

The Principle of Non-discrimination in Tax Treaties

Research and Insights

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Glossary

Abbreviation	Terminology
BIPA	Bilateral Investment Promotion and Protection Agreement
OECD	Organisation for Economic Co-operation and Development
OECD MC	OECD Model Convention
PE	Permanent Establishment
POEM	Place Of Effective Management
Tax Treaty	Double Taxation Avoidance Agreement
UN	United Nations
UN MC	UN Model Convention
US	United States
US MC	US Model Convention



Preface

Dear readers,

The Article on non-discrimination was conceptualised in tax treaties from old friendship, navigation and commerce treaties, in which foreign nationals were treated at par with the nationals of specific countries. Over the years, the ambit of the non-discrimination Article has expanded to cover other elements of non-discrimination, including for the permanent establishment of a foreign company, expense deductibility, etc.

In this report, we have walked you through the framework of the extant tax non-discrimination Article with elementary illustrations and business-related tax incidents. This is not a technical research paper, but aims to help you comprehend the applicability of the non-discrimination Article. And while there may be diverse schools of thought on tax non-discrimination, what we have attempted to do in this report is simplify the framework of the non-discrimination Article.

In the following chapters, we have provided instances where courts and international commentaries have evaluated the application of the non-discrimination Article and elaborated on the legal route to invoke it. Chapter 2, inter alia, deals with the contemporaneous topic on whether the non-discrimination Article can be applied to disallowance of interest-related expense on account of Thin Capitalisation rules. If you want to quickly move ahead, you could omit Chapter 1 and jump to Chapter 2 or Chapter 3, since the chapters are organised in such a manner that the content in each is complete in itself.

Non-discrimination is not generally seen as a forefront argument in tax analysis. I hope this publication helps to simplify the non-discrimination Article for you. For a comprehensive tax analysis, you can deliberate on non-discrimination-related arguments to ensure that any legitimate tax position on account of discrimination in domestic tax laws is not missed.

We will be happy to receive your input and feedback on this report.

Happy reading!

Frank D'Souza

Chapter 1: The ‘what’ and ‘how’ of non-discrimination

“...a difference in treatment is discriminatory...if it ‘has no objective and reasonable justification’, that is if it does not pursue a ‘legitimate aim’ or if there is not a reasonable relationship of proportionality between the means employed and the aim sought to be realized....”

- European Court of Human Rights¹

- 1.1 The nucleus of the ‘non-discrimination’ principle is aptly captured in the excerpt above from the judgment on the non-discrimination Article (i.e. Article 14) of the Convention for the Protection of Human Rights and Fundamental Freedoms. Article 14² provides for non-discrimination on grounds of sex, race, colour, etc.
- 1.2 As the word suggests, non-discrimination means anti-discrimination or against discrimination. Even the Indian Constitution includes the non-discrimination principle in its Article 14, which provides that “...*the state shall not deny to any person equality before the law or the equal protection of the laws within the territory of India...*”. Non-discrimination principles are also included in the India Model of the Bilateral Investment Treaty³, which states that intentional and unlawful discrimination against foreign investment on the basis of nationality constitutes breach of the Bilateral Investment Treaty.
- 1.3 In general, non-discrimination rules include principles that deal with provisions of the domestic laws of a country discriminating against certain categories of persons. The underlying objective is rooted in ensuring equality, so that such persons are not treated differently due to their disparate characteristics. The aim is to resolve non-discrimination-related problems by means of fair and equitable treatment. This is enshrined in taxation laws in tax treaties. Our report seeks to provide focused insights on tax-related non-discrimination from the standpoint of direct tax and its practical application in India.

1. In the case of Walker v. the United Kingdom, Application no. 37212/02

2. Article 14 of the Convention for the Protection of Human Rights and Fundamental Freedoms provides that “*The enjoyment of the rights and freedoms set forth in Convention shall be secured without discrimination on any ground such as sex, race, colour, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status.*”

3. Article 4.1 of the India Model of BIPA provides that ‘*each Party shall not apply to Investments, Measures that accord less favourable treatment than that it accords, in like circumstances to domestic investments with respect to the management, conduct, operation, sale or other disposition of Investments in its territory.*’ Further Article 4.2 provides that, ‘*a breach of Article 4.1 will only occur if the challenged Measure constitutes intentional and unlawful discrimination against the Investment on the basis of nationality.*’

What is tax non-discrimination?

- 1.4 Article 24 of the OECD MC (2017), the UN MC (2018)⁴ and US MC 2006⁵ comprise the non-discrimination Article. One of the prime objectives of the Article is to ensure that the source country does not levy an additional taxation burden on foreign investments vis-à-vis domestic investments. This Article is meant to support the goal of efficient allocation of taxing rights between a source country and a national or resident country, and thereby, supplements the tax-related principles of the tax treaty. The non-discrimination Article is incorporated in most tax treaties signed by India, with a few exceptions such as its tax treaty with Oman, Saudi Arabia and Greece.
- 1.5 Before we concentrate on the granular aspects of the tax-related non-discrimination Article and understand its practical application (as detailed in Chapter 2 and Chapter 3), it is imperative for us to understand its basic structure and denotation.
- 1.6 The non-discrimination Article in the OECD MC is divided into six paragraphs. The first five deal with different types of discrimination in a source country, i.e. nationality-based discrimination, discrimination against stateless persons, and discrimination relating to PE, expense and ownership. The last paragraph deals with the scope of taxes covered under the Article. However, every paragraph is a self-contained provision in itself and should be read on its own.
- 1.7 The prime objective of Article 24 is to identify discriminative treatment in specific circumstances. Therefore, any other form of discrimination that is not covered in the five paragraphs of the non-discrimination Article cannot be regarded as an unwarranted provision. Moreover, in such cases, the plea of non-discrimination cannot be used.



