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An e-newsletter from
**Lakshmikumaran & Sridharan,** New Delhi, India

June 2015 / Issue–11

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June
2015

Article

## The Revenue Rule and International Taxation

By **Sumitha Krishnan**

International law is generally considered as the law of the nations and therefore, the rules of international law have developed into a long standing custom that they are dutifully followed by the individual countries. International taxation is one among such areas of law which is widely encroached by the international law and its rules. International law is broadly classified into public international law and private international law.

Of all the significant rules of private international law, the "Revenue rule" is widely recognized with respect to international taxation. Revenue rule is otherwise called as Rule 3 as enunciated by Dicey and Morris in their book *"The Conflict of laws"*. Revenue rule, as understood in the English law, is the rule that prevents revenue authorities of a state from initiating a legal proceeding to claim or enforce its revenue, directly or indirectly in a foreign court. According to Dicey, it is the rule that the courts of one country will not enforce the penal or revenue laws of another country. The rule is traced back to the decision in the case *Government of India* v. *Taylor*[1]. In this case a company was registered in England which was trading in India. The undertaking of the company was sold in 1947 and the proceeds were remitted back to England, and the company was placed in voluntary liquidation in the UK. The Indian Government sought to claim capital gains tax on sale of the undertaking. The House of Lords held that foreign revenue claims are unenforceable in English Courts.

The original purpose of the rule was to promote commerce by enforcing contracts that violated foreign customs laws. However, the content of the rule witnessed a change in the 20th century and is now applied to bar foreign government claims on tax matters and also the rationale shifted from promoting commerce to independent sovereignty, territoriality of legislations and administrative difficulties.

### *Revenue rule under common law as well as civil law system*

The revenue rule is widely recognized in both common law as well as civil law countries.

### *Common Law System*

The countries under the common law system enacted various legislations to be in consonance with the revenue rule. For example, the United Kingdom enacted the Foreign Judgments (Reciprocal Enforcement) Act, 1933 and USA ordained the Uniform Foreign Money-Judgments Recognition Act, which was adopted by 29 states and the District of Columbia. Both these legislations granted the right to recognize foreign judgments, however claims that are revenue and penal in nature are not enforceable. Further, the

[1] 1955 AC 491

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Brussels Convention, which provides for the recognition and enforcement of judgments within the European Union, is limited to "civil and commercial matters" and does not extend, in particular, to revenue. The revenue rule was applied by the Second circuit Court of Appeals of the United States in the case *Attorney General of Canada* v. *R.J.Reynolds Tobacco Co*[2]. In a series of three cases, claims were made by the Canadian Government, European Community along with the fifteen member states of the community and the Government of Ecuador for lost duties and taxes. In all three cases, the US court struck out the claim by the foreign government on the grounds that it was a claim for collection of taxes and that this contravened the revenue rule. In the case *QRS 1 Aps* v. *Frandsen*[3] the Court of Appeal in England rejected the claims of Danish tax authorities and upheld the revenue rule. The appellants were all Danish companies put into liquidation for asset stripping in contravention of Danish law. The respondent was resident in the UK and had owned them. The Danish tax authorities issued tax demands and the liquidators sought a similar sum in damages against the respondent.

## Civil Law Countries

The national courts of civil law countries declined to recognize or enforce foreign laws on the ground that they are public laws. "Public law" includes penal or tax laws. The rationale behind this is that the public laws are subjected to the territorial limits and they cannot be enforced outside the territory[4]. The International Law Association in its report on *"Transnational Recognition and Enforcement of Foreign Public Laws"*[5], sought to analyze the status of recognition and enforcement of foreign public laws by the civil law countries. According to the report, all the civil law countries are of the opinion that foreign tax claims cannot be enforced in their courts. For example in the case *Bulgariskastaten* v. *Takvorian*[6] the Swedish court was of the view that *"a state cannot use a Swedish court to collect taxes or to have other contributions made to a foreign state"*. However, civil law countries would enforce a foreign tax claim if there is existence of a treaty or reciprocal enforcement agreement between the concerned parties[7].

