Issues to be considered while drafting Foreign Tax Credit Rules in India

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INDEX

Introduction:

Foreign Tax Credit (FTC) implies that credit should be provided for 'foreign tax' or income tax paid in foreign countries which result in double taxation of the same income. Double taxation of income can arise due to juridical double taxation or economic double taxation. Juridical double taxation occurs when the same income is taxed in the hands of the same person in more than one jurisdiction (Companies operating through branches in foreign countries). Economic double taxation occurs when the same income is taxed in the hands of more than one person (Parent company and subsidiary).

According to The Organisation for Economic Co-operation and Development (OECD), international 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 – has harmful effects on the international exchange of goods and services and cross-border movements of capital, technology and persons. In recognition of the need to remove this obstacle to the development of economic relations between countries, as well as of the importance of clarifying and standardizing the fiscal situation of taxpayers who are engaged in activities in other countries, the OECD Model Convention on Income and on Capital provides a means to settle on a uniform basis the most common problems that arise in the field of international juridical double taxation.

Double Taxation Avoidance Agreements (DTAAs) usually provide the mechanism to mitigate the impact of juridical double taxation. The FTC mechanism in India is at present governed by Sec 90 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.

DTAAs being bilateral agreements will not be able to provide a comprehensive solution to mitigate the impact of juridical double taxation arising from various circumstances. Many countries provide 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 and framework to offset the impact of double taxation. These rules may also relieve the impact of economic double taxation.

As India's share in international trade is increasing and Indian companies are globalizing their operations, the Central Board of Direct Taxes (CBDT) should urgently introduce FTC rules in India to provide relief from double taxation arising from various circumstances. The FTC rules in India can be used as a means to provide a uniform relief from double taxation of income arising from similar circumstances in various countries. The CBDT should provide clear and elaborate guidelines on the FTC procedure so that the implementation of the FTC rules is easy for taxpayers and the income tax department, reducing the scope for interpretation and litigations.

This discussion paper provides a summary of the various types of income taxes payable by Indian companies in foreign countries which results in double taxation in India, various issues to be considered while drafting the FTC rules in India, computation of FTC and the practices followed in some countries. This discussion paper suggests that the amount of FTC to be allowed in India should always be the lower of the total amount of foreign taxes paid or the total amount of income tax payable in India on the total foreign source income, so that India does not subsidise higher income taxes paid in foreign countries during a financial year.

1. Framework of FTC rules in some countries

It is necessary to define the various types of income tax eligible for FTC, eligible taxpayers, circumstances under which FTC is eligible, the method of computing and claiming FTC and the documentary evidence to support FTC. Many countries provide detailed guidelines on claiming FTC.

A. United States of America.

Sec 901 to 907 of the Internal Revenue Code of the United States of America provides the mechanism for claiming FTC. This table summarizes the Code sections that authorize and limit the FTC.

Summary of IRC Sections Authorizing and Limiting the FTC:

Code Section	Description
901	Allows direct credit for taxes paid to a foreign country by a U.S. taxpayer based on realized net income.
902	Allows deemed paid or indirect credit for foreign taxes based on the proportion of taxes paid by a corporation on its distributed earnings and profits.
903	Allows direct credit for taxes (typically foreign withholding taxes based on gross receipts) paid "in lieu of" the generally imposed net income tax.
904	Limits the amount of credit available in each year, including carryovers of credit.
905	Provides guidelines on foreign tax adjustments, redeterminations and proof of credits.
906	Allows the foreign tax credit for nonresident alien individuals and foreign corporations engaged in a trade or business in the United States.
907	Contains credit limitation for foreign oil and gas income.
960	Allows an indirect credit for deemed distributions.

Eligible Taxpayers:

i. Taxpayers subject to U.S. taxation on foreign source income are generally entitled to the FTC.

ii. U.S. citizens and domestic corporations may generally claim a credit for the eligible foreign taxes they pay or accrue. Foreign taxes paid on the following types of income that are generally exempt from U.S. taxation in the hands of U.S. citizens, are not eligible for a FTC:
   a. Income from sources within possessions of the United States by certain bona fide residents of the possession
   b. All excluded foreign earned income

iii. Foreign corporations and Individuals and corporations residing in a U.S. possession (except Puerto Rico) that are not otherwise citizens and not residents of the United States are generally not subject to tax on non-U.S. source income and so are not entitled to the FTC.

