Relieving of Economic Double Taxation in the Indian Context

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What is economic double taxation

Transfer pricing rules based on the arm's length principle allow national tax authorities to adjust the profits of an enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated parties in similar circumstances. Transfer pricing adjustments are enabled through domestic tax legislations. In India, transfer pricing provisions are contained in Chapter X (“Special provisions relating to avoidance of tax”) of the Income Tax Act 1961 as well as the Income Tax Bill 2025.

The tax treaties or the Double Taxation Avoidance Agreements (DTAAs) under a separate Article, generally numbered as Article 9 (Associated Enterprises), deal with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises on other than arm's length terms.

If the income of an associated enterprise in Country A is increased because of a transfer pricing adjustment, it would be reasonable to expect a corresponding transfer pricing adjustment or correlative relief to reduce the income of the other associated enterprise in Country B, provided a consistent transfer pricing evaluation is made by both countries. However, if the tax authority of Country A makes a transfer pricing adjustment, double taxation will occur if the tax authority of Country B does not agree with the adjustment and does not allow a corresponding downward adjustment. The risk of economic double taxation arises where two different legal entities are taxed on the same profits. Paragraph 2 of Article 9 of the OECD Model Tax Convention addresses economic double taxation. According to the said paragraph 2, Country B will have to make an appropriate adjustment to relieve the double taxation in the circumstances mentioned above. As per OECD Commentary on paragraph 2 of Article 9, an adjustment is not to be made automatically in Country B simply because the profits in Country A have been increased. The adjustment is

due only if Country B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis. Country B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in Country A is justified both in principle and as regards the amount.

Role of MAP and BAPA in relieving economic double taxation

Relieving of economic double taxation caused by transfer pricing adjustment requires convergence on transfer price by the countries of which the associated enterprises are residents. This may be achieved through Competent Authorities' consultations under the Mutual Agreement Procedure (MAP) as per the tax treaty between the countries of which the associated enterprises are residents. If a Bilateral Advance Pricing Agreement (BAPA) is in place, economic double taxation will be prevented from occurring for the period covered by BAPA. Transfer pricing adjustments because of audit by tax authorities for the period covered by BAPA are overridden by the BAPA once it is signed.

Role of Article 9(2) of OECD and UN Model tax Conventions in grant of correlative relief

As per the OECD and UN Model Convention Commentary on Article 25 (Mutual Agreement Procedure), corresponding adjustments (termed as correlative relief as well) to be made in pursuance of paragraph 2 of Article 9 fall within the scope of the Mutual Agreement Procedure, both as concerns assessing whether they are well founded and for determining their amount. Further, as per the Commentary, even in the absence of paragraph 2 in Article 9 limited to the text of paragraph 1 which only confirms broadly similar rules existing in domestic laws indicates that the intention was to have economic double taxation covered by the tax treaty. Some countries, however took the position that in the absence of treaty provision based on paragraph 2 of Article 9, they are not obliged to make corresponding adjustments or to grant access to the MAP or BAPA with respect to economic double taxation that may otherwise result from a primary transfer pricing adjustment.

India's Position on correlative relief

Most of India's tax treaties contain Article 9 as well as paragraph 2 mentioned above. Some of the India's tax treaties did not have paragraph 2 in Article 9 and they had paragraph 1 as the sole paragraph thereby espousing the arm's length principle for transactions between associated enterprises. Up to a certain point of time, India's view was not to allow access to MAP or BAPA in the absence of paragraph 2 in Article 9 (Associated Enterprises) in the tax treaty or the Double Taxation Avoidance Convention. This stand taken by India came in the way of MAP or BAPA with countries such as France or Germany which did not have paragraph 2 in Article 9 under the respective tax treaties. Situation has changed as discussed below.

The Final Report of Action 14 of the Base Erosion and Profit Shifting project released in 2015 provided certain minimum standards and best practices to make dispute resolution mechanisms more effective. The first Minimum Standard was that countries should provide access to MAP in transfer pricing cases because failure to grant MAP access with respect to a treaty partner's transfer pricing adjustments, with a view to eliminate economic double taxation that may follow from such an adjustment, will likely frustrate a primary objective of tax treaties. The Minimum Standard 1.1 read as follows," *Where, in particular, treaty provisions such as paragraph 2 of Article 9 or, in the absence of paragraph 2 of Article 9, provisions of domestic law enable contracting states to provide for a corresponding adjustment and it is necessary for the competent authorities of the contracting states to consult to determine the appropriate amount of that corresponding adjustment with the aim of avoiding double taxation, countries should provide access to MAP."* Further, the first

Best Practice under 2015 Final Report of BEPS Action 14 provides that countries should include paragraph 2 of Article 9 in their tax treaties. It was noted that some countries take the position that in the absence of treaty provision based on paragraph 2 of Article 9, they are not obliged to make corresponding adjustments or to grant access to the MAP with respect to economic double taxation that may otherwise result from a primary transfer pricing adjustment. Countries should accordingly include paragraph 2 of Article 9 in their tax treaties, with the understanding that such a change is not intended to create any negative inference with respect to treaties that do not currently contain a provision based on paragraph 2 of Article 9.

