of Direct Taxes itself issuing a circular opining that where a specific provision has been made in a double tax convention, the same would prevail over the general provisions contained in \textit{Income Tax Act}, 1961, there are many disputes raised by the tax department where the

\textsuperscript{454} \textit{CIT} v. Vishakhapatnam Port Trust, (1984) 38 CTR 1 (AP).


\textsuperscript{456} Associated Cement Co. Ltd. v. \textit{CIT}, (1982) 27 CTR 210 (Bom).

\textsuperscript{457} Shell Co. of India Ltd. v. \textit{CIT}, (1964) 51 ITR 669 (Cal).
courts have to reiterate and clarify this position.\textsuperscript{458} The two landmark judgments, one from House of Lords\textsuperscript{459} and other from the Chancery Division\textsuperscript{460}, lay firm ground for this position. After independence, the judgment from House of Lords was relied on by the Andhra Pradesh High Court.\textsuperscript{461} The Andhra Pradesh High Court’s view has been further approved by the Apex Court of India.\textsuperscript{462}

In some other cases, refusal to accept the meaning and interpretation of words or phrases as given by international bodies or internationally acclaimed commentaries has raised disputes between tax payer and the department. In \textit{Asia Satellite Telecommunication Co. Ltd}’s Case, the meaning of word ‘royalty’ as given in commentary on model convention by OECD was refused to be adopted by the Income Tax Appellate Tribunal but the position was reversed by the Delhi High Court. The Delhi High Court observed that the well settled internationally accepted meaning and interpretation placed on identical or similar terms employed in various double tax conventions should be followed by the courts in India when it comes to construing similar terms occurring in India’s \textit{Income Tax Act}.\textsuperscript{463} This position was accepted in light of various precedents on this issue.\textsuperscript{464}

5.5 Applicability of Bilateral Investment Treaties for Resolution of

\textsuperscript{458} Circular No. 333 dated 2 April 1982, Central Board of Direct Taxes.


\textsuperscript{460} \textit{General Reinsurance Co. Ltd. v. Tomlinson (Inspector of Taxes)}, (1971) 79 ITR 681 (Ch. D).


\textsuperscript{462} \textit{Union of India & Ors. v. Azadi Bachao Andolan & Anr.}, (2003) 263 ITR 706 (SC).


International Tax Disputes

After a full round of Vodafone tax controversy the matter seemed to settle down in favour of the assessee, when the Apex Court of India gave its verdict against the tax department.\textsuperscript{465} Subsequently, the review petition filed by the tax department was also dismissed in favour of the assessee.\textsuperscript{466} But such matters don’t die a silent death. The Finance Ministry taking lesson from this dispute proposed some sweeping amendments in the \textit{Income Tax Act, 1961} under the \textit{Finance Bill} of 2012.\textsuperscript{467} Although these proposals which have now become part of the statute were claimed to be not Vodafone specific but still the scope of this amendment includes Vodafone’s case. Feeling aggrieved by this state of affairs, Vodafone served an arbitration notice under the Bilateral Investment Treaty between India and Netherlands.\textsuperscript{468}

Hence, neither of the party is letting this dispute die a silent death as the amount involved is very high. Apart from Vodafone: Sistema, Telenor and TCI (The Children’s Investment Fund) have also invoked bilateral investment treaties to protect their investments and may opt for arbitration in case talks fail to resolve the issues.\textsuperscript{469} All these disputes point towards another mode of

\textsuperscript{465}Vodafone International Holdings BV v/s Union of India and Ors, [2012] 204 Taxmann 408 (SC).


\textsuperscript{467}For details visit, http://indiabudget.nic.in / bill.asp.


settling international tax disputes, and that too under bilateral investment treaties. In backdrop of these happenings it is important to discuss the concept of bilateral investment treaties and their relevance in settling the disputes under international tax jurisprudence.

5.5.1 Bilateral Investment Treaties: A Conceptual Analysis

The international legal framework governing investment has gradually been distanced from a focus on customary international law and on the exercise of diplomatic protection as a means of enforcing that law, to one increasingly based on treaty provisions, by which foreign investors are more and more likely to be covered.\textsuperscript{470} These treaty provisions are covered by the various multilateral treaties, such as the North American Free Trade Agreement (NAFTA) and the various bilateral investment promotion and protection treaties (or BITs). The provisions of bilateral investment treaties and multilateral treaties governing investment (jointly referred as investment treaties) contain many common substantive features. For their enforcement, they also typically make international arbitration mechanisms directly available to covered investors.