Paragraph	Particulars
Paragraph 1	Nationality-related non-discrimination
Paragraph 2	Non-discrimination of stateless person
Paragraph 3	PE-related non-discrimination
Paragraph 4	Expense-related non-discrimination
Paragraph 5	Ownership-related non-discrimination
Paragraph 6	Taxes covered

Paragraph 1: Nationality-related non-discrimination

“...Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States...”

- Paragraph 1 in Article 24 of OECD MC

- 1.8 Paragraph 1 deals with nationality-related tax non-discrimination. It establishes that for taxation purposes, discrimination on the basis of nationality is forbidden, i.e. nationals of one country cannot be subjected to additional taxation compared to the nationals of the source country. This is however subject to both the nationals being in the same circumstances in the source country. And unlike in the rest of the tax treaty, the peculiarity of this paragraph lies in its emphasis on the nationality of persons rather than on their residential status. Therefore, a person may be a national of one country and yet not a resident of that country, and vice versa. As a corollary, this paragraph also covers a national of one country, who may not be a resident of any of the two countries involved.
- 1.9 To illustrate this further, ‘A’, an Australian national earning an income in India, should not be treated differently in India vis-à-vis Indian nationals, other circumstances remaining the same. This is the case, irrespective of the residential status of ‘A’ in Australia. In this context, the taxation treatment accorded to ‘A’ in Australia is irrelevant.

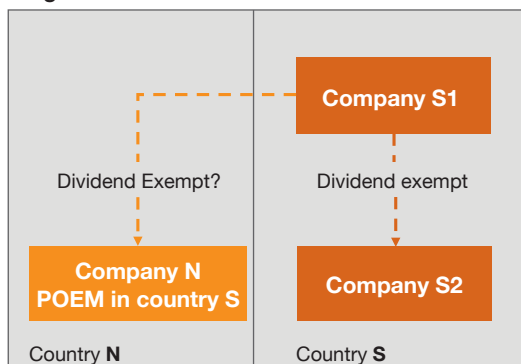
4. Considering that OECD MC and UN MC have similar language for non-discrimination provision, wherever in the publication ‘OECD MC’ is referred, the same analogy can also be applied for the UN MC

5. The US MC is similar in language to OECD MC, with exception of an additional paragraph for dividend, ‘Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in Paragraph 8 of Article 10 (Dividends)’

1.10 The nationality and residential status of a company is generally based on the country of its incorporation. The commentary on OECD MC provides a classic example that elucidates nationality-based discrimination with respect to companies. The following case study is explained with a reference to Diagram 1.1:

- Under the domestic Income Tax law of ‘country S’, companies incorporated in it or with their POEM in it are its residents.
- Under the domestic Income Tax law of ‘country N’, only companies that have their POEM in it are its residents.
- Company ‘N’ has its POEM in ‘country S’, and therefore is its resident according to the tax laws of ‘country N’ and ‘country S’.
- Companies ‘S1’ and ‘S2’ are incorporated in ‘country S’ and are resident in it.
- The domestic tax law of ‘country S’ provides that dividends paid to a company incorporated in ‘country S’ by another company incorporated in it are exempt from tax.

Diagram 1.1



1.11 In view of this, ‘company N’ will have its POEM in ‘country S’ and will be a resident of ‘country S’ for the purpose of the tax treaty of country S and country N. However, dividends paid by ‘company S1’ to ‘company N’ will not be eligible for this exemption, as company N is not incorporated in ‘country S’, even though it (the recipient company) is in the same circumstances with respect to its residency as ‘company S2’ (which is incorporated

in ‘country S’). Therefore, taxation of dividends in the hands of company N would be discriminatory treatment and constitute a breach of Paragraph 1.

1.12 Against the backdrop given above, it is pertinent to dwell on the meaning of the expression ‘*taxation and connected requirements*’ used in Paragraph 1. This is also relevant for other paragraphs of Article 24. The term ‘*taxation*’ goes beyond only tax rates. It refers to different parameters in tax computation and includes those parameters referring to deduction of bad debts⁶ and profit-linked deductions⁷. Practical insights on ‘*taxation*’ are further elaborated in Chapter 3.

1.13 The expression ‘*connected requirements*’ does not refer to taxation as such⁸, but to all other obligations that may be required to make the tax levy concrete. In this context, the OECD MC suggests that ‘*connected requirements*’ include formalities connected with taxation such as tax return filing, payment of taxes and prescribed timelines⁹. A case in point is the observation made by the Pune bench of the Tribunal in *Daimler Chrysler India*¹⁰ that any precondition such as carry forward of losses that has a vital bearing on determination of tax liability is a requirement connected with taxation.