Eligible Foreign Taxes:

i. Only foreign income, war profits, and excess profits taxes qualify for FTC (IRC section 901(b).)
ii. To be creditable, a foreign tax must be:
- A compulsory payment to a foreign government, and
- An income tax, or a tax in lieu of an income tax

iii. Tax on income in the U.S. is a tax on net gain. A tax is likely to reach net gain if it meets three criteria:
- Realization test (imposed generally when income is "realized" under the Internal Revenue Code)
- Gross receipts test (based on the fair market value of amount realized)
- Net income test (gross income is reduced by expenses)

Credit Applicable Only to Taxes:

i. The following are examples of payments not creditable as taxes.
- Penalties, interest, fines and custom duties
- Compulsory loans
- Amounts reasonably certain to be refunded, credited, rebated, abated, or forgiven

ii. Principles of U.S. law determine whether a payment is a tax. A payment to a foreign country is not a tax if the payor receives, or will receive, a specific economic benefit in exchange for the payment.
iii. Soak–up taxes are not creditable. A soak–up tax means that the U.S. taxpayer is liable for the tax only to the extent that the tax is creditable.

Payment or Accrual of the Foreign Tax

i. A U.S. taxpayer that pays tax to a foreign country may claim a direct credit on either the cash basis or the accrual basis, subject to the limitations.
ii. The term "direct tax credit" applies to foreign taxes paid outright by a U.S. taxpayer. Either the person claiming the credit or a withholding agent may make the actual payment. The foreign tax must be the liability of the person claiming the credit.

Deemed Paid Credit

Indirect credit is a computed amount of credit related to an actual or deemed distribution to an eligible corporate shareholder. The amount of the credit is proportionate to the amount of foreign income taxes the corporation making the distribution paid on its Earnings and Profits (E&P). The term indirect (or deemed paid) credit refers to the fact that the foreign income tax is paid by the foreign subsidiary.

Election of FTC

i. Taxpayers have an annual choice of electing FTC or deducting foreign taxes. Taxpayers may claim a credit in one year and a deduction the following year, or vice versa.
ii. Attaching a completed Form 1116 or 1118 to a U.S. tax return constitutes an election to take the FTC. An election by one member of a consolidated group binds all the corporations joining in the consolidated return. In the absence of an election,

taxpayers may deduct foreign taxes meeting the requirements for deductibility under IRC sections 162 & 164.

iii. Foreign taxes not qualifying for credit are deductible in the same year qualifying foreign income taxes are creditable.

iv. Taxpayers electing FTC may not take a deduction for any portion of the qualified foreign taxes for the taxable year. However, a computation of a net operating loss carryback or carryover may properly include a deduction for foreign income taxes.

B. Other Countries

Taxation (International and Other Provisions) Act 2010 in the United Kingdom prescribes the regulations for FTC. Similar regulations are prescribed by other countries such as Australia and Canada.

Suggestion:

1. A foreign tax eligible for FTC in India should either be an income tax or a tax in lieu of an income tax such as withholding tax.
2. 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. Taxpayers in India should also be given a yearly choice to either claim FTC or deduct income tax paid in foreign countries. 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.
3. Foreign taxes not qualifying for credit should be eligible for deduction in the same year qualifying foreign income taxes are creditable.
4. The CBDT should modify the income tax returns appropriately to enable Indian companies to claim FTC or deduction in India of income tax paid in foreign countries.

2. 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 may define the procedure to determine taxable income separately. However, many states refer to some extent to federal concepts for determining taxable income.

The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal evasion (DTAA) with respect to taxes on Income is concluded between the Government of India and the Government of the United States of America. As per Article 2, the existing taxes in the United States to which this Convention shall apply are 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 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.

An Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal evasion (DTAA) with respect to taxes on Income and on Capital is concluded between the Government of India and the Government of Canada.As per Article 2, the existing taxes in Canada to which this Agreement shall apply are the taxes imposed under the Income-tax Act of Canada.

Consequently, Indian companies are unable to avail FTC in India on the income taxpaid in the 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 taxhas 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 2012, the effective corporate tax rate in Germany, including trade tax and solidarity tax was about 30%–33%.

An Agreement for the Avoidance of Double Taxation (DTAA) with respect to taxes on Income and on Capital is concluded between the Government of India and the Government of the Federal Republic of Germany. As per Article 2,this Agreement shall apply to taxes on income and on capital imposed on behalf of a Contracting State, of a land or a political sub-division or local authority thereof, irrespective of the procedure in which they are levied.

As the India-Germany DTAA includes taxes on income imposed by a political sub-division or local authority thereof for relief from double taxation, 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.

An agreement between the Government of India and the Government of the Swiss Confederation is concluded for the Avoidance of Double Taxation (DTAA) with respect to taxes on Income. As per Article 2, the taxes to which this Agreement shall apply in the case of Switzerland arethe federal, cantonal and communal taxes on income (total income, earned income, income from capital, industrial and commercial profits, capital gains, and other items of income).

As the India-Swiss DTAA includes cantonal and communal taxes on income for relief from double taxation, 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 91does not distinguish between state and federal taxeseligible 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' includesbusiness profits tax charged on the profits by the Government of any part of that country or a local authority in that country. It states: In this section, the expression 'income-tax' in relation to any country includes any excess profits tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country.

f. On a review of the domestic tax regulations in a few countries, the following countries allow income tax paid to states, cities, provinces, local authorities, territories, municipalities, cantons, communes and local governments to be claimed as Foreign Tax Credit

   A. Australia
   B. Canada
   C. France
   D. Japan
   E. The United Kingdom
   F. The United States of America

A. Australia

The Guide to foreign income tax offset rules issued by the Australian Tax Office states that income tax paid to national, state, provincial, local or municipal authorities qualify for Foreign Tax Credit in Australia:

To count towards a tax offset, foreign income tax must be imposed under a law other than an Australian law and be:

- a tax on income
- a tax on profits or gains, whether of an income or capital nature, or
- any other tax that is subject to an agreement covered by the International Tax Agreements Act 1953 (Agreements Act).

The foreign income tax may be imposed at a supra-national, national, state, provincial, local or municipal level. An example of a supra-national tax is that imposed by the European Union on pensions paid to its former employees.

B. Japan

Code No. 12007 Credit for foreign taxes in Japan states that income tax paid to local authorities are eligible for Foreign Tax Credit in Japan:

"Foreign income taxes" qualified for the credit for foreign taxes are taxes that are imposed on individual income by foreign governments or its local authorities in accordance with foreign laws and ordinances.

C. The United Kingdom

The Taxation (International and Other Provisions) Act 2010 of the United Kingdom states that income tax payable under the law of a province, state or other part of a country or is levied by or on behalf of a municipality or other local body qualify for Foreign Tax Credit in the United Kingdom:

8. Interpretation: "unilateral relief arrangements" means rules 1 to 9, etc

(1) In this Part "unilateral relief arrangements", in relation to a territory outside the United Kingdom, means the rules set out in sections 9 to 17.

(2) In sections 11 to 17, and in Chapter 2 (except section 29) in its application to relief under unilateral relief arrangements, references to tax payable or paid under the law of a territory outside the United Kingdom include only—
(a) taxes which are charged on income and which correspond to income tax,
(b) taxes which are charged on income or chargeable gains and which correspond to corporation tax, and
(c) taxes which are charged on capital gains and which correspond to capital gains tax.

(3) For the purposes of subsection (2), tax may correspond to income tax, corporation tax or capital gains tax even though it -
(a) is payable under the law of a province, state or other part of a country, or
(b) is levied by or on behalf of a municipality or other local body.

