Notified Foreign Tax Credit Rules in India

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In this era of globalization, it is common for many individuals, companies and entities to earn income from multiple countries. Such income would often be subject to dual taxation arising from source country and residence country. Double Taxation Avoidance Agreements (DTAAs) usually provide the mechanism to mitigate the impact of juridical double taxation, generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods

DTAAs being bilateral agreements are not able to provide a comprehensive solution to mitigate the impact of juridical double taxation arising from various circumstances. It is also not able to provide a uniform relief from double taxation of income arising from similar circumstances in multiple countries. To address this concern, many countries have provided a unilateral relief under their domestic tax laws through Foreign Tax Credit (FTC) rules, in addition to the relief under the DTAAs. These rules describe the country's approach, framework and the mechanism to compute and offset the impact of double taxation under various circumstances. These rules may also relieve the impact of economic double taxation.

The FTC mechanism in India is at present governed by sections 90, 90A and Sec 91 of the Income Tax Act, 1961. Sec 90 provides relief from double taxation of income in India through a DTAA concluded between the Government of India and the Government of another country. Sec 91 provides unilateral relief from double taxation of income arising from a country with which the Government of India has not concluded a DTAA. The Central Board of Direct Taxes (CBDT) recently notified Foreign Tax Credit Rules (notified FTC rules) in India which will be applicable from 01 April 2017. Unfortunately, these Rules do not even address some of the elementary double taxation challenges faced by tax residents in India earning income from multiple countries, which has resulted in tax litigation. The focus of this article is on the challenges faced by corporations resident in India, even though it may apply in certain circumstances to other tax residents.

1. Types of foreign taxes eligible for FTC in India

a. In the United States of America, income tax is imposed on the net income of corporations by the federal, most state, and some local governments. The tax systems within each jurisdiction define the procedure to determine taxable income separately. However, many states refer to some extent to federal concepts for determining taxable income.
   The India-U.S. DTAA applies only to the Federal income taxes imposed by the Internal Revenue Code. Consequently, Indian companies are unable to avail FTC in India on the income tax paid in the various states and cities

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in the United States of America as they are not Federal income taxes imposed by the Internal Revenue Code.

b. Corporations and permanent establishments such as branches in Canada have to pay provincial and territorial income tax in addition to federal income tax. Provinces and territories in Canada legislate their corporate income tax provisions, but the Canada Revenue Agency (CRA) administers them, except for Quebec and Alberta. If a corporation has a permanent establishment in any province or territory in Canada other than these two, provincial and/ or territorial income taxes and credits as well as federal income taxes and credits have to be calculated on the federal return.

   The India-Canada DTAA applies only to the taxes imposed under the Income-tax Act of Canada. Consequently, Indian companies are unable to avail FTC in India on the income tax paid in the various provinces and territories of Canada as they are not taxes imposed under the Income-tax Act of Canada.

c. The corporate tax rate in Germany is 15%. An additional tax called "solidarity tax" is payable at 5.5% of the normal tax rate. This tax has been imposed to help the merger of the two Germanys and is levied on corporations and individuals. In addition, there is a municipal trade tax of 14%-17% that is imposed by a municipality. In 2016, the effective corporate tax rate in Germany, including trade tax and solidarity tax is about 30%–33% for companies operating in the main cities.

   The India-Germany DTAA includes taxes on income imposed by a political sub-division or local authority thereof for relief from double taxation. Consequently, municipal trade tax paid in Germany is eligible for tax credit in India, subject to the overall tax rate in Germany being lower than the corporate tax rate in India.

d. Income taxes in Switzerland are levied at a federal level and also by the cantons. Based on the tax laws of their canton, the communes also levy income taxes. The federal tax in Switzerland is identical for all its territories. The cantonal tax is specific to each of the 26 cantons. Communal taxes are added to the cantonal tax with varying rates according to the wealth of the community. The India-Switzerland DTAA includes cantonal and communal taxes on income for relief from double taxation. Consequently, income taxes paid in various cantons and communes in Switzerland are eligible for tax credit in India, subject to the overall tax rate in Switzerland being lower than the corporate tax rate in India.