1.14 The crucial element of this paragraph is that nationals of both countries (i.e. the source country and the national country) need to be in the ‘*same circumstances*’. This means that the nationals need to be in substantially similar circumstances, both in law and fact, for application of taxation laws and regulations. Moreover, the ‘*same circumstances*’ can be seen in their form of constitution, for instance, a foreign proprietorship concern cannot be said to be in the same circumstances as a domestic company. Similarly, the PE of a foreign bank cannot be said to be in the same circumstances as a domestic bank.

1.15 In the context of Indian tax law, Paragraph 1 can be invoked in circumstances when any provision of the Income-tax Act, 1961 or a tax treaty discriminates against taxation of the national of another country vis-à-vis that of an Indian national. For instance, section 80R¹¹ and section 80RRA¹² of the Income-tax Act, 1961 were observed¹³ to be discriminatory under Paragraph 1, as these sections only apply to citizens of India.

6. Standard Chartered Bank v. IAC (1991) 39 ITD 57 (Mumbai Tribunal)

7. Credit Llyonnais v. DCIT (2005) 94 ITD 401 (Mumbai Tribunal)

8. Regina v. Inland Revenue Commissioners Exp. Commerzbank AG [S.T.C.] 271 (QBD), published in Common Market Law Review 3, 633 (1991)

9. OECD MC (2017) para 15 of Article 24

10. Daimler Chrysler India (P) Ltd. v. DCIT (2009) 29 SOT 202 (Pune)

11. Section 80R of the Income-tax Act, 1961 is the provision for deduction in respect of remuneration received by citizens of India from certain foreign sources in the case of professors, teachers, etc. However, no deduction is available under this section with effect from 01 April, 2004

12. Section 80RRA of the Income-tax Act, 1961 provides for deduction in respect of remuneration received by citizens of India for services rendered outside India. However, no deduction is available under this section with effect from 01 April, 2004

13. Credit Llyonnais vs DCIT [2005] 94 ITD 401 (Mum)

- 1.16 To sum up, from the perspective of India's tax law, if you are a national of any country (other than India), and are subjected to burdensome taxation in India vis-à-vis an Indian national, you might want to explore how this Article can help you against such discrimination.

Paragraph 2: Non-discrimination of a stateless person

“...Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected...”.

- Paragraph 2 in Article 24 of OECD MC

- 1.17 Paragraph 2 is relevant for a stateless person who is not considered a national of either of the countries for a particular tax treaty. This paragraph provides that stateless persons should not be subjected to more burdensome taxation, compared to the nationals of the concerned country. However, it is important that stateless persons and comparative nationals are in the same circumstances, especially with respect to their residential status.
- 1.18 The intent of including this paragraph was to extend ‘national treatment’ to stateless persons who receive assistance from UN agencies and perhaps enjoy privileges attached to those who are nationals of a particular country. But these stateless persons are still not regarded as the country’s ‘nationals’. However, there is limited application of this paragraph, and some countries such as India¹⁴, Japan, the USA and Switzerland have reserved the right not to insert it.

Paragraph 3: PE-related non-discrimination

“...Taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents...”.

- Paragraph 3 in Article 24 of OECD MC

- 1.19 Paragraph 3 deals with tax-related non-discrimination for a PE. It emphasises that taxation levied on the PE of a foreign enterprise in its source country should not be less favourable than taxation of the enterprises of the country conducting the same activities. The source country may choose to but is not obliged to grant personal tax allowances or reductions to the PEs of non-resident individuals, which it may have granted to its own residents. The paragraph does not prohibit this.
- 1.20 To illustrate this further, a company incorporated in Spain may have a project office in India, which is to be considered a PE for the India-Spain Tax Treaty. By virtue of Paragraph 3, such a PE should not be taxed less favourably in India vis-à-vis an Indian company carrying on the same activities in the country.
- 1.21 The equal treatment granted by this paragraph to PEs vis-à-vis resident entities has widespread inferences. At the very outset, this paragraph does not require the same rate of tax¹⁵ to be levied on the profits of the PE of a foreign company as that levied on a resident company. This analogy is derived as residents are usually taxed on their global income, whereas non-residents are only taxed on income sourced from a particular country. To further fortify its position, India has reserved its right to clarify in the commentary to the OECD MC that a higher tax rate levied on the profits of a PE than that for a similar Indian company will not be in conflict with this paragraph.¹⁶

14. Indian Tax Treaty with Romania and Latvia contains the Paragraph of non-discrimination for stateless persons

15. Advance Ruling Application No. P-16 of 1998, In re [1999] 236 ITR 103 (AAR)

16. India has also inserted an Explanation to section 90 of the Income-tax Act, 1961, stating, ‘...the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.’

- 1.22 The phraseology ‘less favourable’ treatment in Paragraph 3 is with respect to ‘taxation’ alone. Thus, equal treatment in taxation should be accorded, e.g. deduction of expenses, claim of depreciation, carry forward or backward of losses and claiming of tax incentives. Consequently, it is clear that Paragraph 3 does not extend ‘less favourable’ treatment to ‘connected requirements’. As a corollary, connected requirements such as stringent information-related requirements, group consolidation rules and transfer pricing-related enquiries for transactions with associated enterprises cannot be considered to be prohibited by implying this paragraph. This makes it distinct from Paragraph 1, which deals with ‘taxation and connected requirements’.
- 1.23 In the context of Paragraph 3, Indian court¹⁷ has observed that the PE of a foreign enterprise whose activities include borrowing and lending of money, but which is not registered as a bank in India, cannot be said to be carrying on the same activities as those conducted by a domestic bank. In another instance, wherein PE non-discrimination was applied, the Court¹⁸ held that claim of a tax incentive provision for development of economically backward areas cannot be denied to a PE if it fulfils the same conditions as those relevant for resident enterprises.
- 1.24 To sum up, from the perspective of Indian tax law, if you are a foreign company with a PE in India, this PE cannot be accorded less favourable taxation-related treatment than an Indian company, which is carrying on the same activities.