D. The United States of America

Foreign Taxes Eligible for a Credit in the United States of America include income tax paid to a foreign state, any possession of the United States and any political subdivision of any foreign state or of any possession of the United States:

Reg. Sec 1.901-(2)(g)(2) states the following:

The term "foreign country" means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term

"possession of the United States" includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

Suggestion:

The principle followed under Section 91 of the Income Tax Act, 1961 and other foreign countries 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.

3. Eligibility of Branch Profits Tax for FTC in India

Many Indian companies operate in foreign countries through a branch structure. Countries such as the United States of America, Canada, France, Greece, Spain and Turkey require branches of foreign corporations to pay Branch Profits Tax (BPT) in addition to the corporate income tax. The method of computing BPT differs amongst countries and is payable on deemed profit distribution. Some DTAAs concluded by the Government of India provide relief from the payment of BPT. Let us examine the BPT provisions in some countries.

A. BPT in the United States of America:

Reg § 1.884-1. Branch profits tax

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(**a) General rule.** A foreign corporation shall be liable for a branch profits tax in an amount equal to 30 percent of the foreign corporation's dividend equivalent amount for the taxable year. The branch profits tax shall be in addition to the tax imposed by section 882 and shall be reported on a foreign corporation's income tax return for the taxable year. The tax shall be due and payable as provided in section 6151 and such other provisions of Subtitle F of the Internal Revenue Code as apply to the income tax liability of corporations. However, no estimated tax payments shall be due with respect to a foreign corporation's liability for the branch profits tax. See paragraph (g) of this section for the application of the branch profits tax to corporations that are residents of countries with which the United States has an income tax treaty, and § 1.884-2T for the effect on the branch profits tax of the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary.

(b) Dividend equivalent amount

(1) Definition. The term “dividend equivalent amount” means a foreign corporation's effectively connected earnings and profits (“ECEP”, as defined in paragraph (f)(1) of this section) for the taxable year, adjusted pursuant to paragraph(b)(2) or (3) of this section, as applicable. The dividend equivalent amount cannot be less than zero.

(2) Adjustment for increase in U.S. net equity. If a foreign corporation's U.S. net equity (as defined in paragraph (c) of this section) as of the close of the taxable year exceeds the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be reduced (but not below zero) by the amount of such excess.

(3) Adjustment for decrease in U.S. net equity

(i) In general, except as provided in paragraph (b)(3)(ii) of this section, if a foreign corporation's U.S. net equity as of the close of the taxable year is less than the foreign corporation's U.S. net equity as of the close of the preceding taxable year, then, for purposes of computing the foreign corporation's dividend equivalent amount for the taxable year, the foreign corporation's ECEP for the taxable year shall be increased by the amount of such difference.

(ii) Limitation based on accumulated ECEP. The increase of a foreign corporation's ECEP under paragraph (b)(3)(i) of this section shall not exceed the accumulated ECEP of the foreign corporation as of the beginning of the taxable year. The term “accumulated ECEP” means the aggregate amount of ECEP of a foreign corporation for preceding taxable years

beginning after December 31, 1986, minus the aggregate dividend equivalent amounts for such preceding taxable years. Accumulated ECEP may be less than zero.

In summary, the domestic tax laws in the United States of America require foreign corporations to pay BPT at 30% in addition to normal income tax payable. The procedure for computing BPT is also provided.

Clause 5 of Article 26(Non-discrimination) of the India-U.S. DTAA states the following:

5. Nothing in this article shall be construed as preventing either Contracting State from imposing the taxes described in Article 14 (Permanent Establishment Tax) or the limitations described in paragraph 3 of Article 7 (Business profits).

Article 14 of the India-U.S. DTAA provides for a Permanent establishment tax.

***ARTICLE 14** – Permanent establishment tax –- 1. A company which is a resident of India may be subject in the United States to a tax inaddition to the tax allowable under the other provisions of this Convention.*

(a) Such tax, however, may be imposed only on:

(i) the portion of the business profits of the company subject to tax in the United States which represents the dividend equivalent amount ; and

(ii) the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 [Income from Immovable Property (Real Property)], Article 12 (Royalties and Fees for Included Services) as fees for included services, or Article 13 (Gains) of this Convention over the interest paid by or from the permanent establishment or trade or business in the United States.