e. Sec 91 of the Income Tax Act, 1961 provides relief from double taxation of income arising to a resident of India from countries with which India has not concluded a DTAA. Section 91 does not distinguish between state and federal taxes eligible for tax credits against income tax liability in India. Explanation (iv) to Sec 91 of the Income Tax Act, 1961 specifically states that 'income tax' includes business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

In summary, some DTAAs permit FTC against regional income tax paid while others do not. There is no consistency among the DTAAs in this aspect. Sec 91 of the Income Tax Act specifically provides FTC relief against income tax paid to a local authority in a country not covered by the DTAA. The notified FTC rules do not even address this issue. It provides the following

> *"128. Foreign Tax Credit.-*
>
> *(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax paid by him in a country or specified territory outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the manner and to the extent as specified in this rule.*
>
> *(2) The foreign tax referred to in sub-rule (1) shall mean,-*
>
> *(a) in respect of a country or specified territory outside India with which India has entered into an agreement for the relief or avoidance of double taxation of income in terms of section 90 or section 90A, the tax covered under the said agreement;*
>
> *(b) in respect of any other country or specified territory outside India, the tax payable under the law in force in that country or specified territory in the nature of income-tax referred to in clause (iv) of the Explanation to section 91.*
>
> *(3) The credit under sub-rule (1) shall be available against the amount of tax, surcharge and cess payable under the Act but not in respect of any sum payable by way of interest, fee or penalty."*

The notified FTC Rules do not define "specified territory" nor does it specifically provide FTC relief on income tax paid in a State or a province or a local government. It requires the taxpayer to refer to the respective DTAAs to claim FTC or section

91, if no DTAA is concluded with that country. Consequently, taxpayers in India may have to rely on the Karnataka High Court ruling in the case of Wipro Limited (March 2015) and the Mumbai Tribunal ruling in the case of Tata Sons Limited (November 2010) which permitted the taxpayer to avail FTC under section 91 even though the India-US DTAA did not specifically provide for FTC on state income tax paid.

The principle followed under section 91 of the Income Tax Act, 1961 should be similarly followed under the FTC rules. The definition of foreign taxes eligible for credit or deduction in India under the FTC rules should be comprehensive so that income tax paid in jurisdictions not covered under a DTAA are also eligible for credit or deduction in India. Income tax paid in foreign countries which should be eligible for credit or deduction in India should include income tax paid to federal governments, states, cities, provinces, territories, municipalities, cantons, communes and local governments; and levies such as surtax, cess and surcharge payable on any of the above income taxes.

2. Method of computing FTC in India

The purpose of FTC under a DTAA is to prevent double taxation of the same income in two countries. At the same time, the DTAA protects the resident country from subsidising the income taxes paid in the source country. This is achieved by limiting the FTC to the amount of income tax that would have been payable in the resident country on that foreign source income.

The amount of FTC that can be claimed in India as per the various DTAAs or under section 91 of the Income Tax Act is the lower of:

a. The amount of foreign income tax paid; or
b. The amount of income tax chargeable on that foreign source income in India.

Consequently, a taxpayer will be able to claim full FTC in India only if the income tax rate in the foreign country is lower than the income tax rate in India. However, if a taxpayer has paid income taxes in a foreign country whose income tax rate is higher than the income tax rate in India, the taxpayer will not be able to claim FTC in India on such excess taxes.

The notified FTC rules provide the following -

> *"(5) The credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India and shall be given effect to in the following manner:-*
>
> *(i) the credit shall be the lower of the tax payable under the Act on such income and the foreign tax paid on such income:*
>
> *Provided that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess shall be ignored for the purposes of this clause;*
>
> *(ii) the credit shall be determined by conversion of the currency of payment of foreign tax at the telegraphic transfer buying rate on the last day of the month immediately preceding the month in which such tax has been paid or deducted."*

There are two parts to the above clause - Computation of FTC and the treatment of excess FTC