As far as bilateral investment treaties are concerned, they were an answer to the failure to conclude a general multilateral investment treaty. Germany and Pakistan were the first to conclude a bilateral investment treaty in 1959 and since then the network of such treaties has expanded in all parts of the world. In the 1990s the number of bilateral investment treaties increased dramatically and at the end of 2006, there were a total of 2,573 treaties.\textsuperscript{471}


5.5.1.1 Bilateral Investment Treaties and India

As part of the economic reforms measures initiated in 1991, the foreign investment policy of the Government of India was liberalized and negotiations undertaken with a number of countries to enter into Bilateral Investment Promotion and Protection Agreement (BITs) in order to promote and protect on reciprocal basis investment of the investors. Government of India have, so far, (as on 9 December 2011) signed bilateral investment treaties with eighty two countries out of which seventy two have already come into force and the remaining agreements are in the process of being enforced. In addition, agreements have also been finalized and / or being negotiated with a number of other countries.472

5.5.1.2 Contents of Bilateral Investment Treaty

A look at various bilateral investment treaties to which India is a party will make it clear that each treaty is quite different from the other in its own way although there are many common characters present.473 The following are the essential clauses covered under various bilateral investment treaties:

5.5.1.2.1 Applicability

Generally, the bilateral investment treaties apply to all investments made by investors of either Contracting Party in the territory of the other Contracting Party, whether made before or after the coming into force of this

472For details visit, http://finmin.nic.in/bipa/bipa_index.asp.
Agreement. However, there are certain exceptions like bilateral investment treaty with Egypt where the scope is limited as the provisions of such agreements do not apply to disputes existing before the agreement comes into force.

5.5.1.2.2 Fair and Equitable Treatment

One of the most common features of international investment treaties is the obligation of a state to grant ‘fair and equitable treatment’ to investors and investments. The precise meaning and nature of the fair and equitable treatment clause has, to date, remained unclear. Rosalyn Higgins, a former President of the International Court of Justice (ICJ), has commented that fair and equitable treatment to nationals and companies ‘are legal terms that are well known in the field of overseas protection’, but there has been a failure to explain what this term specifically entails. Treatment giving rise to allegations of breaches of this obligation has taken many forms, namely bad faith, discrimination, denial of justice, frustration of legitimate expectations, lack of transparency, coercion and harassment, and arbitrariness or arbitrary conduct.

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474 Article 2 of various Agreements between the Government of the Republic of India and the Governments of other countries like Turkmenistan, Israel, Germany etc.
476 Article 3 of various Agreements between the Government of the Republic of India and the Governments of other countries like United Kingdom, Israel, Germany etc.
5.5.1.2.3 National Treatment and Most Favored Nation Treatment

The vast majority of bilateral investment treaties in force around the world today contain certain form of most favored nation provision. Typically, such provisions require each contracting state to accord to investors of the other contracting state treatment that is no less favorable than that accorded to the investors of third states. In doing so, they link bilateral investment treaty by requiring state parties to one treaty to provide investors with treatment that is no less favorable than the treatment provided by them to other investors under other treaties. However, critically, the wording of individual most favored nation clauses varies widely from treaty to treaty, with the result that the scope and extent of the protection offered by the clauses can be very different under one treaty as compared with another.

5.5.1.2.4 Protection Against Expropriation

Expropriation in general terms, is the compulsory acquisition of private property by a state with or without compensation. It is understood that expropriation of foreign investment in itself might not be illegal; it is the circumstances surrounding the taking that determines the legality or otherwise of such. The various bilateral investment treaties entered by India have in place a number of safeguards for the foreign investors. Such

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(1), pp. 77-107 at p. 77.

480 Article 4 of various Agreements between the Government of the Republic of India and the Governments of other countries like United Kingdom, Israel, Germany, the Netherlands etc.


safeguards include expropriation only in public interest; non discrimination; adequate compensation to be given; and such expropriation to be in accordance with law. Further, a right of judicial review is also available to the foreign investor whose property has been expropriated.

5.5.1.2.5 Dispute Resolution

The fact that dispute settlement has been increasingly made available through specific clauses in trade and investment treaties has had a crucial impact on the current state of international economic law. By giving interested parties, ranging from States and inter-State entities like the EU to private investors, the option of enforcing their rights in specific forums has made such rights real and effective. The bilateral treaties signed by India usually contain two provisions on dispute settlement. One provision deals with the settlement of disputes between investor and the contracting party and the other deals with the dispute between contracting parties.