India's position on allowing access to MAP in transfer pricing cases or to enter into BAPA in the absence of paragraph 2 of Article 9 in the DTAA changed in 2017, as a consequence of BEPS Action 14 report referred to above. Ministry of Finance Press Release dated 27th November 2017 reads as under:

"Clarification of India's position on the acceptance of MAP and bilateral APA in cases of countries where Article 9(2) of OECD Model Tax Commentary is absent

A number of references have been received from time to time regarding the acceptance of applications pertaining to Transfer Pricing MAP cases and Bilateral Advance Pricing Agreements (APAs) where the Associated Enterprise (AE) of the Indian entity is resident of a country with which India has entered into a Double Taxation Avoidance Agreement (DTAA) but the Agreement does not contain Paragraph 2 of Article 9 (or its relevant equivalent Article) relating to 'Corresponding Adjustment'.

The matter has been examined by the Central Board of Direct Taxes (CBDT) and it has been decided to accept Transfer Pricing MAP and bilateral APA applications regardless of the presence or otherwise of Paragraph 2 of Article 9 (or its relevant equivalent Article) in the DTAAs. "

Besides the changed position as above, paragraph 2 of Article 9 has been introduced proactively in India's tax treaties where it was not present, either through bilateral negotiations for amending the treaty or through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). India has opted for Article 17 of the MLI as per which wherever paragraph 2 of Article 9 is absent in a tax treaty, the same would get inserted if the other country also takes the same position and names Indian treaty as a covered tax agreement.

As a result of above, i.e. firstly the Press Release and secondly insertion of para 2 in Article 9 of tax treaties, wherever absent, no procedural hurdle remains in relieving situation of economic double taxation discussed above through MAP or BAPA. As far as India is concerned, both MAP and BAPA programs are vibrant with most countries having significant cross-border transactions amongst associated enterprises. MAP and BAPA are progressing with countries like Germany and France where absence of paragraph 2 of Article 9 restricted it earlier.

Economic double taxation under Unilateral Advance Pricing Agreements, Safe Harbor, etc.

Corresponding adjustment or correlative relief is however not assured where a Unilateral Advance Pricing Agreement (UAPA) is entered into or the Safe Harbor provisions under domestic law are opted for. The transfer price or the ALP determined under UAPA or Safe Harbor is not binding on the other country and a situation of economic double taxation may prevail. India's MAP Guidance dated 7th August 2020 provides that while access to MAP will be provided where a UAPA is entered into, or safe harbor is opted for, the terms and conditions of the UAPA or Safe Harbor will not be altered through MAP and the other country will be requested to provide correlative relief. Expecting the treaty partner country to provide correlative relief in respect of unilateral determination by India under UAPA etc. of the arm's length price or the transfer price is not realistic. Possibility of economic double

taxation can therefore be not ruled out. Opting for BAPA as against UAPA or Safe Harbor can prevent the economic double taxation caused due to taxation of the income of associated enterprise in the other country.

Another kind of economic double taxation with no remedy

There is another kind of economic double taxation that could take place in a situation where income of associated enterprise is taxable in India. Let us take an illustration to understand this – Say the ALP of royalty paid by India Co. to its associated enterprise X Ltd. in country A is re-determined from INR 100,000 to INR 60,000 under transfer pricing audit or UAPA and India Co. has already deducted tax at source on INR 100,000. X Ltd. has filed its return of income disclosing INR 100,000 as its income taxable in India. While deduction allowed to India Co. would be restricted to INR 60,000, X Ltd.'s tax liability in India continues to be on INR 100,000. Under the domestic transfer pricing law, there is no provision in Indian law to make corresponding adjustment in the case of counter party associated enterprise for the purposes of its own taxation in India. Rather, second proviso to section 92C(4) forbids such corresponding adjustment where tax has been deducted or is deductible from payments made to associated enterprise, which are subject matter of transfer pricing adjustment. This legal position was noted by the special bench of ITAT in the case of Instrumentarium Corporation Limited [TS-5736-ITAT-2016(Kolkata)-O], *"Second proviso to section 92C(4) also constitutes a bar against lowering income of the non-resident AE, as a result of lowering the deduction in the hands of the Indian AE, rather than enabling a higher deduction in the hands of the Indian AE as a result of increasing non-resident AE's income."*

Let's take the illustration further. A transfer pricing MAP is initiated between India and country A under India-country A tax treaty which results into the competent authorities of the two countries coming to an agreement restricting the transfer pricing adjustment to the royalty paid by India Co to X Ltd. at INR 80000. Implementation of MAP will mean correlative relief or corresponding adjustment of INR 20,000 to X Ltd.'s income in country A. But there seems to be no automatic or corresponding mechanism to reduce the taxable income of X Ltd by INR 20000 in India, even in pursuance of MAP concluded. Rather, second proviso to section 92C(4) may come in the way.