I. The notified FTC rules requires the Indian taxpayer to claim FTC separately for each source of income on a country-by-country basis. The FTC shall be the lower of the tax payable in India under the Income tax Act and the foreign tax paid on such income.
The notified FTC rules do not refer to a rate of tax, but requires the taxpayer to compute the amount of credit separately for each source of income.
The notified FTC rules do not specify the manner of tax computation in India. It does not stipulate if the taxpayer is required to compute the tax payable in India before or after considering the impact of any tax incentives/exemptions/deductions enjoyed by it in India. This may lead to litigation in India. In the case of Wipro Limited, the tax authorities had denied FTC for income tax paid overseas against exempt income under Sec 10A of the Income Tax Act. The Karnataka High Court passed its judgment in favour of Wipro Limited. The tax authorities have now filed a Special Leave Petition in the Supreme Court against the Karnataka High Court decision.

II. The notified FTC rules provide that excess FTC shall be ignored for this clause. It states:
"Provided that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the agreement for relief or avoidance of double taxation, such excess shall be ignored for the purposes of this clause;
DTAAs permit FTC on a country-by-country basis and not on a source-by-source basis. Article 25(2)(a) of the India-U.S. DTAA provides the following:

> *2.(a) Where a resident of India derives income which, in accordance with the provisions of this*

> *Convention, may be taxed in the United States, India shall allow as a deduction from the tax on the income of that resident an amount equal to the income-tax paid in the United States, whether directly or by deduction. Such deduction shall not, however, exceed that part of the income-tax (as computed before the deduction is given) which is attributable to the income which may be taxed in the United States.*

Article 25(2) of the India-UAE DTAA provides the following:

> *2. Where a resident of India derives income or owns capital which, in accordance with the provisions of this Agreement, may be taxed in U.A.E., India shall allow as a deduction from the tax on the income of that resident an amount equal to the income-tax paid in U.A.E. whether directly or by deduction; and as a deduction from the tax on the capital of that resident an amount equal to the capital tax paid in U.A.E. Such deduction in either case shall not, however, exceed that part of the income-tax or capital tax (as computed before the deduction is given) which is attributable, as the case may be, to the income or the capital which may be taxed in U.A.E. Further, when such resident is a company by which surtax is payable in India, the deduction in respect of income-tax paid in U.A.E. shall be allowed in the first instance from income-tax payable by the company in India and as to the balance, if any, from the surtax payable by it in India.*

DTAAs concluded by India with other countries also contain similar clauses for relief from double taxation.

It appears that income tax paid on a source of income under a higher rate can be offset against the income tax paid on another source of income from that country under a lower rate.

The computation of the FTC is examined below under various scenarios.

a. Different types of income earned from the same country.
b. Same type of income earned from different countries.
c. Different types of income earned from different countries.

a. Different types of income earned from the same country, for e.g. business income, dividend income and royalty income.

An Indian company may operate in a foreign country under multiple structures such as a branch and subsidiary thereby earning different types of income such as business income, interest income or dividend income. The Indian company may also earn income from that foreign country without the involvement of the branch and the subsidiary, for e.g. royalty income.

Let us assume that an Indian Company A earns royalty income of $200 from Country X, business profits (determined on 'Net Income' method) of $300 from its branch in Country X and dividend income of $100 from its subsidiary in Country X. Consequently, Company A has **foreign source income of $600**. Country X levies 15% withholding tax (WHT) on royalty payments, business profits of a branch are taxed at 40% and dividends are subject to a 15% WHT. Company A is thus subject to foreign taxes of $30 on royalty income, $120 on business profits and $15 on dividend income resulting in the payment of **total foreign tax of $165**. This results in an effective tax rate (ETR) of 27.50% on foreign source income. Corporate tax rate in India is 32.45%.

Company A's FTC would be as follows:

Royalty income	Lower of: (a) Actual foreign tax: $30; (b) Domestic tax on foreign source royalty income (32.45%*$200) = $64.90	Source Limitation: $30
Business Profits	Lower of: (a) Actual foreign tax: $120; (b) Domestic tax on foreign source business profits (32.45%*$300) = $97.35	Source Limitation: $97.35
Dividend income	Lower of: (a) Actual foreign tax: $15; (b) Domestic tax on foreign source dividend income (32.45%*$100) = $32.45	Source Limitation: $15

If "source-by-source, country-by-country" principle is applied for determining FTC, Company A's FTC would be limited to $142.35 (i.e. $30+$97.35+$15) against its India tax liability of $194.70 on the foreign source income (i.e., 32.45% on $600), resulting in an incremental tax liability of $52.35 in India ($194.70-$142.35).