In a dispute involving an investor and the other contracting party, an amicable settlement through negotiations is desired at the first instance. If such negotiations fail, then the dispute may be referred to conciliation in accordance with the United Nations Commission on International Trade Law Rules of Conciliation, 1980. This conciliation is possible only if both the parties agree, else the dispute may be referred to arbitration. The forum and

483 Article 5 of various Agreements between the Government of the Republic of India and the Governments of other countries like United Kingdom, Israel, Germany, the Netherlands etc.


485 Article 9, Agreement between the Government of the Republic of India and the Government of Netherlands for the Promotion and Protection of Investments.

procedure to be followed in such arbitration proceedings have prescribed under various circumstances.\textsuperscript{487}

Similarly, a dispute between the contracting parties may be settled amicably through negotiations at first instance. Failing such settlement, the matter may be referred to the arbitration. The forum and the procedure have been prescribed under the relevant article of the treaty itself.\textsuperscript{488}

\textbf{5.5.2 Settlement of Tax Disputes under Bilateral Investment Treaties}

It is quite evident from above discussion that bilateral investment treaties are crucial in protection and promotion of foreign investment. An investor alleging the breach of any provision by the other contracting state can initiate a binding arbitration proceeding against such other state. Now, the question arises that whether a tax dispute can fall under the breach of a provision enshrined under bilateral investment treaty. To find a solution to this question it shall be desirable to analyze certain decided arbitration cases.

\textbf{5.5.2.1 The Occidental Case}

In this case\textsuperscript{489}, the Occidental Exploration and Production Company (incorporated in the United States of America) entered into participation contract with Petroecuador (incorporated in Ecuador) to undertake exploration for and production of oil in Ecuador. The US Company applied regularly to the tax department of Ecuador for reimbursement of Value Added Tax paid by company on purchases required for its exploration and exploitation activities under the contract. Such reimbursement was also

\textsuperscript{487}Supra note 20, clauses 3 and 4 of Article 9.
\textsuperscript{488}Supra note 21, clauses 3, 4 and 5 of Article 10.
\textsuperscript{489}Occidental Exploration and Production Company (OEPC) v. Republic of Ecuador, London Court of International Arbitration, Case No. UN 3467 (Final Award) decided on 1 July 2004.
made on regular basis. The dispute arose when tax department of Ecuador issued resolutions to deny all further reimbursement applications by the US Company and required the return of amounts already reimbursed. The US Company filed four lawsuits in the tax courts of Ecuador objecting to the above mentioned resolutions and initiated arbitration proceedings against the Republic of Ecuador alleging that the measures adopted by tax department of Ecuador was in breach of the bilateral treaty between United States of America and Republic of Ecuador.

The Tribunal while rejecting the jurisdictional objection raised by Ecuador in matters relating to taxation held as follows: 490

The Tribunal accordingly finds that, because of the relationship of the dispute with the observance and enforcement of the investment Contract involved in this case, it has jurisdiction to consider the dispute in connection with merits."

It is pertinent to mention here that despite of a provision relating to tax policies 491 in the bilateral treaty between United States and Ecuador which excluded the dispute resolution in tax matters, the Tribunal upheld its jurisdiction to decide tax disputes with justifiable reasons. However, the Indian treaty with Netherlands does not contain such provision.

5.5.2.2 The Feldman Case

In the Feldman case 492, the tribunal found Mexico’s refusal to continue to honor tax exemptions and demand that an investor hand over revenue saved from previous exemptions to be arbitrary. These measures were

490supra note 24, Para 77.


492Marvin Feldman v. United Mexican States, International Centre for Settlement of Investment Disputes, Case No. ARB (AF)/99/1 (Final Award) decided on 16 December 2002.
examined in the context of a claim of expropriation and the tribunal found that the measures ‘even though in some instances inconsistent, and arbitrary - should not be treated as expropriatory’.