Paragraph 4: Expense-related non-discrimination

“...Except where the provisions of Paragraph 1 of Article 9, Paragraph 6 of Article 11, or Paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State...”

- Paragraph 4 in Article 24 of OECD MC

- 1.25 Paragraph 4 deals with expense-related non-discrimination. It emphasises that a resident company should be eligible to claim deduction for disbursements to a non-resident for the purpose of determining its taxable profits, if deduction under the same conditions is available when paid to a resident. Such an expense claim is subject to the rigours of the Arm’s Length principle of transfer pricing enumerated in Article 9(1), Article 11(6) and Article 12(4) of the OECD MC. The same situation may also occur in the sphere of capital taxation in regard to debts contracted to a non-resident.¹⁹ This paragraph does not preclude countries from introducing measures to curb tax avoidance or double non-taxation by either bilaterally modifying their tax treaties or introducing anti-avoidance domestic tax rules, as long as these measures are compatible with the provisions of the tax treaty.
- 1.26 To illustrate the above, by virtue of Paragraph 4, an Indian company should be eligible to claim expense for interest paid to a French company if the interest expense in the same conditions is deductible if paid to another Indian company.
- 1.27 To recapitulate, from the perspective of Indian tax law, if you are an Indian company making payment to a non-resident, and such payment would be an eligible expense had it been made to a resident payee, then payment to a non-resident should also be deductible from its taxable profits. Moreover, on the basis of this paragraph, any restriction on such payments by virtue of domestic tax law would be discriminatory. Chapter 2 of this publication appraises this paragraph and analyses whether the recently introduced Indian Thin Capitalisation rules are discriminatory in nature.



17. Chohung Bank vs DDIT [2006] 286 ITR 231 (Mum)

18. Rajeev Sureshbhai Gajwani vs ACIT [2011] 8 ITR(T) 616 (Ahmedabad) (SB)

19. OECD MC, Para 73 to Article 24

Paragraph 5: Ownership-related non-discrimination

“...Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected...”

- Paragraph 5 in Article 24 of OECD MC

- 1.28 Paragraph 5 deals with ownership-related non-discrimination. The objective of this paragraph is to ensure non-discriminative treatment to resident taxpayers, irrespective of who owns or controls capital. It does not extend the benefit to non-residents that own or control capital.
- 1.29 To elaborate on this further, let us take the instance of a hypothetical Indian company with Italian shareholders. The company should not be subjected to more burdensome taxation or connected requirements than those subjected to an Indian company with Indian shareholders.
- 1.30 The phrase ‘*taxation or connected requirements*’ is similarly interpreted in Paragraph 1 of this Article. The term ‘*other similar enterprises*’ implies that foreign-owned and locally owned subsidiaries should be comparable, and that such foreign-owned subsidiaries should not be compared with subsidiaries owned by the residents of a third country.
- 1.31 In context of Paragraph 5, the Indian Court²⁰ held that an Indian company whose foreign holding company has shares listed on a foreign stock exchange should be treated at par with another Indian company that has shareholders whose shares are listed on an Indian stock exchange.
- 1.32 To summarise, from the perspective of Indian tax law, if you are an Indian company with a foreign shareholding, you cannot be subjected to more

burdensome taxation or connected requirements vis-à-vis that levied on any Indian company with an Indian shareholding.

Paragraph 6: Taxes covered

“...The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description...”

- Paragraph 6 in Article 24 of OECD MC

- 1.33 Paragraph 6 is general in nature and seeks to cover all forms of taxes, irrespective of the provisions of Article 2²¹, which cover only taxes on income and capital. The US Commentary to its MC considers Customs Duty to be outside the ambit of this paragraph. Many Indian tax treaties²² have limited the scope of this paragraph to only cover the taxes to which the tax treaty applies.

How to invoke non-discrimination

- 1.34 The basic framework of the non-discrimination Article covers within its ambit five specific circumstances wherein discrimination can be challenged by a taxpayer. The next germane point is the manner in which the Article is invoked.
- 1.35 The obligation to prove application of the non-discrimination Article is on the taxpayer. Under the Indian taxation regime, taxpayers have two broad routes they can follow to face the tax authority—a reactive one and a proactive one. They can apply this interpretation while filing tax returns and answer the tax officer at the time of assessment or audit proceedings (in the reactive model). And if the tax officer does not agree with their interpretation of non-discrimination, they can opt for the traditional appellate mechanism or file an application with the competent authorities through the Mutual Agreement Procedure²³. Alternatively, taxpayers can file an application with the Authority for Advance Rulings²⁴ to obtain certainty on its tax interpretation (in the pro-active model), either before or after filing tax returns, but before the issue is raised by the tax officer in audit proceedings²⁵.