Even though the ETR on foreign source income at 27.50% is lower than the corporate tax rate in India at 32.45%, the Indian company will not able to claim full FTC in India as the actual foreign income tax liability on business profits is higher than the tax liability in India on such income.

On the other hand, the pooling of different types of income from each country will result in adding high-tax income and low-tax income thereby increasing the amount of creditable foreign taxes available for tax set off.

In this example, in case the "country pooling method" is adopted, foreign source royalty income, business profits and dividend income are pooled together and the total foreign tax of $165 would be eligible for FTC against its India tax liability of $194.70 on the foreign source income, resulting in an incremental tax liability of only $29.70 in India. Under the 'pooling method' the Indian company will be able to claim full FTC in India as the ETR on foreign source income at 27.50% is lower than the corporate tax rate in India at 32.45%.

The total tax liability of Company A will be lower at $194.70 under the 'country pooling method' as compared to the total tax liability of $217.35 under the 'source-by-source' limitation.

b. Same type of income earned from different countries, for e.g. business income.

Different countries have different corporate income tax rates. At present, the corporate income tax rate in countries such as Belgium, Germany, France, Japan and the U.S.is higher than the corporate income tax rate in India, whereas the corporate income tax rate is lower in many other countries.

Indian companies will be able to claim FTC in India on a "source-by-source and country-by-country" method based on the notified FTC rules. The notified FTC rules also provide that excess FTC shall be ignored. Consequently, there is no mechanism to offset the corporate income tax paid in a foreign country under a higher rate with the income tax paid in another foreign country under a lower rate. Income taxes paid in local jurisdictions such as states, provinces or local governments which are not covered under a DTAA are also not eligible for FTC in India. Consequently, Indian companies operating in multiple countries under a branch structure are not able to claim full FTC in India on the total amount of foreign income taxes paid.

c. Different types of income earned from different countries.

Under the "worldwide pooling method", all types of income from all foreign countries are pooled together and the total amount of foreign taxes paid on such pooled income from all sources and all countries is available for offset against the India tax payable on the total foreign source income. The worldwide pooling method has the advantage that high-tax income and low-tax income from all sources in all countries are pooled together and the total amount of foreign taxes paid on the total foreign source income is available for offset against the India tax payable on such pooled income.

Singapore was following the "source-by-source and country-by-country" method of computing FTC. The amount of FTC to be granted in Singapore was the lower amount of foreign tax paid and Singapore tax payable on the income computed on a "source-by-source and country-by-country" basis.

Singapore has introduced a new FTC pooling system from the Year of Assessment ("YA") 2012. Under the FTC pooling system, taxpayers in Singapore may elect to pool the foreign taxes paid (including any underlying tax, where applicable) on any items of foreign income, if the foreign income meets certain conditions. The amount of FTC to be granted is based on the lower of the total Singapore tax payable on those foreign income and the pooled foreign taxes paid on those income.

The FTC rules in India should provide a choice to taxpayers to aggregate income taxes paid in all foreign countries for claiming FTC in India. This will allow pooling of foreign taxes paid on 'low-tax' and 'high-tax' income from all sources in all foreign countries, thereby optimizing FTC eligibility. The amount of FTC to be allowed in India should be the lower of the total amount of foreign taxes paid or the income tax payable in India on the total foreign source income so that India does not subsidise higher income taxes paid outside India during a financial year.

3. Carry forward of excess foreign tax paid

Companies that do not receive full tax credits for taxes paid in foreign countries are said to be in 'excess credits'.

Excess credits could arise if a multinational company is carrying on business in a portfolio of countries where the income tax rate is higher than the income tax rate in the residence country. Excess credits could also arise if the ratio of high-tax income or the ratio of income earned from a high-tax country during a financial year is high. The payment of Branch Profits Tax (BPT) in a financial year in a foreign country could also result in 'excess credits' for that year as the BPT is paid in addition to the corporate income tax and the method of computing BPT is different from the method of computing income tax on the same income.