## Applicability of revenue rule is not absolute

The applicability of revenue rule suffers from certain exceptions. They are:

a. ***Existence of a treaty or agreement between parties***[8]: This is evident from the case *Revenue and Customs Commissioners* v. *Ben Nevis (Holdings)*

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2 [2001] U.S. App. Lexis 21,775;(2000) 4 I.T.L.R xxx (2d Ct. of Apps.,2000)

3 [1999] STC 616

4 *Re State of Norway's applications*[1990] 1 AC 723 AT 808

5 Report of the 63rd conference719 (1988)

6 1954. S.268

7 International Law Association , *Report of International Committee on Transnational Recognition and Enforcement of Foreign Public Laws.*

8 Lord Keith of Avonholm in *Government of India* v. *Taylor* [1955] AC 491,511

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*Ltd*[9]. In this case there existed a treaty between UK and South Africa for mutual assistance even before Finance Act, 2006 and Protocol 2010. SARS approached HMRC to recover the taxes owed by Ben Nevis in South Africa. The Court of Appeal held that though the concept of revenue rule prohibited the enforcement of foreign tax liabilities in the UK, the rule was always liable to be set aside by treaty.

b. ***Cross-border Insolvency:*** This is a situation in which a person becomes insolvent in one state but holds assets in another state, and the creditors include the revenue authorities of the first state. The judgment of courts in several states is that the trustee in bankruptcy, liquidator or receiver can gain access to the assets in another country to satisfy the claim of creditors including revenue authorities. However, if the sole creditor is the revenue authority the exception does not operate and the rule is applicable.

c. ***Indirect enforcement against executors or trustees:*** The revenue authorities cannot bring an action against the estate of a deceased person for taxes due. Secondly, if the executor or trustee is exclusively appointed to obtain access to the assets for the purpose of foreign tax credit, then the rule would operate. However, the courts will permit trustees to transfer assets abroad to meet a tax claim if the payment would be in the interest of the beneficiaries or trustees who would otherwise be personally liable for the debt.

To conclude, it could be said that the presence of the concept of revenue rule in the nascent stage of international taxation contributed to the development of source and resident based taxation in which the seed and very soul of international taxation lies. The recent developments in international taxation such as the adoption of European Union (EU) Council Directive 2011/16/EC & EU Council Directive 2010/24, insertion of Article 27 (Assistance in collection of taxes) in the 2003 OECD Model Convention and revision of Article 26 (Exchange of information) in the 2005 OECD Model Convention, Tax Information Exchange Agreements (TIEAs), Foreign Account Tax Compliance Act (FATCA) and intergovernmental agreement (IGA) might lead to substantial decline in the use of the concept in the long-run.

**[The author is an Associate, Direct Tax Practice, Lakshmikumaran & Sridharan, Chennai]**

[9] [2012] EWHC 1807(Ch), [2013] EWCA Civ 578.

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## Circular and Notification

### Clarification on rollback provisions of APA

Advance Pricing Agreement ('APA') Scheme was introduced in the statute in 2012. Rollback provisions in the Scheme were introduced later by Finance Act, 2014. The Central Board of Direct Taxes ('CBDT') has now given detailed clarifications vide Circular No. 10/ 2015 dated 10-6-2015,on the applicability of the rollback provisions. It has, *inter alia*, been clarified that the applicant cannot pick and choose the years for which it wishes to rollback the agreement.

### Tax Treaty with Demark amended

The Tax Treaty between India and Denmark, entered into in 1989, has been amended by Notification No 45/2015 dated 22-5-2015 to provide for a more efficient exchange of tax information scheme so as to avoid tax evasion. The amended treaty now provides for 'Tax Examination Abroad' as envisaged in paragraph 9.1 of the 2010 version of OECD Commentary on Article 26.