20. Daimler Chrysler India (P) Ltd. v. DCIT (2009) 29 SOT 202 (Pune)

21. Article 2 provides for Taxes Covered under the Tax Treaty

22. The term taxation is defined to mean, ‘*taxes to which this Convention applies*’ in the Indian Tax Treaties with Brazil, Mauritius, Slovak Republic, New Zealand, Japan, Morocco, Swiss Confederation, China, Denmark, Kuwait, Italy, Singapore, Bangladesh, Indonesia, UK, South Africa, China, Poland, UAE, UAR (Egypt), Philippines, Bhutan, Bulgaria, Ukraine, Qatar, Malta, Mongolia, Zambia, Thailand, Belarus, Uzbekistan

23. MAP is filed under Tax Treaty (corresponding to Article 25 of the OECD MC), within three years from the first notification of the action, resulting in taxation not in accordance with the provisions of the respective Tax Treaty

24. Advance Ruling Application No. P-16 of 1998, In re [1999] 236 ITR 103 (AAR)

25. Section 245R of the Income-tax Act, 1961 prohibits the acceptance of application filed before the AAR, if the issue is already pending before any income-tax authority or appellate tribunal or any court

Chapter 2: Expense-related non-discrimination

- 2.1 Paragraph 4 of the non-discrimination Article²⁶ aims to provide parity in deductibility of expenses to payers when payment is made to non-residents, compared to payment made to residents. This paragraph provides for expense-related non-discrimination for the benefit of payers (and not payees). What is important here is that deductibility of expenses is to be viewed '*under the same conditions*' while determining taxable profits, subject to '*exceptions*' provided in Article 9(1), Article 11(6) or Article 12(4).
- 2.2 The expression '*under the same conditions*' refers to the nature of receipt and conditions of deductibility. A case in point is section 40(a)(i) of the Income-tax Act, 1961, which provides for disallowance of payment made to non-residents on their failure to withhold taxes. Prior to the insertion of section 40(a)(ia)²⁷, similar payments made to residents were not disallowed. In such scenarios, when the same payment was made without withholding taxes to residents and non-residents, disallowance was only attracted on payment made to non-residents. Thus, payments were made under the same circumstances, but disallowance of payment to only non-residents was discriminatory in nature.
- 2.3 Dealing with the phrase '*under the same conditions*', the Delhi High Court (in the case of *Herbalife*)²⁸ held that lack of parity in allowing payment (to non-resident vs resident payees) as deduction resulted in discrimination. In this case, the tax officer disallowed payment made by an Indian payer to a US entity for certain administrative services rendered by the latter. The Delhi High Court observed that the object of the expense-related discrimination paragraph in the India-USA tax treaty was to ensure non-discrimination in the condition of deductibility of payment in the hands of the payer where the payee is either a resident or a non-resident. This objective would be defeated due to the discrimination against the non-resident payee, by disallowing the expense in hands of payer if no tax was withheld while making payment for administrative services in terms of section 40(a)(i) of the Income-tax Act, 1961, when analogous provisions for resident payees were not provided for in the tax laws.²⁹
- 2.4 What also merits attention are the following exceptions of expense-related non-discrimination outlined at the beginning of Paragraph 4:
- Article 9(1): Transfer pricing adjustment for transactions between associated enterprises
 - Article 11(6): Non-application of beneficial provisions of the tax treaty for taxability of interest in the source state due to a special relationship between the payer and the beneficial owner of such interest income
 - Article 12(4): Non-application of beneficial provisions of the tax treaty for taxability of royalty in the source state due to a special relationship between the payer and the beneficial owner of such royalty income
- 2.5 Paragraph 4 provides that except in the scenarios mentioned above, deductibility of payments to non-residents should be at par with deductibility of payments made to residents. Against this background, it is relevant to analyse whether Indian Thin Capitalisation rules, which provide for disallowance of interest-related expense paid to non-resident associated enterprises, can be said to be discriminatory in nature.

26. Article 24(4) of the OECD MC

27. Finance Act (No 2) 2004 introduced section 40(a)(ia) to end the discriminative treatment, and provides for disallowance of expenses made to residents on account of failure to withhold applicable taxes

28. CIT vs Herbalife International India (P) Ltd [2016] 384 ITR 276 (Delhi HC)

29. There have been numerous judgments on this issue wherein it was held that section 40(a)(i) of the Act was discriminative towards non-residents. Millennium Infocom Technologies Ltd vs ACIT [2008] 117 TTJ 456 (Delhi); Central Bank of India vs DCIT [2010] 42 SOT 450 (Mumbai); B4U International Holdings Ltd vs DCIT [2012] 18 ITR(T) 62 (Mumbai); DCIT vs Incent Tours (P) Ltd. [2012] 25 taxmann.com 222 (Delhi)

Are Indian Thin Capitalisation rules discriminatory?

