An Insight into Foreign Tax Credit

It is an acceptable fact that uniform solution for allowability of FTC cannot be provided in the Convention in view of the wide variety of fiscal policies and techniques in the different States regarding determination of tax especially deductions, allowances and similar benefits. Even the Model Conventions (both the OECD and the UN Model Conventions) acknowledge this fact in the respective Commentaries that there may be a lot of difficulties in universal application of the article on 'relief double taxation.' It, therefore, recommends that the domestic legislation should provide for solutions of all the difficult areas/issues. There are no rules in the domestic statute in India dealing with the manner of granting relief from double taxation. Read on to know more…

Foreign Tax Credit

Payment of taxes in the overseas jurisdiction, over and above the taxability in home jurisdiction, is an inevitable consequence of the inherent conflict between the source rule and residence rule of taxation. The Residence rule taxes a person who is resident of a tax jurisdiction irrespective of the geographic location of the place where the income has been earned. Source Rule, on the other hand, taxes the income earned in its jurisdiction irrespective of the residential status of the person earning the said income. The competing claims of each jurisdiction puts the taxpayer to the risk of being taxed more than once. Since the Source Rule and the Residence Rule form an integral part of the legislative machinery of various jurisdictions, sufficient measures have been provided, both in the domestic tax legislations as well as the Double Taxation Avoidance Agreement ('DTAA' in short) to provide relief to the taxpayers from such double taxation. The Foreign Tax Credit (FTC) mechanism as specified in the DTAAs have to be applied in conjunction with the domestic tax laws.

For availing FTC, the predominant condition is to have double taxation of income at the first instance. In other words, the same income should have suffered taxation more than once in the hands of the same person. A detailed analysis of the FTC mechanism as provided in the Indian Tax laws as well as the Treaties along with associated challenges in availing the same have been discussed in this article.

(Contributed by Committee on International Taxation. Comments can sent to citax@icai.in)

Double taxation of income can arise either due to 'juridical double taxation' or 'economic double taxation'. In case of 'juridical double taxation', the same income is taxed in the hands of the same person in both the state of residence as well as the source state. Economic double taxation, on the other hand, taxes the same income in the hands of two different persons.

FTC in Treaty & Non-Treaty Cases

Double taxation of income can arise either due to 'juridical double taxation' or 'economic double taxation'. In case of 'juridical double taxation', the same income is taxed in the hands of the same person in both the state of residence as well as the source state. Economic double taxation, on the other hand, taxes the same income in the hands of two different persons. It may be pertinent to note that Article on **Relief from double taxation/ Elimination of double taxation**[1] of the Model Conventions[2] deals with elimination of 'juridical' double taxation only and not 'economic' double taxation. The Article specifically contains provisions relating to elimination of double taxation of foreign taxes paid by an Indian taxpayer.

There are many countries with which India does not have a DTAA. In such cases, the domestic legislation provides for unilateral relief for eliminating tax cascading. In the Indian context, FTC mechanism is at present governed by Section 90 and Section 91 of the Income-tax Act, 1961 ('Act' in short). Section 90 of the Act provides relief from double taxation of income in India through a DTAA concluded between the Government of India and Government of another country. Section 91 of the Act, on the other hand, provides unilateral relief from double taxation of income arising from a country with which no DTAA exists. It may be pertinent to note that no other detailed rules or guidelines exist in the Indian domestic tax laws, apart from the manner in which the credit may be availed, as has been specified in the said sections.

Methods of Availing FTC

The existing Conventions[3] recognise certain mechanism/methods of availing FTC which are being stated herein below[4]:-

A. Exemption Method

The exemption method implies that when a resident of State R, derives income which may also be taxed in the State S according to the provisions of the Convention, State R shall be required to exempt from tax such income which suffers double taxation. State R may grant exemption either under 'full exemption' method or 'exemption with progression' method. State R in the former option does not take into account the income which may be taxed in State S either for the purpose of computation or for determination of tax rates. While in the latter option i.e. 'exemption with progression', State R takes into consideration the income from State S for the purpose of determining the amount of tax on the remaining income.

