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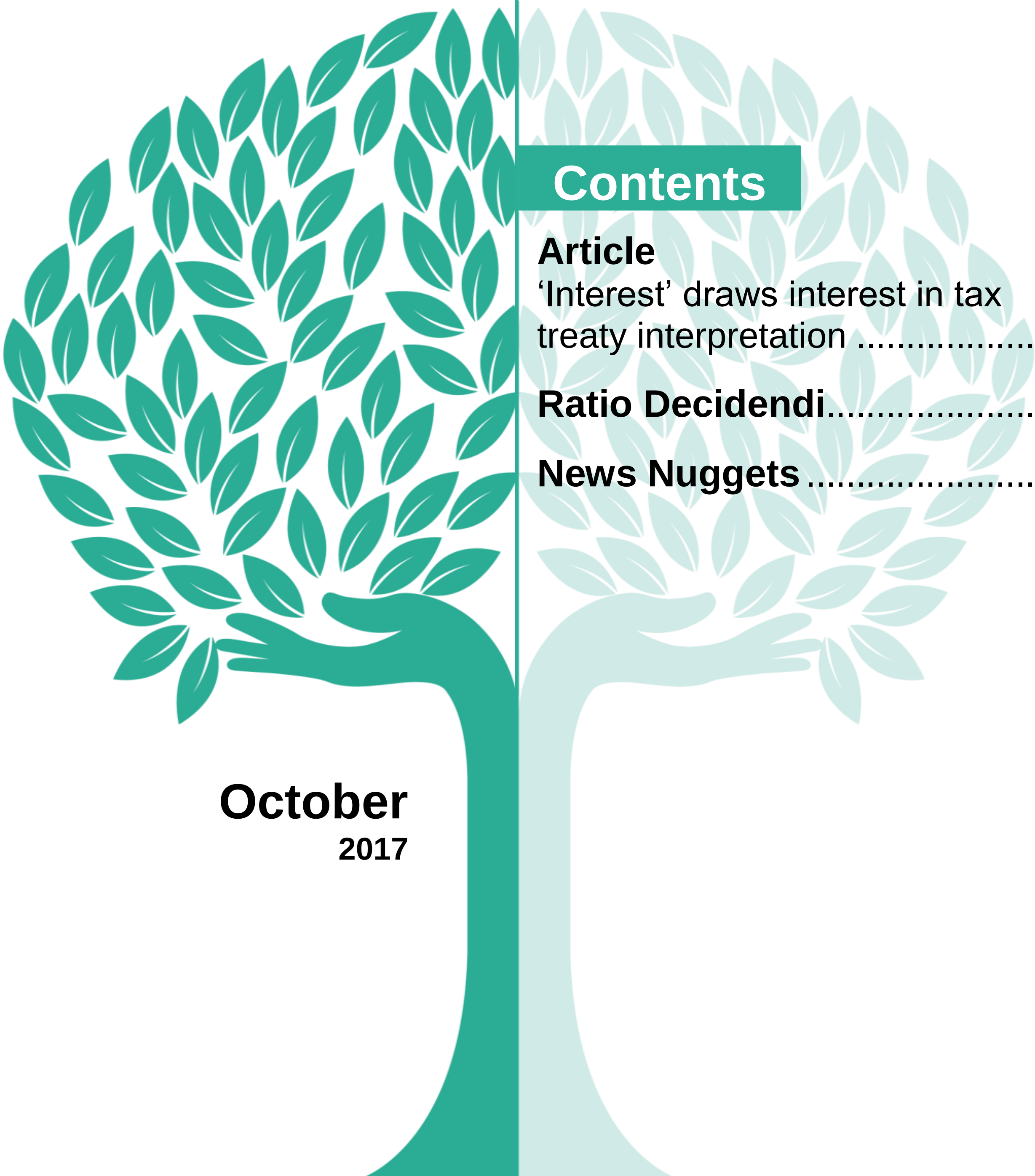

Contents

Article
'Interest' draws interest in tax treaty interpretation 2

Ratio Decidendi........................ 5

News Nuggets 7

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Article

'Interest' draws interest in tax treaty interpretation

By **Sumitha Krishnan & Bharathi Krishnaprasad**

All corporate houses, big and small around the globe constantly seek in financial innovation in raising capital and in allocating rights over sharing of profits. From a plain vanilla equity to participative debt securities to complex warrants etc. of the hybrid derivative clan, there is no dearth of cutting-edge financial instruments. Of course, not to forget the perks they offer to issuers, investors and to the tax consultants!