- 2.6 At the outset, countries such as Argentina, Russia and Tunisia reserved the right to include a provision to apply Thin Capitalisation measures in their domestic laws, notwithstanding any other provisions of the OECD MC. India has not made similar reservations or clarification for Thin Capitalisation rules to the OECD MC.
- 2.7 India's Thin Capitalisation rules were introduced under section 94B in the Income-tax Act, 1961 with effect from 1 April 2017. Section 94B provides that interest-related expenses claimed by an Indian company or the PE of a foreign company (in relation to interest paid to its non-resident associated enterprise or to a lender that is not an associated enterprise, but the loan is being explicitly or implicitly guaranteed by an associated enterprise) will be disallowed for the lower of the following amounts:
- Total interest minus 30% of its earnings before interest, taxes, depreciation and amortization
 - Interest paid or payable to associated enterprise
- 2.8 To illustrate the facts mentioned above, let us take the hypothetical case of an Indian company, which avails a loan facility from its associated enterprise who is a tax resident of France. The India-France Tax Treaty includes relevant provisions corresponding to Article 9(1), Article 11(6) and Article 24(4) of the OECD MC. The Indian company pays an interest to the French associated enterprise according to the terms of the agreement. With regard to this transaction, Article 10(1) of the India-France Tax Treaty [corresponding to Article 9(1) of OECD MC] provides for transfer pricing-related adjustment in the taxable profits of the payer, if the interest paid is in excess of the Arm's Length price. Similarly, Article 12(7) of the India-France Tax Treaty [corresponding to Article 11(6) of the OECD MC] provides that beneficial provision of the tax treaty will not be available to the payee to the extent of the interest payment in excess of the Arm's Length price.
- 2.9 This interest payment, being an international transaction, would have to comply with the transfer pricing Arm's Length principle, and thus be in line with Article 10(1) and Article 12(7) of the India-France Tax Treaty. On the other hand,
- Indian Thin Capitalisation rules are based on the profitability parameters of an Indian company, i.e. subject to 30% of its earnings before interest, taxes, depreciation and amortisation. Therefore, the Indian company having business losses or without sufficient profit, will suffer due to disallowance of interest expense under section 94B of the Income-tax Act, 1961, irrespective of this being at Arm's Length.
- 2.10 In view of the illustration above under point 2.8, the issue to be analysed is whether disallowance of Arm's Length interest payment by an Indian payer to its French associated enterprise is in violation of the expense-related non-discrimination paragraph of the India-France Tax Treaty.
- 2.11 This issue can be analysed from two perspectives. According to one school of thought, disallowance of interest due to Indian Thin Capitalisation rules is discriminatory, and hence, not permitted. The reasoning is that section 94B of the Income-tax Act, 1961 is only applicable in respect of interest payments made to a non-resident associated enterprise, and there is no similar provision under the Act to disallow similar payments to resident associated enterprises. Consequently, according to Article 26(4) of the India-France Tax Treaty [corresponding to Article 24(4) of the OECD MC], interest paid by an Indian company to a resident of France should be deductible by virtue of the expense non-discrimination paragraph.
- 2.12 According to the other school of thought, discrimination in Article 26(4) of the India-France Tax Treaty [corresponding to Article 24(4) of the OECD MC] is with respect to comparison of deductibility of non-resident payment vs resident payment. India's Thin Capitalisation rules only limit deduction of interest paid to non-resident associated enterprises and not all non-residents. Therefore, Thin Capitalisation rules cannot be said to be discriminatory, but are based on the residential status of the payee. Hypothetically, if Thin Capitalisation rules had provided for limitation of the interest paid to non-residents, whether or not they were associated enterprises, then in the absence of a similar provision for resident payees, a taxpayer may have resorted to the option of expense-related non-discrimination. With the extant framework of Thin Capitalisation rules, it is possible to take a stand that these rules are not discriminatory vis-à-vis the residential status of the payee (resident vs non-resident).

2.13 In view of contrary schools of thought, this intricate issue may create convoluted tax positions in the industry and result in protracted litigation. The need of the hour is therefore to receive comprehensive guidance on this from lawmakers. And if this is not foreseen, taxpayers may need to take proactive action to obtain certainty on their tax positions by seeking advance rulings.

Can non-discrimination be explored in all cases of Thin Capitalisation disallowance of interest?

2.14 India has entered tax treaties with more than 95 countries, and the count is growing. However, not

all tax treaties have similar language for expense-related non-discrimination as that of the OECD MC. For example, India’s tax treaties with the UK, Singapore, etc. do not include a paragraph on expense-related non-discrimination. However, its tax treaties with Australia, China, Finland, France, Germany, Israel, Japan, Korea, Malaysia, the Netherlands, Norway, South Africa, Spain, Switzerland and the USA include a paragraph on expense-related non-discrimination such as that of the OECD MC. This implies that payment of interest to associated enterprises in the countries mentioned above could be relevant for application of the expense-related non-discrimination argument if this is not deductible under India’s Thin Capitalisation rules.

Diagram 2.1: India’s tax treaties with expense-related non-discrimination paragraph

Australia	China	Finland	France	Germany
Israel	Japan	Korea	Malaysia	Netherlands
Norway	South Africa	Spain	Switzerland	USA



Chapter 3: Variants of taxation-related discrimination

3.1 The expression 'taxation' finds its place in multiple paragraphs of the non-discrimination Article. These paragraphs provide that 'taxation' cannot be discriminatory in the following cases:

- Paragraph 1: On the basis of the nationality of the taxpayer
- Paragraph 2: For stateless persons
- Paragraphs 3: For PEs
- Paragraph 5: For an Indian company that is foreign-owned

3.2 The non-discrimination Article of many Indian tax treaties³⁰ define the phrase 'taxation' as the taxes to which they apply. In cases where the term 'taxation' is not defined, it needs to be interpreted in a manner that is wider than the rate of tax levied. This means that the ambit of 'taxation' is diverse. Against this backdrop, the following paragraphs delve further into the practical aspects of discriminatory treatment enshrined in Article 24 of the OECD MC vis-à-vis 'taxation'.