B. Credit Method

Under this method, income earned in State S is included in the taxable income and subsequently credit for taxes paid in State S is allowed from the tax liability arising in the State R. The credit for taxes paid in State R could be granted in the form of either 'full credit' or 'ordinary credit'. Under the 'full credit' method, State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State. Under the 'ordinary credit' method, the deduction given by State R for the tax paid in the State S is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State.

Credit for taxes paid in State S is limited to the tax liability on the doubly taxed income in the State R. There are some inherent problems associated with the Credit Method which are discussed in the subsequent section of this article.

C. Underlying Tax Credit

Under the provisions of domestic tax laws of various countries, corporates are subject to corporate tax at the first instance and subsequently the same income is taxed in the hands of the shareholders in the form of dividends. This results in the same income being taxed twice first in the hands of the companies and then in the hands of the shareholders. Underlying tax credit is a mechanism provided

1 Different Articles persist in the DTAAs (Article 25 in India-us DTAA, Article 24 of India-UK DTAA, Article 23 of India-Japan DTAA and so on. Unless specific reference to an Article of the Convention is given in this article, 'Article' shall be construed as 'Article on Relief from/Elimination of Double Taxation'.

2 Two alternative versions Article 23A and 23B are given in the UN Model and OECD Model.

3 Conventions shall refer to both the OECD Model Convention as well as UN Model Convention

4 While discussing the methods of availing FTC and subsequent part of the article, the 'State of Residence' has been referred to as 'State R' and 'State of Source' as 'State S' for the sake of brevity.

in the Convention by means of which such double taxation could be mitigated. Under the principle of 'underlying tax credit', State R not only gives credit of tax paid in State S on the dividend but also the tax paid on profits out of which dividend is paid by the company. It may be pertinent to note that not all DTAAs have the underlying tax credit provisions and generally DTAAs prescribe minimum shareholding conditions for availing the same. India's DTAAs with Australia, Mauritius, Singapore, USA, UK *etc.* facilitates underlying tax credits.

D. Tax Sparing Credit

Tax sparing credit provisions may take the form of a credit or deduction or an exemption. These provisions are included in the Convention with an intent to allow the foreign investors to obtain tax credit for taxes that have been spared under the incentive programme of the Source State. Thus, in the absence of these provisions, the taxpayer would still need to pay taxes in the residence State and the benefit which is intended for the foreign investors is passed on to the Residence State. Though tax sparing may provide inherent incentive to foreign investors, there are a number of concerns associated with granting of tax sparing relief *viz.* potential abuse of the relief, not an effective tool to promote economic development *etc.* India's DTAAs with Japan, Canada, Singapore, Philippines, Russia, Switzerland *etc.* contain provisions for tax sparing reliefs.

Challenges Faced/Considerations in Availing FTC

In the absence of any detailed guidelines or rules with respect to granting/availment of FTC, uncertainty persists on various aspects, some of which are being discussed hereunder:-

A. Scope of Taxes- For the purpose of the Article on Elimination/Relief from Double Taxation, some of the DTAAs entered by India (India-USA, India-Canada) specifically provide that the taxes referred to in Article 2 of the Convention shall be considered for relief. The issue that arises for consideration is that will the taxpayer be entitled to a relief for the taxes, which are not covered in the Convention?

Section 91 provides for deduction of 'income tax' and super tax actually paid in the source country in accordance with the corresponding laws in force of the said country. In this context, it may be pertinent to note that in distinction to the relief provided by the DTAAs, provisions of Section 91 does not discriminate between the taxes levied by the Federal Governments and State Governments.

The Mumbai Income Tax Appellate Tribunal (ITAT) in the case of Tata Sons[5] held that the taxpayer would be entitled to a relief under Section 91 in respect of federal as well as state taxes. The relief as provided in Section 91 being more beneficial to the taxpayer *vis-à-vis* the credit available under the applicable treaty, the provisions of Section 91 would apply to the State income taxes as well. However, the Delhi Tribunal in the case of Manpreet Singh Gambhir[6], referring to Article 2 of the Indo-US DTAA held that the taxes covered are only in respect of Federal Income-tax imposed and not the State Income-tax and therefore, relief would be restricted to the Federal Income tax only.

In light of the above discussion and scope of Section 91 (specifically referring to Explanation (iv) to Section 91, which provides that 'income tax' shall include tax levied by the Government of any part of that country or a local authority), one could argue that even state taxes should be entitled to a relief.