The European Court of Justice ('ECJ'), exercising arbitration procedure under Article 273 of the Treaty on the Functioning of the European Union ('TFEU') interpreted the term 'debt-claims with participation in profits[1]' appearing in Article 11(2)[2] of the Austro-German Double Tax Avoidance Agreement ('DTAA')[3]. It is significant to note that, this is the first time the doors of the ECJ have been knocked taking recourse to Article 25 (5) of the DTAA for resolving disputes between two Member States in a tax treaty context.

The brief facts of the case are that Bank Austria AG ('Austrian Bank') which has its seat in Republic of Austria purchased certificates (*Genussscheine)* from Landesbank NRW ('German Bank'), based in Federal Republic of Germany. *Genussscheine or certificates* are hybrid form of financial instruments issued by corporates which generally have characteristics of either equity or debt or both. The certificates issued by the German bank conferred upon the holder the right to receive fixed percentage of interest annually, subject however to the German Bank making accounting profits. In the event of losses, the interest payment is reduced with a right to receive deficit as arrears in subsequent years when profits are made. The holder, in this case, the Austrian Bank did not have any right to participate in the proceedings of winding up.

The dispute before the ECJ was whether the certificates issued by the German Bank to the Austrian Bank also conferred rights to participation in profits. The issue arose out of Article 11 of the DTAA which deals with tax treatment of interest income earned by the residents of the respective States. Explained lucidly, Article 11(1) grants the right to tax interest income to the State in which the holder of the instrument resides or the place where the beneficial owner is established i.e. in Austria. On the contrary, Article 11 (2) vests the taxing rights with the State of source provided the interest is earned out of debt-claims with participation rights in profits, in the present case, Germany.

The Republic of Austria contended that the certificates issued by the German Bank cannot be categorized as debt claims with participation

[1] In case C-648/15, application pursuant to Article 273 TFEU lodged on 03rd December 2015

[2] Article 11 deals with allocation of taxing rights between Austria and Germany over interest income earned by a resident of the respective States.

[3] Double taxation avoidance agreement on income and capital entered into between Republic of Austria and Federal Republic of Germany which entered into force on 24th August 2000.

rights in profits and therefore Austria should get the exclusive right to tax the interest income. The Federal Republic of Germany on the other hand contended the contrary by placing reliance on the decision of Federal Finance Court of Germany rendered on 26th August 2010 in IR 53/09.

In this background, the ECJ referred to Article 3 (2) of the DTAA. Article 3 sets out the rule of interpretation of treaties and as per Article 3(2), a term or phrase not defined in the DTAA must be interpreted by giving the meaning it has under the tax law of the State applying it. The ECJ, although referring to Article 3 (2), observed that while resolving disputes between two States, such a rule of interpretation by a single State at a given point in time is not to be regarded as a rule. The ECJ referred to Article 31(1) of the Vienna Convention on Law of treaties ('VCLT') which reads as "*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*" and held that a term not defined in any tax treaty must be interpreted according to the methods proper to international law. Preferring the rule of interpretation as per VCLT over Article 3 (2), the ECJ ordered that the interest income earned from the certificates issued by the German Bank is not in the nature of 'debt-claims with participation rights in profits' to warrant invocation of Article 11(2) of the DTAA.

In concluding so, the ECJ observed that the phrase 'participation in profits' is to be understood in a scenario where the interest receivable is uncertain at the commencement of the year and varies based on the profits of the business which cannot be predicted. Sometimes, the interest receivable could be as low as zero if the business incurs a loss. In the present case, the interest receivable is a determined fixed percentage, though the incidence of payment depends on the profitability. Further, the ECJ also found support to its reasoning by referring to the list of financial instruments covered by Article 11 (2), all of which suggest that the income receivable varies/ should vary depending on the annual profits.