5.5.3 India’s Bilateral Investment Treaty with Mauritius

In India, over forty percent of the foreign direct investment is routed through Mauritius to take advantage of tax treaty between the two countries. The Central Board of Direct Taxes circular, issued in 2000, states that a certificate of residence issued by the Mauritian authorities would be adequate proof of residence in Mauritius and no further enquiries could be made. However, the Finance Act, 2012 has now amended income tax law to make submission of tax residency certificate containing prescribed particulars, as a necessary but not sufficient condition for availing benefits of the DTAA. This amendment hints toward International tax disputes where India’s bilateral investment treaty with Mauritius may come into picture. It is pertinent to mention here that this treaty also contains similar provisions as discussed in the preceding paragraphs and provides for settlement of disputes between an investor and contracting party through International arbitration which may be exercised by the investors.

There is a long standing tension between trade and tax officials as they approach the relationship between trade and tax issues from different perspectives. Tax experts focus on developing tax policies and administrative rules to raise revenues in fair and equitable manner where as trade experts focus on eliminating measures that can be viewed as distorting trade and


494Central Board of Direct Taxes, Circular No. 789, dated 13-4-2000.

495Article 8, Bilateral Investment Treaty between India and Mauritius.
investment. The difficulty for tax and trade policy experts lies in balancing these fundamental trade and investment principles with the sovereign right to tax. To put the discussion of balancing tax and trade objectives in context, some recent international arbitration have limited the sovereign right to tax by declaring tax measures invalid under trade or investment agreements. Although the United States of America have included tax policy clause in bilateral investment treaties restricting the scope of arbitration in tax matters but Indian bilateral investment treaties do not contain such clause. The absence of such clause widens the scope of arbitration under bilateral investment treaty to include disputes relating to tax matters.

5.6 Recovery of Tax in Respect of Non Residents from his Assets

Section 173 of the Income Tax Act, 1961 is a non-obstante clause which provides that where the person entitled to the income referred to in clause (i) of sub section (1) of section 9 is a non-resident, the tax thereon, whether in his name or in name of his agent who is liable as a representative assessee, may be recovered by deduction under provisions of chapter XVII-B and any arrear of tax may be recovered also in accordance with the provisions of this Act from any assets of the non-resident which are or may at any time come within India. The key feature of this provision is that it removes any limitation period for recovery of taxes in case of non-residents. The question which came before Madras High Court in relation to this provision was that whether limitation can also be removed in case a non-resident income has actually accrued but not as deemed income under the legal fiction of section 9(1)(i).

The court while explaining the scope of this provision answered the question


497 Sakalchand Babulal v. Income Tax Officer, (1963) 47 ITR 673 (Mad).
in negative. It held that the limitation period was ignored only in cases where the income was deemed to accrue in India. Although this case was rendered in relation to proviso to section 42(1) of the *Income Tax Act*, 1922 but it still holds ground as these provisions have been reproduced without any change in section 173 of the 1961 Act.

### 5.7 Conclusion

An analysis can be made for the disputes highlighted above under various heads to know their causes and nature. To facilitate this analysis, the researcher has prepared the following table in which the various bases of disputes have been deduced for the different subject matter of disputes.

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Subject of Dispute</th>
<th>Basis of Disputes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Classification of Income</td>
<td>Interpretation of Heads of Income</td>
</tr>
<tr>
<td>2</td>
<td>Salary Income</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>3</td>
<td>Business Income</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>4</td>
<td>Capital Gains</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>5</td>
<td>Apportionment of Income</td>
<td>Computation of Income</td>
</tr>
<tr>
<td>6</td>
<td>Royalty Income</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>7</td>
<td>Income from Dividends</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>8</td>
<td>Interest Income</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
<tr>
<td>9</td>
<td>Income from Shipping Business</td>
<td>Movement/Non-Movement of Funds/Persons</td>
</tr>
</tbody>
</table>
This table highlights the different basis on which the disputes may arise. These points can be enumerated as follows:

(i) Interpretation of Heads of Income
(ii) Movement/Non-Movement of Funds/Persons
(iii) Computation of Income
(iv) Applicability and Interpretation of International Tax Agreements
(v) Assessment of Non-residents
(vi) Basis of Charge
(vii) Enforcement Machinery
(viii) Collection of Taxes

A further analysis reveals that the methods of international tax avoidance or evasion may be restricted to abuse of tax treaties and taking benefit by movement/non movement of funds/persons but the assessee may land up in dispute with the tax department on various grounds. The existence of these grounds points toward an alarming situation. It forces to rethink on the international tax regime which was once decided by the League of Nations in 1920s and is sometimes considered as a miracle. Such disputes also raise certain issues which have to be settled by appropriate steps which have been discussed in the next chapter of this study.