If the FTC rules in India provide a choice to taxpayers to aggregate worldwide income taxes paid in all foreign countries for claiming FTC in India (as suggested earlier), the amount of 'excess credits' from some countries could offset 'deficit credits' from other countries thereby eliminating or reducing excess credits during that year.

Many countries permit limited period for carry-back and unlimited period for carry-forward of excess credits. The carry-back and carry-forward facility will enable taxpayers to use excess credit in a year where the ratio of low-tax income or the ratio of income earned from a low-tax country is higher.

The FTC rules in India should allow carry forward of excess foreign tax paid.

4. Deduction for excess foreign tax paid in lieu of FTC

Many countries provide a choice to taxpayers to either claim credit of foreign taxes paid against income tax payable in that country or deduct foreign taxes as an expense. Even though income tax paid is an 'appropriation of income' and not a 'charge on income', taxpayers in India should be given an annual choice to either claim FTC or deduct income tax paid in foreign countries in lieu of FTC. However, taxpayers electing FTC in a year should not be allowed to take a deduction for any portion of the qualified foreign taxes in that year.

5. 'Deemed tax credit' or Tax Sparing benefits under FTC rules

Many countries such as the United States of America, United Kingdom, Australia, Japan and Canada offer tax incentives such as Research & Development Tax Credit (R&D Tax Credit) to encourage spending on qualified R&D activities. The R&D Tax Credit in the U.S. is a credit against regular 'federal income tax' and/or 'income or franchise taxes' of many states. The R&D Tax Credit scheme in the UK, Australia and Canada similarly offer a credit against corporate income tax payable in those countries. Some countries offer incentives such as a tax holiday scheme or lower tax rate regime or even 'zero tax' facility for a certain period for the promotion of economic development.

Companies operating through branches in foreign countries also qualify to claim such tax incentives. R&D tax credits and tax incentive schemes reduce the amount of corporate income tax payable in those foreign countries. This will correspondingly reduce the amount of FTC in India for Indian companies operating through a branch structure in those countries. Consequently, Indian companies that qualify for such incentives in those countries will not get any net benefit as their global tax liability will remain the same. Let us examine the following scenarios:

If R&D tax credit is not claimed in the foreign country:

Corporate income tax paid in a foreign country	**900**
Tax payable in India on worldwide income including foreign source income from a branch	1,500
Less: Amount eligible for FTC in India (assuming corporate income tax rate in India is higher than the tax rate in the foreign country)	900
Tax payable in India on worldwide income	**600**
Total tax payable on worldwide income	**1,500 (900 + 600)**

If R&D tax credit is claimed in the foreign country:

Corporate income tax payable in a foreign country	900
Less: R&D tax credit	800
Corporate income tax paid in the foreign country	**100**
Tax payable in India on worldwide income including foreign source income from a branch	1,500
Less: Amount eligible for FTC in India (assuming corporate income tax rate in India is higher than the tax rate in the foreign country)	100
Tax payable in India on worldwide income	**1,400**
Total tax payable on worldwide income	**1,500 (100 + 1,400)**

In both the examples above, the total tax payable on worldwide income remains the same at 1,500 except that the tax payable in India in the first example is lower at 600 and the tax payable in India in the second example is higher at 1,400. There is no benefit for the taxpayer in claiming the tax incentive in the foreign country considering that the overall tax liability of the taxpayer remains the same after claiming such incentives.

Some of the bilateral DTAAs concluded by India with Kenya, Korea, Malaysia, Mauritius, Nepal, Philippines and Singapore provide 'tax sparing' benefits to an Indian taxpayer. Tax sparing refers to granting a deemed FTC for specific foreign taxes that would have been payable but for the tax exemption in the foreign country.