This decision of the ECJ is a landmark ruling with regard to treaty interpretation in the Indian context as well. By way of a protocol entered into between the Republic of India and the Federal Republic of Germany on 19th June 1995, the phrase *'debt-claims carrying a right to participate in profits'* finds place in Article 10 and 11 and the taxing right is vested equally in both the States by the usage of word 'may' in the said Article.

It is of relevance to note that the decision of the ECJ is silent if the phrase 'debt claims with participation rights on profits' was defined either in the domestic law of Austria or Germany. Without such an observation, it has categorically rejected the application of Article 3 (2) to the case in hand.

This leads us to the crucial question whether a term, not defined in the treaty, can be interpreted without taking recourse to Article 3 (2) as is the stand taken by the ECJ.

VCLT being an international customary law[4] is applicable to States irrespective of whether such States are a party to it [According to Ned Shelton[5] *'If we accept that Vienna Convention is an accurate codification of customary international law, the rules of interpretation laid*

[4] This view is also supported by the decision of UK Supreme Court in the case of *Anson* v. *HMRC* [2015] UK SC 44

[5] Ned Sheldon, Interpretation and Application of Tax Treaties, Reed Elsevier (UK) Ltd, 2004, p.156

down in the Vienna Convention are also applicable to states which have not ratified or acceded to it, on the basis that they too must respect customary international law. *This is of special importance to those countries which have entered into tax treaties but which are not parties or even signatories to the Vienna Convention such as India, Ireland, France and South Africa*]. The authors are of the view that, the presence of Article 3(2) specifically in any tax treaty, makes it compulsory and binding on the parties to the treaties to refer to the domestic law meaning of an undefined term. In this regard, the concept of Pacta Sunt Servanda under Article 26 of the VCLT specifies that "*every treaty in force is binding upon the parties to it and must be performed by them in good faith*". Therefore, without applying Article 3 (2), the general rule of interpretation under VCLT cannot be resorted to or in other words Article 3 (2) read with Article 26 of the VCLT cannot be bypassed to apply the general rule of interpretation as per Article 31 (1) of the VCLT.

We find support in the words of *Klaus Vogel*[6] wherein while dealing with Article 3 (2), he states, *Article 3(2) of OECD and UNMC can also be regarded as a procedural rule. The interpretation in the light of domestic law constitutes the default rule. The burden of proof lies on the person who wants to deviate from the domestic law meaning to find strong arguments in favor of a contextual interpretation.* Per *Klaus Vogel*, the order of reference in interpreting terms in a treaty is as below:

1) First, special treaty definitions, will be applied.

2) If no such special rules are applicable the question to be asked is whether the law of the State applying the treaty (lex fori) attaches a special meaning to the term to the extent that it relates to the taxes covered by the treaty. The same question has to be asked if the treaty definition is not exhaustive or if the context requires not to apply the definition.

3) If the law of the State applying the treaty uses the term the terms' meaning needs to be ascertained in order to ask whether the context suggests a different interpretation and, in the light of the weight to be given to alternative interpretations, whether the context requires a different interpretation.

4) If question (2) is answered in the negative, the general rules of interpretation should apply.

To conclude, if the ruling of the ECJ is taken as a binding precedent, then it may lead to a situation where, reliance would be placed on the general rule of interpretation as per Article 31 (1) of VCLT in every case where a term is not defined in a tax treaty, even though that term is given a meaning under the domestic legislation of the State(s) applying it. This may render Article 3(2) of the DTAA otiose, which cannot be the intention of the negotiating parties and which is also contrary to the generally understood principles of International taxation.