One may think that X Ltd. has the shield of foreign tax credit in country A and would hence not suffer economic double taxation. Let us probe the MAP situation above from the point of view of allowance of foreign tax credit in country A to X Ltd. India Co. had deducted tax of INR 10,000 at the rate of 10% as provided under the DTAA from royalty of INR 100,000 paid to X Ltd. In accordance with Article 23 (Elimination of Double Taxation) of the DTAA, X Ltd. had claimed foreign tax credit with reference to INR 10,000 in country A. After MAP resolution, foreign tax credit admissible in country A to X Ltd. will be only with reference to agreed ALP value of royalty income, i.e. INR 80,000 due to condition of "in accordance with the provisions of this Agreement" built into Article 23:

"Double taxation shall be eliminated as follows:

(a) in country A:

(i) where a resident of India derives income which, ***in accordance with the provisions of this Agreement****, may be taxed in India, country A shall allow as a deduction from the tax on the income of that resident, an amount equal to the tax paid in India.*

Such deduction shall not, however, exceed that portion of the tax as computed before the deduction is given, which is attributable, as the case may be, to the income which may be taxed in India."

However, in the absence of legal machinery provision in India's domestic law, tax liability of X Ltd. in India will continue to be INR 10,000. Thus X Ltd. will not be getting relief through foreign tax credit and would suffer double taxation even after MAP resolution.

Similar would be the situation in a case where UAPA is concluded resulting in increase in the income of Indian entity but without corresponding reduction in the case of associated enterprise for the purposes of taxation of its income in India. To overcome this difficulty, at present, a few corporates have started lodging a UAPA in India by the foreign associated enterprise as well (typically referred to as mirror-APA or parallel-APA) to avail of corresponding adjustment to the arm's length price determined in a unilateral APA in the case of Indian entity. On conclusion of the UAPA in the case of Indian entity, it is expected that same ALP would be applied in the UAPA applied for by the foreign entity for the same transactions. This may take care of such kind of economic double taxation. However, corresponding adjustment may not be available under the mirror UAPA for the rollback years due to Rule 10MA of income tax rules which precludes reduction below the returned income.

One can understand and appreciate absence of corresponding relief in the hands of associated enterprise for the purposes of taxation of its income in India till the matter attains finality in an audit process. Before attaining finality in the case of Indian entity, grant of corresponding relief in the hands of associated enterprise in India may be premature. However, once the matter has attained finality in the case of Indian entity be it through domestic litigation or MAP or UAPA, there is a case for introducing mechanism in the domestic law for corresponding adjustment in the hands of associated enterprise, in an automatic manner, to relieve this kind of economic double taxation.

How to overcome this economic double taxation situation

To grant relief from the economic double taxation of the kind discussed above, an amendment in the Indian domestic transfer pricing law in section 92C(4) may be needed.

The rationale for 2nd proviso to section 92C(4) as per CBDT Circular 14 of 2001 was as follows:

"55.13 The second proviso to section 92C(4) refers to a case where the amount involved in the international transaction has already been remitted abroad after deducting tax at source and subsequently, in the assessment of the resident payer, an adjustment is made to the transfer price involved and, thereby, the expenditure represented by the amount so remitted is partly disallowed. Under the Income-tax Act, a non-resident in receipt of income from which tax has been deducted at source has the option of filing a return of income in respect of the relevant income. In such cases, a non-resident could claim a refund of a part of the tax deducted at source, on the ground that an arm's length price has been adopted by the Assessing Officer in the case of the resident and the same price should be considered in determining the taxable income of the non-resident. ***However, the adoption of the arm's length price in such cases would not alter the commercial reality that the entire amount claimed earlier would have been received by the entity located abroad.*** *It has therefore been made clear in the second proviso that income of one associated enterprise shall not be recomputed merely by reason of an adjustment made in the case of the other associated enterprise on determination of arm's length price by the Assessing Officer."*

Recommended Solution

Transfer pricing adjustments for the purposes of tax law are not subject to payment or receipt of the underlying amounts. Receipt of amount claimed earlier by the entity located abroad, therefore does not seem to be a valid justification for denying corresponding relief to the non-resident in India. There is a strong case for introducing provision in law as per which the non-resident should be able to request for an adjustment to be allowed or made, in its own case, adopting the arm's length price as determined in the case of resident associated enterprise which has attained finality in domestic legislation or a UAPA. To overcome the rationale behind second Proviso to section 92C(4), as above in CBDT Circular 14 of 2001, availability of such benefit may be made contingent upon bringing back the excess funds remitted outside India. This will match with the secondary adjustment

provisions under section 92CE as well. Besides 2nd Proviso to section 92C(4), amendment may also be required in section 92(3) to carve out an exception for the stipulated situations.