B. 'May be Taxed' - The interpretation of the connotation 'may be taxed' as used in the treaty plays a vital role for determining the allowability of FTC. For certain incomes, an exclusive right to tax is given to one of the Contracting States and the relevant Article[7] states that income 'shall be taxable only' in one State. In such cases, the exclusive right to tax is generally given to State R. The prevailing legal position, therefore, is that once an income is held to be taxable in a tax jurisdiction under a DTAA, and unless there is a specific mention that it can also be taxed in the

One method of availing FTC is the exemption method, which implies that when a resident of State R, derives income which may also be taxed in the State S according to the provisions of the Convention, State R shall be required to exempt from tax such income which suffers double taxation. State R may grant exemption either under 'full exemption' method or 'exemption with progression' method.

5 DCIT vs Tata Sons Ltd (2011) 43 SOT 27 (Mum)
6 Manpreet Singh Gambhir vs DCIT (2208) 26 SOT 208 (Delhi)
7 Article on Pensions, Dependent Personal Services, Shipping & Air Transport, Capital

other tax jurisdiction, the other tax jurisdiction is denuded of its powers to tax the same. The income to which Article on Elimination of Double Taxation is applicable should be taxable not only in the Source State but also in the State of residence. Thus, where the relevant Article uses the phrase 'shall be taxed only', the contracting State is given exclusive right to tax a particular kind of income.

Delhi ITAT in the case of Telecommunications Consultant[8] has also held that *"If, in the DTAA, an item of income is 'may be taxed' in state of source and nothing is mentioned about taxing right of state of residence in convention itself, then state of residence is not precluded from taxing such income and can tax such income using inherent right of state of residence to tax such global income of its resident. Only in the case of phrase 'shall be taxed only' used, then only the state of residence is precluded from taxing it. In such cases, where the phrase 'may be taxed' used, the state of residence has been given its inherent right to tax."*

In view of the above, it can be inferred that double taxation shall persist only when the taxing rights are distributed amongst the contracting States and not when one of the States is precluded from its taxing rights.

C. 'In Accordance With Provisions of this Convention'- The interpretation of the connotation 'in accordance with the provisions of this Convention/Agreement/DTAA which is prevalent in both Articles (i.e. Article 23A and Article 23B) is particularly important while dealing with cases where the State R and State S classify the same item of income differently for purposes of the provisions of the Convention. The provision stipulates that State R is required to give relief for double taxation only when taxation by the State S is in accordance with the provisions of the Convention. When State S levies taxes based on an incorrect interpretation of the provisions of the DTAA, State R reserves a right to disregard the claim of credit. However, State R is obliged to give credit/deduction where it believes that State S has correctly invoked its taxing rights in accordance with its DTAA. There is a possibility that the domestic laws of the Contracting States with regard to interpretation of the provisions of DTAA may differ from each other. The Commentary to the Model Conventions stipulate that in such a situation, relief from double taxation should be allowed by State R. There could even be instances where State S taxes income at rates higher than those provided in the Convention, it is uncertain as to whether the excess tax shall be allowable as a deduction in State R?

In the absence of any detailed guidelines or rules with respect to granting/availment of FTC, uncertainty persists on various aspects. One such aspect is scope of taxes. For the purpose of the Article on Elimination/Relief from Double Taxation, some of the DTAAs entered by India (India-USA, India-Canada) specifically provide that the taxes referred to in Article 2 of the Convention shall be considered for relief. The issue that arises for consideration is that will the taxpayer be entitled to a relief for the taxes, which are not covered in the Convention?

D. Timing Mismatch- Generally, the year in which the income may be taxed in various jurisdictions, differs on account of divergent domestic laws of each State. It becomes even more challenging when the source State taxes the income in a later year. The provisions of the Convention do not provide any restriction as to when such tax is to be levied. The State of residence must therefore provide relief of double taxation with respect to such income regardless of whether the source State taxes such income in an earlier or a later year.

The Bombay High Court in the case of Petroleum India International[9] has held that the objective of Section 91(1) of the Act is to give relief from taxation in India to the extent taxes have been paid abroad for the relevant previous year. The deduction/relief is not dependent upon the payment being made in the previous year.