Clause 2 and 3 of Article 24 (Elimination of Double Taxation) of India–Malaysia DTAA states the following:

> *2. In the case of India, double taxation shall be eliminated as follows:*
>
> *Where a resident of India derives income which, in accordance with the provisions of this Agreement, may be taxed in Malaysia, India shall allow as a deduction from the tax on the income of that resident an amount equal to the amount of tax paid in Malaysia whether directly or by deduction at source. Such amount shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Malaysia.*
>
> *3. For the purposes of paragraph 4, the term "tax paid in Malaysia" shall be <u>deemed to include the tax which would</u>, under the laws of Malaysia and in accordance with this Agreement, <u>have been payable on any income derived from sources in Malaysia had the income not been taxed at a reduced rate or exempted from Malaysian tax</u> in accordance with the provisions of this Agreement and the special incentives under the Malaysian laws for the promotion of economic development of Malaysia which were in force at the date of signature of this Agreement or any other provisions which may subsequently be introduced in Malaysia in modification of, or in addition to, those laws so far as they are agreed by the competent authorities of the Contracting States to be of a substantially similar character.*

If the DTAA concluded between the Government of India and the Government of any country includes tax sparing benefits under the relevant Article dealing with Elimination of Double Taxation, the FTC in India would increase in respect of specific foreign taxes otherwise payable in those countries in respect of foreign source income (including income earned by a foreign branch of an Indian company). Tax sparing benefits provided in India would not reduce India's tax collection as illustrated in the example below. Instead, it would reduce the worldwide tax liability of the company.

Corporate income tax payable in a foreign country	900
Less: R&D tax credit	800
Corporate income tax paid in the foreign country	**100**
Tax payable in India on worldwide income including foreign source income from a branch	1,500
Less: Amount eligible for FTC in India (assuming corporate income tax rate in India is higher than the tax rate in the foreign country)	100
Less: Deemed tax credit adjustment	800
Tax payable in India on worldwide income	**600**
Total tax payable on worldwide income	**700 (100 + 600)**

The tax payable in India on worldwide income would be 600 which is the same amount of tax payable in India if the R&D tax credit is not availed in the foreign country. However, the total tax payable by the Indian company on worldwide income would reduce to 700 which would otherwise be 1,500 if the R&D tax credit is not availed in the foreign country.

Many countries have provided 'tax sparing' benefits to their companies under the DTAAs concluded by them with the Government of India. The DTAAs concluded between the Government of India and the Governments of Australia, Canada, France, and the United Kingdom of Great Britain and Northern Ireland do not provide 'tax sparing' benefits to Indian companies. However, these DTAAs provide 'tax sparing' benefits to companies in those countries. This is to encourage companies from those countries to take benefit of the income tax holiday and tax incentive schemes provided by the Government of India under sections 10A, 10B, 10(4), 10 (4B), 10(6)(viia), 10(15)(iv), 80 HHD, 80-I and 80-IA and similar sections of the Income Tax Act, 1961, thereby reducing their worldwide tax liability.

However, Indian companies are unable to obtain similar benefits provided by many countries if these benefits are not covered by the DTAAs concluded by the Government of India with those countries.

'Deemed tax credit' benefits should be provided to Indian companies to encourage them to obtain the income tax benefits, credits and incentives provided in foreign countries. As a practice, the value of income tax benefits, credits and incentives provided by foreign countries will be reduced from the amount of corporate income tax payable in those countries. Under the 'deemed tax credit' benefits, the value of income tax benefits, credits and incentives which is reduced from the amount of corporate income tax payable in those countries should also be reduced from the amount of income tax liability in India in addition to the FTC. In other words, the value of these incentives received by foreign branches of Indian companies will be deemed to have been paid by these foreign branches as income tax in those foreign countries. The deemed tax credit benefits will reduce the amount of worldwide income tax payable by Indian companies thereby reducing their effective tax rate. However, India's tax collection would not reduce by providing deemed tax credit benefits in India.