## Ratio decidendi

**Foreign tax credit available on income earned from foreign jurisdiction despite Section 10A benefit:** Article 23 of the Double Taxation Avoidance Agreement ('DTAA') between India and Japan provides for allowing of credit in India, for the taxes paid in the Japan, provided the income is chargeable to tax in India. The taxpayer had earned certain income which was eligible for deduction under Section 10A of the Income Tax Act. The sum was remitted to the taxpayer after deduction of tax in Japan. The Revenue Authorities contended that the said income was not liable to tax in India and hence the taxpayer was not entitled to credit in India for tax deducted in Japan. On appeal, the Tribunal held that the said sum was liable to tax in India and was only eligible to deduction through a scheme under the Act. It held that once a sum was liable to tax in India, though there was no actual payment, tax credit would be available to the extent of tax that would be payable in India. [*Blue Star Infotech Ltd* v. *ACIT,* Order dated 17-4-2015 in ITA No 5750/ Mum/10, ITAT Mumbai]

**Consideration paid to foreign liaison agent is not in the nature of FTS:** The taxpayer had engaged the services of a non-resident service provider for liaisoning with the foreign government and other clients in the foreign jurisdiction. On the question of whether the payment made to such liaison agent would be regarded as 'Fee for Technical Services' ('FTS') under the Income Tax Act, the High Court observed that the services were not in the nature of advisory services and hence cannot be regarded as FTS. The High Court further held that, a statement by the service provider that the services were in the nature of FTS would not by itself characterize the consideration as being in the nature of FTS. [*CIT* v. *Grup ISM Pvt. Ltd*., Order dated 29-5-2015 in ITA 325 of 2014, Delhi High Court]

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**Extended credit period is not a separate 'international transaction':** The taxpayer had sold its goods to its Associated Enterprise ('AE'), with a credit period 60 days. The Revenue Authority noted that the taxpayer had extended a longer credit period to its AE than the other un-related enterprises to which goods have been sold. The Revenue Authority accordingly treated the extended credit period as a separate international transaction and imputed an Arm's Length Price ('ALP'). The Tribunal however observed that the transaction of allowing the credit period to an AE for realisation of sale proceeds has to be considered along with the main international transaction in respect of sale to AE. Given that the main transaction of sale of goods was at ALP, the Tribunal observed that, no adjustment can be made on account of extended credit period. [*ACIT* v. *Information Systems Resource Centre*, Order dated 29-5-2015 in ITA 7757/Mum/2012, ITAT Mumbai]

**"Vend fee" payable to State Government for granting a privilege, would fall within Section 43B:** The Government of Kerala imposed a levy of 'vend fee' on the taxpayer, per bulk litre of arrack sold by it. The fee was to go into a fund which would then be used for the repair / replacement of old machinery and equipment belonging to the taxpayer. The Supreme Court observed that the 'vend fee' collected by the Government conferring a special benefit on the taxpayer, viz., the repair and replacement of existing machinery and equipment. The fee so collected by the Government, the Supreme Court observed, will be covered within the definition of 'fee by whatever name called' as contained in Section 43B of the Income Tax Act and was to be allowed as a deduction in the year in which the payment was made, irrespective of the year to which the fee pertained to. [*CIT* v. *Travancore Sugars and Chemicals Ltd.*, Judgment dated 7-5-2015 in Civil Appeal No. 2558 of 2005, Supreme Court]

**Taxpayer does not have a right to inspect documents at the stage of issue of authorization for search:** The Supreme Court has held that the statute provides for recording of reasons to ensure accountability and responsibility in the decision making process and that the assessee has a right to inspect documents only at the stage of assessment proceedings, otherwise the exercise envisaged under Section 132 of the Income Tax Act would be undermined. Reversing the decision of the High Court, the Apex Court held that the High Court had committed a serious error in reproducing in great detail the contents of the satisfaction note which could confer an undue advantage on the assessee. The Court referred to the cases of *Seth Brothers* and *Pooran Mal*, to comment on the power of the High Court under writ jurisdiction. This judgment touches upon the contrast between the necessity and sufficiency of reasons recorded for conducting search under Section 132. While the High Court had held in favour of the assessee going into the merits and sufficiency of the reasons, the Apex Court has impliedly held that since the necessary condition of duly recording the

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reasons had been met, the search was valid. [*DGIT* v. *Spacewood Furnishers Pvt. Ltd.*, [2015] 57 taxmann.com 292 (SC)]

**Monetary limits for filing appeals by department applicable to pending appeals also:** The Allahabad High Court has joined several other High Courts to hold that monetary limits for filing appeals to the ITAT and higher Courts, as laid down by instructions issued under Section 268A of the Income Tax Act, are applicable to appeals which are pending at the time of coming into force of such instruction. It has been further held that Instruction No. 3/2011 is defective insofar as it only partly complies with the National Litigation Policy and does not provide for review of pending cases. It was also held that in case the application of such instruction is held to be only prospective, it would lead to discrimination between pending appeals and new appeals. This judgment construes the instruction using a combination of literal and purposive approaches. [*CIT* v. *Shyam Biri Works,* [2015] 57 taxmann.com 157 (Allahabad)]