POEM of foreign company and tax-related non-discrimination

3.3 POEM is a newly introduced concept in India's domestic tax laws. The definition of a company resident in India has been revised to include a foreign company whose POEM is in India in a particular year. To buttress implementation of POEM provisions in India, the Government has issued a notification³¹ dated 22 June 2018, which, inter alia, provides that the tax rate of 40% (plus

the applicable surcharge and cess) will continue to apply to foreign companies with POEM in India.

3.4 With the tax rates applicable for a resident foreign company being different from those for a resident domestic company, the moot point is whether different tax rates for two resident companies can be considered as discrimination under the non-discrimination Article. In this instance, it is relevant to refer to the example from the commentary to the OECD MC discussed in point 1.10 and point 1.11 above. In reference to the discussion on discrimination in the OECD MC, foreign companies with Indian POEM, suffering from different tax treatment based exclusively on their nationality³², may consider taking recourse to the non-discrimination Article.

PE discriminated against for deduction of expenses

3.5 Section 44C of the Income-tax Act, 1961 restricts deduction of head office-related expenses (i.e. executive and general expenses) up to a maximum of 5% of the adjusted total income from the business or profession of a PE in India. Article 7(3) of the tax treaty provides that a PE should be allowed deduction for expenses in accordance with the provisions of domestic law. Article 24(3) of the OECD MC provides for non-discrimination in relation to taxation of the business profits of PEs vis-à-vis resident companies.

3.6 Therefore, the question is whether domestic law-related restrictions amount to discrimination



30. The term taxation is defined to mean, 'taxes to which this Convention applies' in the Indian Tax Treaties with Brazil, Mauritius, Slovak Republic, New Zealand, Japan, Morocco, Swiss Confederation, China, Denmark, Kuwait, Italy, Singapore, Bangladesh, Indonesia, UK, South Africa, China, Poland, UAE, UAR (Egypt), Philippines, Bhutan, Bulgaria, Ukraine, Qatar, Malta, Mongolia, Zambia, Thailand, Belarus, Uzbekistan

31. Notification No. S.O. 3039(E) dated 22 June 2018

32. A company incorporated outside India is generally treated as national of the country of its incorporation

against the PEs of foreign companies, since there is no similar restriction for Indian companies. The Mumbai bench of the Tribunal, in the case of *Metchem Canada*,³³ held that restriction on admissibility of the head office overheads of the PE of a Canadian company constituted discrimination against the PE vis-a-vis a domestic Indian entity because no such restriction was applicable for deduction of the head office overheads of the Indian company. Accordingly, Article 24(2) of the India-Canada Tax Treaty [similar to Article 24(3) of the OECD MC] was held to override the provisions of Article 7(3) and the restriction imposed by section 44C of the Income-tax Act, 1961 was held as discriminatory. An analogy can also be inferred for the benefit of the PEs of foreign companies from other countries, whose Indian tax treaties use a similar language, e.g. Mauritius.

- 3.7 Certain tax treaties signed by India, such as those with Vietnam, the USA, Spain, Sweden, Germany, Finland and Cyprus, specifically provide that the provisions of Article 7(3) will prevail over PE-related non-discrimination. Therefore, in such cases, the restrictions in domestic laws will not be treated as discriminatory against a PE.

Non-discrimination for a ‘company in which the public are substantially interested’

- 3.8 Section 2(18) of the Income-tax Act, 1961 defines a ‘company in which the public are substantially interested’ to include a company, the shares of whose parent company are listed on a recognised stock exchange in India, in accordance with the Securities Contracts (Regulation) Act, 1956. This concept of ‘company in which the public are substantially interested’ is relevant in multiple provisions of the Income-tax Act, 1961, such as deemed dividend taxability provided in section 2(22)(e)³⁴, carry forward and set-off of business losses provided in section 79³⁵.
- 3.9 In the case of *Daimler Chrysler India*³⁶, the Pune bench of the Tribunal examined whether an Indian company can be said to be a ‘company in which the public are substantially interested’ if

the shares of its German shareholding are listed on international stock exchanges (and not on an Indian stock exchange). The Tribunal observed that the shares of a foreign parent company could never have been listed on a recognised stock exchange in India, and therefore, an Indian subsidiary of a foreign company would always be in a disadvantageous position in the sense that the shares of its foreign parent company would only be listed on international stock exchanges, and so it would not be treated as a ‘company in which public are substantially interested’. On the other hand, according to the Tribunal, the Indian subsidiary of a domestic company would be entitled to be a ‘company in which public are substantially interested’ if the shares of its domestic parent company were listed in a recognised stock exchange in India.