6. Underlying Tax Credits

Companies have a choice to operate in foreign countries through a branch or subsidiary structure. To understand the tax consequences under both the structures, let us examine a scenario of an Indian company operating in a foreign country for one year only under the following assumptions:

a. The Indian company earns worldwide business income of ₹10,000. The company earns business income of ₹4,000 in the foreign country either through a branch or subsidiary.
b. The corporate income tax rate in India is 34.608% and the corporate income tax rate in the foreign country is assumed to be 35%.
c. As the company is assumed to operate in the foreign country for one year only, all the post-tax business profits are deemed to be distributed at the end of the year.
d. The domestic tax laws of the foreign country require branches of foreign companies to pay Branch Profits Tax (BPT) and the DTAA concluded between the Government of India and the Government of that country does not prevent the foreign country from charging BPT. Similarly, the domestic tax laws of the foreign country impose withholding tax on payment of dividends.
e. The tax rate applicable for payment of Branch Profits Tax (BPT) and the applicable withholding tax rate on dividends are assumed to be 15%. The applicable income tax rate in India for taxing dividend income is assumed to be 15%.
f. The Indian company follows the same TP method to compute taxable income from business activities of the branch and the subsidiary in the foreign country i.e., Net Income method.

Structure of operating in the foreign country	Branch	Subsidiary
Business profits in the foreign country	4,000	4,000
Tax payable in the foreign country on business profits @ 35%	1,400	1,400
Deemed distribution of business profits / Dividends paid by subsidiary (post-tax profits)	2,600	2,600
Branch Profits Tax (BPT) or Dividend withholding tax @ 15%	390	390
Total tax payable in the foreign country	**1,790**	**1,790**
Worldwide business profits of the Indian company	10,000	6,000
Tax payable in India on worldwide business profits @ 34.61%	3,461	2,077
Tax payable in India on BPT/dividends received at 15%	NA	390
Total tax payable in India before FTC	3,461	2,467
Amount eligible for FTC in India	1.384	390
FTC claimed in India	1,384	390
Total tax payable in India after FTC	**2,077**	**2,077**
Total worldwide tax payable	**3,867**	**3,867**

In this scenario, the tax consequences are the same under both the structures – branch or subsidiary. However, the tax consequences could change if any of the above assumptions change such as:

i. Corporate tax rate in the foreign country is lower than the corporate tax rate in India.
ii. The TP method used to compute taxable income of the branch (for e.g., Cost Plus method or any other TP method) is different from the TP method used to compute the taxable income of the subsidiary (for e.g., Net Income method).
iii. Charging BPT on the deemed distribution of branch profits is restricted under a DTAA with that country, or
iv. No withholding tax is applicable in the foreign country on dividend distribution or the income tax rate in the residence country on dividend income is higher than the withholding tax rate in the foreign country.

In summary, there are two levels of taxation in the foreign country on inter-company dividends – corporate income tax on the taxable income earned in the foreign country and thereafter withholding tax on dividend distribution. The U.N. and OECD Model Tax Conventions expressly state the taxation of dividends is in addition to (or independent of) the taxation of the company in respect of the profits out of which the dividends are paid. The methods for elimination of double taxation provided in Article 23 of the U.N. and OECD Model Tax Conventions however do not recognize the tax levied on the profits of the company for the purposes of relief of double taxation on the dividends. This is discussed in paragraphs 49-52 of the OECD Commentary on Art. 23:

> *These provisions effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. [...] The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. [...] In the end, it appeared preferable to leave States free to choose their own solution to the problem.*

Many countries have chosen 'Underlying Tax Credit' as a solution. Underlying tax credit with reference to dividends is the tax credit provided in the residence country for the income tax paid in the foreign country on the underlying profits of the company out of which the dividends have been paid. Such relief may be given either under a DTAA or through a unilateral relief under its domestic tax laws.

The DTAA concluded between the Government of India and the Government of Singapore permits an Indian company which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, to claim underlying tax credit in India on the dividends received from such company in Singapore. Clause 2 of Article 25 (Avoidance of Double Taxation) of the India-Singapore DTAA states the following:

> *2. Where a resident of India derives income which, in accordance with the provisions of this Agreement, may be taxed in Singapore, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Singapore tax paid, whether directly or by deduction. <u>Where the income is a dividend paid by a company which is a resident of Singapore to a company which is a resident of India</u> and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, <u>the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid</u>. Such deduction in either case shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Singapore.*

The DTAA concluded between the Government of India and the Government of Mauritius permits an Indian company which owns at least 10 per cent of the shares of the company paying the dividend, to claim underlying tax credit in India on the dividends received from such company in Mauritius.