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[6] Klaus Vogel, Klaus Vogel on Double Tax Conventions, Kluwer Law International BV, The Netherlands, 2015, p.213 (fourth edition)

Ratio Decidendi

Jurisdictional issue of existence of an international transaction to be decided by AO before referring the matter to TPO

The taxpayer in this case was served with a scrutiny assessment notice followed by a notice of Transfer Pricing Officer (TPO). The notice of TPO was challenged in a writ contending that there is no international transaction. The High Court then declined to interfere holding that taxpayer may seek remedy before Dispute Resolution Panel (DRP). After the final assessment order was passed by the Assessing Officer(AO), the taxpayer again filed a writ challenging the conduct of AO in referring the matter to TPO without first deciding on the jurisdictional aspect of existence of an international transaction. Allowing the writ, the Honorable High Court held that AO has to first decide the jurisdictional issue after providing an opportunity to be heard to the taxpayer and pass a speaking interim order on that. The Court also held that though Instruction No. 3 of 2016 issued by CBDT is not retrospective, the law even prior to that is the same as the instruction is founded on the principle of natural justice. [*PCM Strescom,* (2017) 85 Taxmann.com 165 (Cal HC)]

DRP has power of enhancement even qua the transactions for which no variation is proposed in the TP order

The taxpayer in this case had made certain payments to its Associated Enterprise (AE) for certain intra-group services. TPO had made detailed enquiries in this but did not make any reference to the same in his order. While disposing off objections raised on other counts the DRP held that TPO's failure to deal with intra-group transactions in his order seemed to be an oversight which can be set right by DRP. It rejected the contention of the taxpayer than any error by TPO in proposing a variation on that front could only be remedied by Commissioner exercising powers under Section 263. In appeal before it the Tribunal held that DRP has rightfully exercised its power of enhancement in the facts of the case. [*Bausch & Lomb,* 85 Taxmann.com 163 (Del Trib)]

Deduction under Section 80 IA – Assessee cannot opt to not claim depreciation

Stating that Section 80-IA was a code in itself and any device adopted to reduce or inflate profits of eligible business is to be rejected, the Supreme Court upheld the judgment of the Bombay High Court that profits of eligible business must be calculated after deducting all allowable deductions. The assessee contended that as per the decision of the Supreme Court in *Mahendra Mills*, (which was on Section 32 as it stood then) the assessee may opt to not claim depreciation and leave the written down value unadjusted in the books of account. [*Plastiblends India Ltd* v. *CIT*, CA No. 238/2012 and others, judgement dated 9-10-2017, Supreme Court]

Reduction in limitation period under Section 254(2) not to apply retrospectively

Section 254(2) was amended w.e.f 1-4-2016 providing that the Appellate Tribunal may amend any order within 6 months from the end of the month in which the order is passed if the mistake is brought to its notice by the assessee or the Assesseing Officer. In the case of the petitioner, the order was passed *ex-parte* on 25-8-2015 and the miscellaneous application was preferred within one year on 23-8-2016. The ITAT dismissed the appeal citing that it was filed beyond the period of limitation. However, the High Court held that the law prescribing a shorter limitation period takes away a vested right of the assessee. In the fact of the case, as on the date of the ITAT order, the assessee had 4 years to prefer his appeal. It followed various rulings of the Supreme Court that though law pertaining to limitation being a procedural law would apply retrospectively, it cannot take way a vested right and quashed the order of the Tribunal. [*District Central Co-op Bank v. UOI*, 2017 86 taxmann.com 176 (Madhya Pradesh)]

Penalty under Section 271G is for an absolute failure to furnish documentation and not for mere delay

In this case the taxpayer had not maintained TP documentation for the stated reason of ignorance of the accountant employed by it. In response to the notice of TPO the taxpayer got the documentation prepared and furnished. TP proceedings were completed based on the said documentation without making any addition. Taxpayer successfully argued before the Tribunal that penalty under Section 271G is not warranted in this case as the documentation referred to in Section 92D(3) was very much furnished though with delay and that there was no absolute failure to furnish the same, a default on which alone the said penalty could sustain. [*Karvy Computershare,* 85 Taxmann.com 182 (Hyd Trib.)]

Expense cannot be disallowed under Section 40(a)(ia) for short deduction of TDS

The assessee incurred expenses in respect customer support services and deducted TDS at 2% under Section 194C whereas the AO was of the view that TDS should have been deducted @10% under Section 194J towards technical services and disallowed the entire expenditure. The CIT(A) deleted the disallowance citing that it was not a case of non-deduction which attracts disallowance under Section 40(a)(ia). Following the judgement of the Calcutta High Court in *S.K. Tekriwal 361 ITR 432* which is in favour of the assessee rather than judgement of the Kerala High Court in *PVS Memorial Hospital*, the Tribunal held that the assessee could not be treated as a defaulter for shortfall in deduction of TDS. [*Dish TV India Ltd* v. *ACIT*, [2017] 86 taxmann.com 177 (Mumbai – Trib.)]