E. Treatments of Exemptions/Deductions- The provisions as specified in the respective Conventions stipulates that a taxpayer, resident of State R who is also taxed on the same income in State S, is to be allowed deduction from the income in State R to the extent to which the tax is paid in the State S. However, the question that arises is to what extent the credit is allowable. The credit is granted against tax liability in the resident country. Effectively, therefore, the resident would not be required to pay tax to the extent of credit available to him. However,

8 Telecommunication Consultant India Ltd vs ACIT (2012) 20 taxman 31 (Del)
9 CIT vs Petroleum India International (2013) 29 taxmann 250 (Bom)

if the taxpayer is not liable to pay tax or if the tax payable by him in State R is less than the tax payable outside its territory because of deduction/exemption granted, will the taxpayer be able to claim credit for entire taxes paid? The credit is certainly out of the tax on the income of the resident in State R. Thus, if there is no tax or tax liability is lower because of exemption/ deduction, there is no double taxation. The tax payable by the taxpayer in State R is not on the entire income outside its territory but also in respect of other income.

There have been host of rulings which have held that, for claiming credit under section 90 of the Act, there has to be real double taxation of the same income in both the countries. The country where the person is resident is to grant credit for taxes paid in the country where the income arises but only to the extent to which State R levies tax. There cannot be a situation that taxes are paid outside State R and refund is claimed without actually being liable to be taxed in State R.

F. **Gross vs. Net Basis of Taxation**- One of the important factors by virtue of which FTC arises is the gross basis vs. net basis of taxation. Certain incomes like royalties, fees for technical services, interest, dividends *etc.* are taxed on gross basis in State S but are only taxed on net basis in State R according to the domestic laws of its jurisdiction. It is quite possible that a taxpayer pays tax in State S on gross basis but ends up incurring losses after considering all deductions in State R. The essential philosophy of the source rule of taxation on gross basis is that irrespective of the actual overall profits and losses in earning those incomes, the taxpayer must pay certain amount of tax in the State in which it is earned. Litigation arising by reason of the difference in the basis of taxation in the contracting states.

G. **Treatment of Losses**- Article 25(2)(a)[10] states that the deduction on account of tax paid in the State S from income tax payable in State R shall not exceed that part of income tax which is attributable to the income in State S. Being granted tax credits in excess of the actual domestic liability would result in a situation that even when the taxpayer had no liability in the State R, he was to be allowed credit in respect of entire taxes paid in State S. This perhaps would entitle the taxpayer entitling itself to refund in State R of taxes being paid outside its territory. The issue had been analyzed by Mumbai Tribunal in the case of Digital Equipments[11]. The Tribunal held that the restriction on deduction is unambiguous and beyond any controversy and credit of income tax paid in US cannot exceed the Indian income tax liability in respect of income which was paid in US.

In sight of the challenges discussed in the previous section of this article it could be inferred that ambiguity in relation to both, availing and granting FTC, has been persisting and it is critically important to address the same at the earliest by way of specific rules with an intent to mitigate the foreseeable protracted litigation.

H. **Effective/Actual Payment of Taxes and Documentary Evidence**- For allowing the claim of FTC, it is imperative that sufficient evidences of the taxes being paid in the other jurisdiction be provided in the State where FTC is being claimed. Revenue Authorities, on the other hand, should verify and ensure that taxes have indeed been levied and paid in State S. Credit is usually allowed on the basis of certificate of TDS payment in State S, or original documents evidencing tax payment in State S. The onus in any case lies upon the taxpayer to prove that the tax liability on income arising in the State S has been discharged by him. In the Indian context no predefined guidelines exist for the documentation which needs to be furnished in support of the FTC claims. In absence of any specific requirements there are differing requests made by the Revenue authorities in this regard. Moreover, the fact that proof would vary across different source States should also be kept in consideration.

Conclusion

In sight of the challenges discussed in the previous section of this article, it could be inferred that ambiguity in relation to both, availing and granting FTC, has been persisting and it is critically important to address the same at the earliest by way of specific rules with an intent to mitigate the foreseeable protracted litigation. ■

10 India-US DTAA has been referred for the sake of explanation
11 JCIT vs Digital Equipments India Ltd (2005) 94 ITD 340 (Mum)