(b) For purpose of this Article, business profits means profits that are effectively connected (or treated as effectively connected) with the conduct of a trade or a business within the United States and are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 [Income from Immovable Property (Real Property)], Article 12 (Royalties and Fees for Included Services) as fees for included services or Article 13 (Gains) of this Convention.

(c) The tax referred to in sub-paragraph (a) shall not be imposed at a rate exceeding:

(i) the rate specified in paragraph 2(a) of Article 10 (Dividends) for the tax described in sub-paragraph (a)(i) ; and

(ii) the rate specified in paragraph 2(a) or (b) (whichever is appropriate) or Article 11 (Interest) for the tax described in sub-paragraph (a)(ii).

The rate specified in paragraph (2)(a) of Article 10 (Dividends)under the India-U.S. DTAA is 15%. Consequently, the BPT rate of 30% applicable under the U.S. domestic tax regulations is reduced to 15% as per the India-U.S. DTAA.

B. BPT in France:

Article 115 of The France Tax Code imposes Branch Profits Tax in France. However, India-France DTAA provides relief from BPT. Clause 7 of Article 11 of India-France DTAA relating to Dividends states the following:

Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other Contracting State may not impose any tax on the dividends paid by the company except in so far as such dividends are paid to a resident of that other Contracting State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other Contracting State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other Contracting State.

In summary, Where an Indian company derives profits or income from France, France may not impose any tax on the dividends paid by the company except in so far as such dividends are paid to a resident of France or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in France, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in France.

In summary, the domestic tax laws in France require foreign corporations to pay BPT in France. However, Article 11(7) of the India-France DTAA provides relief from the payment of such BPT.

C. BPT in Canada:

Section 219 of the Income Tax Act in Canada proposes an additional tax to be levied on non-resident corporations which is in the nature of BPT. Section 219 prescribes 25% as the rate of tax and also describes the procedure to compute this additional tax.

However, India-Canada DTAA provides relief from BPT. Clause 6 of Article 10of India-Canada DTAA relating to Dividends states the following:

Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

In summary, Where an Indian company derives profits or income from Canada, Canada may not impose any tax on dividends paid by the company, except insofar as such dividends are paid to a resident of Canada or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in Canada, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in Canada.

The DTAAs concluded between the Government of India and the Governments of France and Canada have similar clauses which provide relief from the payment of BPT.

However, Article 24 (Non-discrimination) of India-Canada DTAA overrides Article 10 (Dividends) which provides the relief from the payment of BPT. Clause 4 (a) of Article 24 (Non-discrimination) of India-Canada DTAA states the following:

4. (a) Nothing in this Agreement shall be construed as preventing Canada from imposing on the earnings of a company, which is a resident of India, attributable to a permanent establishment in Canada, a tax in addition to the tax which would be chargeable on the earnings of a company which is a national of Canada, provided that any additional tax so imposed shall not exceed the rate specified in sub-paragraph 2(a) of Article 10 of the amount of such earnings which have not been subjected to such additional tax in previous taxation years. For the purpose of this provision, the term 'earnings' means the profits attributable to a permanent establishment in Canada in a year and previous years after deducting therefrom all taxes, other than the additional tax referred to herein, imposed on such profits by Canada.

The rate specified in paragraph (2)(a) of Article 10 (Dividends)under the India-Canada DTAA is 15%. Consequently, the BPT rate of 25% applicable under the domestic tax regulations in Canada is reduced to 15% as per the India-Canada DTAA.

Suggestion:

A branch of an Indian company operating in a foreign country is required to pay an additional tax called Branch Profits Tax in some countries. The BPT is payable by the branch on its post-tax profits. However, the computation procedure is different resulting in tax payments in different years. While the domestic tax regulations in many countries require payment of BPT, the impact of the same is offset only in some countries through the DTAAs concluded by the Government of India. The India-U.S. DTAA supports the payment of BPT through a specific Article. This results in inconsistency in the payment of BPT to different countries.