Interest income from temporary deposits of capital infused is not revenue

The assessee was in the construction phase of setting up a solar power plant and received an interest from fixed deposits which was reduced from the capital work in progress of the assessee. Question before the Tribunal was whether the said interest income was capital or revenue in nature. On facts, the assessee was required to meet a criterion with respect to net worth so that it becomes eligible to set up the solar power plant. The parent company of the assessee infused funds in the assessee so as to enable it to bid for the project. Out of the proceeds received from the parent company, an amount of Rs.40 crore which was not immediately required was temporarily invested in fixed deposit. It was held that the infusion of funds is inextricably linked to the project of the assessee as without such infusion, the assessee could not have bid for the project. On 1st of May, the assessee had opened the fixed deposit and on 29th May, the assessee entered into a contract developing a 20MW solar photo voltaic power plant. The Tribunal was of the view that these clearly demonstrated that the funds were only temporarily kept in FD till such time they were deployed in the project. Thus, interest from fixed deposits were to be reduced from capital work in progress and cannot be held to be taxable as revenue. [*Solarfield Energy Two Private Limited,* TS-409-ITAT-2017-Mum]

Interest is payable on refund of excess interest charged under Section 234B

The question here was whether interest under Section 244A is payable to a taxpayer on refund of excess interest charged under Section 234B. The Tribunal, upheld the order passed by CIT (A) and it was held that interest under Section 244A would apply to also excess interest paid under Section 234B and the expression tax in Section 244A(1)(b) cannot be read in the context of Section 2(43) and must be interpreted to include interest as well. The opening part of Section 244A uses the term amount and the purpose served by clause (b) is only to determine the periods for which interest on refund needs to be paid. [*ACIT v. National Dairy Development Board* (TS-439-ITAT-2017 (Ahd))]

News Nuggets

Framing of rules for Country by Country Reporting (CbCR) – Comments sought by CBDT

On 6-10-2017 the CBDT communicated the rules proposed to be inserted in Income Tax Rules 1962, which would provide the guidelines for maintaining and furnishing of transfer pricing documentation in the Master File and Country by Country Report. As per proviso to Section 92D of the Income Tax Act, 1961 every person being a constituent entity of an international group - that is a group with entities resident in two or more countries or operating through permanent establishments in other countries – shall maintain information about the group as prescribed. The proviso was inserted w.e.f. 1-4-2017.

It is proposed to insert 10DA, 10DB and forms 3CEBA to 3CEBE. As per proposed Rule 10DA if the consolidated financial revenue as reflected in the consolidated financial statement exceeds INR 500 crores, and the aggregate of international transactions

(i) during the reporting year exceeds INR 50 crores; or

(ii) in respect of purchase, sale, transfer, lease or use of intangible property exceeding INR 10 crores,

then the constituent entity should maintain a list of all operating entities, chart of ownership structure of the group, description of important drivers of profits, description of service arrangements, information on intangibles besides a description of unilateral Advance Pricing Agreements and tax rulings. All information mentioned in Rule 10DA are to be furnished in Form 3 CEBA for reporting accounting year 2016-17 on or before 31-3-2018. Form 3 CEBA is thus the form for reporting information maintained as master file. The procedure of electronic filing of the form is proposed to be specified shortly.

As per proposed Rule 10DB, where the parent entity is outside India, a constituent entity should provide information of whether it is the alternate reporting authority or details of the parent entity and alternate reporting authority in Form 3 CEBB. The CbCR containing overview of allocation of income , taxed and business activities in each tax jurisdiction and list of constituent entities in each tax jurisdiction is to be furnished in Form 3CEBC. As per Section 286 (4), where the parent entity is a country with which India does not have an agreement for exchange of these reports or there has been systemic failure of the country to share such information, the report may be furnished by any one constituent entity which is duly designated and this information is to be conveyed to the tax authorities. Form3 CEBD is proposed to be notified for this purpose.

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