- 3.10 In this factual matrix, the precise point of ownership-related discrimination was that an Indian subsidiary with an Indian parent company, whose shares were listed on a recognised stock exchange in India, would be treated as a ‘company in which the public are substantially interested’. However, if the subsidiary of an Indian company has a German parent company, whose shares were listed in any international stock exchange, it will not be given the status of a ‘company in which public are substantially interested’. There is no rational basis for this difference in treatment, and therefore the provisions of section 79, read with section 2(18), were held to be incompatible with the ownership-related non-discrimination provision in Article 24(4) of the India-Germany Tax Treaty [corresponding to Article 24(5) of the OECD MC].
- 3.11 Similar to the above, the analogy in applying non-discrimination to a ‘company in which the public are substantially interested’ can also be applied in other sections such as that on taxability of a deemed dividend. Taking a cue from the decision on *Daimler Chrysler India*³⁷, the Indian subsidiary of a foreign listed shareholder can take the shelter of ownership-related non-discrimination provisions while providing loans or advances to its shareholders or on behalf of its shareholders, and argue non-application of taxability as deemed dividends.

33. *Metchem Canada Inc. vs DCIT 99 TTJ 702*

34. Section 2(22)(e) of the Income-tax Act, 1961, inter alia, provides that if a company (other than the company in which public are substantially interested) gives a loan and / or advance to its shareholders, then such loan is treated as a deemed dividend in the hands of the shareholder.

35. Section 79 of the Income-tax Act, 1961 provides that a taxpayer (other than a ‘company in which the public are substantially interested’), shall have the right to carry forward and set off the business loss on fulfillment of certain conditions. One such condition being that on the last day of the year pertaining to set-off of business losses, the same person/s, who held 51% of the shares on the last day of the year/s when such loss was incurred, beneficially held 51% of the shares.

36. *Daimler Chrysler India (P) Ltd. v. DCIT (2009) 29 SOT 202 (Pune)*

37. *Daimler Chrysler India (P) Ltd. v. DCIT (2009) 29 SOT 202 (Pune)*

Foreign company holding subsidiary merger and tax-related non-discrimination

- 3.12 India's domestic tax laws provide for exemption from Capital Gains Tax in certain corporate restructuring cases. A case in point is section 47(via) of the Income-tax Act, 1961, which provides for exemption on transfer of an Indian company's shares by a foreign shareholder company amalgamating with a foreign amalgamated company, subject to satisfaction of the following conditions:
- (a) At least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company.
 - (b) Such a transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.
- 3.13 Condition (a) stipulated above raises a question about whether the merger of a wholly owned foreign subsidiary with a foreign holding company should be covered under this section 47(via), hypothetically assuming that condition (b) above will be fulfilled. However, based on stringent application of the law, the answer seems to be in the negative. Interestingly, the Finance Act 2012 introduced an exception in section 47 for issue of shares by an amalgamated company in the case of the merger of a holding-subsidiary. The Memorandum to Finance Bill 2012 aptly suggests that in a holding-subsidiary merger, it is not possible for an amalgamated company to issue shares to itself. Hence, legislative amendments were proposed. Thereafter, the provisions of section 47(vii) relating to domestic amalgamations of holding subsidiaries have been relaxed. However, no similar relaxation is available for foreign mergers in section 47(via).
- 3.14 In the case of the foreign merger mentioned above, the amalgamating foreign company may not be eligible for tax exemption under section 47(via) due to non-satisfaction of the condition mentioned above. In this regard, it may be argued that the foreign company is discriminated against in comparison with an Indian company, which is eligible for tax exemption on a holding subsidiary merger under section 47(vi). This line of thought is worth exploring, although it could be argued

that section 47(vi) envisages the resulting entity to be an Indian company, and therefore, cannot be compared with section 47(via), which envisions a foreign company.

Application of transfer pricing provision – a case of discrimination?

- 3.15 Article 7 of the OECD MC provides that attribution of income or expenses to a PE should be accordance with Arm's Length standards. Similarly, by virtue of Article 9, transactions between a resident enterprise and a foreign enterprise should be in line with the Arm's Length principle. Thus, one cannot imply that application of transfer pricing rules to the PE of a foreign enterprise in India results in taxation of the PE, which is less favourably levied than that on domestic enterprises³⁸, and therefore, there is no discrimination in this case.³⁹

Requisitioning additional information from foreign companies – a discriminatory measure?

- 3.16 In Indian audit or assessment proceedings, a tax officer may seek additional information from a non-resident company to ensure similar levels of compliance and verification. In this context, there is no discrimination when a foreign enterprise is required to provide additional information, including transfer pricing-related enquiries that may be different from the requirements imposed on a local enterprise during tax proceedings.⁴⁰



38. OECD MC (2017) para 42 of Article 24

39. M/s Technip Italy S.P.A vs DCIT ITA No. 7171/DEL/2017

40. OECD MC (2017) para 75 of Article 24

Chapter 4: Conclusion

- 4.1 The concept of tax-related non-discrimination is complex and thought-provoking. And with the dearth of Indian rulings on the subject of non-discrimination and evolving taxation, there is enough room for open debate. In this context, taxpayers first need to identify the applicability of the non-discrimination Article to their circumstances. This can be determined by undertaking a detailed analysis of the category of discrimination in coherence with the language of the relevant tax treaties and conditions provided therein.
- 4.2 This report primarily focuses on non-discrimination in Indian tax laws for inbound investments, but the benefit of non-discrimination can also be explored for India's outbound investments made in foreign countries, subject to their tax laws.



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