The DTAA concluded between the Government of India and the Government of Australia permits an Australian company (which controls directly or indirectly not less than 10 per cent of the voting power of the Indian company) to claim underlying tax credit in Australia on dividends received from a company in India. However, <u>the Government of India has not agreed to provide similar relief to an Indian company under that DTAA</u>. Clause 1 of Article 24 (Methods of elimination of double taxation) states the following:

> *1. (a) Subject to the provisions of the law of Australia from time to time in force which relate to the allowance of a credit against Australian tax or*

> *tax paid in a country outside Australia (which shall not affect the general principle hereof), Indian tax paid under the law of India and in accordance with this Agreement, whether directly or by deduction, in respect of income derived by a person who is a resident of Australia from sources in India shall be allowed as a credit against Australian tax payable in respect of that income.*
>
> *(b) Where a company which is a resident of India and is not a resident of Australia for the purposes of Australian tax pays a dividend to a company which is a resident of Australia and which controls directly or indirectly not less than 10 per cent of the voting power of the first-mentioned company, the credit referred to in sub-paragraph (a) shall include the Indian tax paid by that first-mentioned company in respect of that portion of its profits out of which the dividend is paid.*

Companies in the U.S. and the UK that own at least 10 of the voting power of the dividend paying company in India are able to claim UTC in their countries under the DTAAs concluded between the Government of India and the Governments of the United States of America, and the United Kingdom of Great Britain and Northern Ireland, respectively. Companies in Japan that own at least 25% of the voting shares of the dividend paying company in India are able to claim UTC in Japan under the India-Japan DTAA. However, Indian companies are not similarly entitled to claim UTC in India under those DTAAs.

The 'Working Group on Non Resident Taxation' under the chairmanship of Shri Vijay Mathur, Director General of Income Tax (International Taxation), New Delhi, submitted its report to the Ministry of Finance in January 2003. The Working Group has made the following recommendation with respect to underlying tax credit:

> *Outbound investment from India is on the increase. Some domestic companies have set up subsidiaries in other countries that are generating profits. Normally dividends should flow back to the parent company in India as and when declared. The dividends are, however, flowing to lesser tax jurisdictions where holding companies are being set up. The income in such jurisdictions accumulates and may be remitted to India at a later date. There is, therefore, a deferment of tax as also a lack of flow back of the funds at an early date. To induce these Indian companies not to structure their affairs in the above manner but to remit the dividend funds to India as also to relieve the economic double taxation on foreign dividend income, the Working Group recommends that a mechanism known as the allowance of underlying tax credit for the stream of dividend income be adopted. In this scheme, credit is given by the country where the parent company is a resident, not only for the tax withheld at source on the dividend payout by the overseas subsidiary but also in respect of the tax suffered on distributable profits. [Underlying tax = Gross Dividend/Distributable Profits x Actual Tax Paid on those profits] This in the case of an Indian parent company receiving dividend from more than one tax jurisdiction by aggregating the gross dividend, distributable profits and actual taxes suffered on those profits in all such jurisdiction. This would give an incentive for the flow of funds to the parent Indian company and it would also make them more competitive. Larger availability of funds may generate increased investments by these Indian companies and a source of more taxes for the country. The underlying tax credit would be granted on dividends paid by a company whose 25% or more shares are held by an Indian company.*

The DTAAs concluded by the Government of India with a few countries enable Indian companies to claim underlying tax credit in India on the dividends received from companies in those countries in which the Indian company has voting rights beyond a certain percentage. The domestic tax laws of many countries permit companies in those countries to claim underlying tax credit on dividends received from foreign companies, upon meeting some conditions. The notified FTC Rules should be accordingly amended to provide underlying tax credit to Indian companies.

7. Conclusion

The notified FTC rules are not comprehensive in providing unilateral relief from double taxation arising from various circumstances. These rules are not used to remove the inconsistencies in the various DTAAs on the treatment of various income tax issues. The notified FTC rules also do not provide a uniform relief from double taxation of income arising from similar circumstances from all countries. The limited quantum of FTC made available under the "source-by-source and country-by-country" method would erode the competitiveness of the Indian multinational companies.