## News Nuggets

### Draft rules for adopting 'range concept' in determining ALP

The Indian Finance Minister during his Budget Speech of 2014, had announced that 'range concept' would be introduced in India for determination of Arm's Length Price ('ALP'). He also announced that use of multiple year data would be permitted for undertaking comparability analysis. Consequent to the announcement, Section 92C(2) of the Income Tax Act was amended by the Finance Act, 2015, empowering the CBDT to prescribe rules for carrying out the objectives. The CBDT has now released letter [F.No.134/11/2015-Tpl], dated 21-5-2015 containing draft rules for applying range concept and use of multiple year data in determining ALP and has sought comments of stake holders.

### Belgium introduces 'Cayman Tax' to target low-tax wealth structures

The new 'Cayman Tax' introduced by Belgium, following Netherland, aims to introduce a fiction of tax transparency to prevent tax avoidance through a wealth structure. Effective 1st January, 2015, any income received by a non-resident entity formed as a part of low-tax wealth structure, will be taxed as if it were received directly by Belgian promoters, subject to certain exceptions. A structure is deemed to be a low-tax wealth structure if the effective tax rate of the structure is less than 15%.

### Dutch Supreme Court applies Base Erosion Rule to deny interest deduction

The 'Dutch Base Erosion Rules' seek to disallow interest deduction against any borrowing from an AE for the purpose of a capital contribution, dividend distribution or acquisition, if such borrowing is solely for tax savings. The Dutch resident chose to fund its acquisition though a group financing company in Mauritius over equity infusion from its parent company. The Dutch Supreme Court in a decision dated

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5-6-2015, held that even in the case of an acquisition outside the group, where the borrowing from the AE is not based mainly on commercial considerations, interest deduction for such debts would not be allowed as a deduction.

## New Zealand to amend withholding tax regulations to reduce BEPS

New Zealand sourced interest income is subject to withholding tax only on actual payment, while deduction for such expenditure is allowed to the payer on accrual basis. To take undue advantage of this arbitrage in timing of taxation, taxpayer have adopted a wide variety of transactions to prevent or delay the payment of interest with a New Zealand source. This issue has been included as an item under the Base Erosion and Profit Shifting (BEPS) project of the Government's Work Programme and proposals have been made to amend the domestic law with the primary focus on adopting the right method for appropriate taxation of income derived by non-residents from New Zealand.

**NEW DELHI**
5 Link Road,
Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
---
B-6/10, Safdarjung Enclave
New Delhi - 110 029
Phone : +91-11-4129 9811
E-mail : lsdel@lakshmisri.com

**MUMBAI**
2nd floor, B&C Wing,
Cnergy IT Park,
Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025.
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

**CHENNAI**
2, Wallace Garden,
2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

**BENGALURU**
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

**HYDERABAD**
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church, Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail : lshyd@lakshmisri.com

**AHMEDABAD**
B-334, SAKAR-VII,
Nehru Bridge Corner, Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

**PUNE**
607-609, Nucleus, 1 Church Road,
Camp, Pune – 411 001. Maharashtra
E-mail : lspune@lakshmisri.com

**KOLKATA**
2ND Floor, Kanak Building
41, Chowringhee Road, Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

**CHANDIGARH**
1st Floor, SCO No. 59, Sector 26,
Chandigarh - 160026
Phone : +91-172-4921700
E-mail : lschd@lakshmisri.com

**GURGAON**
OS2 & OS3, 5th floor,
Corporate Office Tower,
AMBIENCE Island, Sector 25-A,
Gurgaon- 122001
Phone: +91- 0124 – 477 1300
Email: lsgurgaon@Lakshmisri.com

**EUROPE**
Lakshmikumaran & Sridharan SARL
35-37, Avenue Giuseppe Motta, 1202 Geneva
Phone : +41-22-919-04-30
Fax: +41-22-919-04-31
E-mail : lsgeneva@lakshmisri.com

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