The FTC rules in India should clearly state that tax which is in the nature of Branch Profits Tax and paid by foreign branches of Indian companies is eligible for FTC in India. This will remove any potential ambiguity on the entitlement of Indian companies to claim FTC on Branch Profits Tax paid by its branches in foreign countries.

4. Method of computing FTC in India

Indian companies are liable to pay income tax in India on their worldwide net income from all domestic and foreign sources. They are liable to pay income tax in the foreign country on their foreign source income, if they conduct business in that foreign country through a branch structure. This results in double taxation of the foreign source income in India. Consequently, Indian companies have to claim FTC in India to offset the impact of the income tax paid in the foreign country.

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 only up 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 DTAAs concluded between the Government of India and the Governments of various countries 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 under a DTAA 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. As the CBDT is yet to draft detailed guidelines on the procedure to claim FTC in India, taxpayers in India at present have to claim FTC based on the terms of the DTAAs concluded between the Government of India and the Governments of various countries. Some judgments in India indicate that the FTC under Sec 91(1) of the Income Tax Act, 1961 is to be calculated on a country-by-country method and not on the basis of aggregation or pooling from all foreign countries.

A taxpayer in India may earn income from foreign countries under the following combinations:

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

The method of computing FTC in India under the FTC rules will determine the amount of FTC available to a taxpayer. Let us examine the impact of the method of determining FTC under the combinations described above:

a. 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 are able to claim FTC in India under a ‘country-by-country’ method based on the provisions of the DTAAs concluded between the Government of India and the Governments of various countries. As a result, 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.

b. 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.

If an Indian company earns different types of income from the same foreign country, the FTC rules should clarify whether the FTC should be computed for each type of income separately or if the different types of income from the same country could be 'pooled' together. An example has been provided below to examine the impact of the two methods on FTC computation:

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. Therefore, Company A has **foreign-source income of $600**.Country X levies 15% WHT on royalty, 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%.

In case a 'source–by–source' limitation is adopted, Company A's FTC would be as follows:

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

Company A's FTC would be limited to $142.35 (i.e. $30+$97.35+$15) against its India tax liability of $194.70on 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.

The pooling of different types of income 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 'pooling method' is adopted, foreign-source royalty income, business profits and dividend income are pooled together and the total foreign tax of $165would be eligible for FTC against its India tax liability of $194.70on 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 'pooling method' as compared to the total tax liability of $217.35 under the 'source-by-source' limitation.

c. Different types of income earned from different countries.

If an Indian company earns different types of income from many foreign countries, the FTC rules in India should clarify whether the FTC should be computed

i. For each type of income separately from each foreign country (source-by-source and country-by-country method),or
ii. For all types of income from each foreign country (pooled country-by-country method), or
iii. For each type of income separately from all foreign countries (pooled source-by-source method), or
iv. For all types of income from all countries (worldwide pooling method)

Under the source-by-source and country-by-country method of computing FTC, any type of income from any country is treated on a stand-alone basis and cannot be added to any other type of income from the same country or to the same type of income from any other country. Any excess of foreign tax paid over India tax payable on one type of foreign income from a foreign country (e.g., business profits from the U.S.) is not available for offset against the India tax payable on the same type of income from another foreign country (e.g., business profits from Singapore) which has a lower income tax rate.

Similarly, any excess of foreign tax paid over India tax payable on one type of foreign income (e.g., business profits from the U.S.) is not available for offset against the India tax payable on another type of foreign income from the same country (e.g., dividend income from the U.S.). Any such excess foreign tax paid is disregarded for tax purposes.

Under the pooled country-by-country method, **all types of income from each country** are pooled together and the total amount of foreign taxes paid on such pooled income is available for offset against the India tax payable on such pooled income from that country. The pooling of all types of income from each country has the advantage that high-tax income and low-tax income from that country are pooled together and the total amount of foreign taxes paid on such pooled income is available for offset against the India tax payable on such pooled income from that country.

Under the pooled source-by-source method, **same type of income from all foreign countries** are pooled together and the total amount of foreign taxes paid on such pooled income is available for offset against the India tax payable on such pooled income from each source. The pooling of the same type of income from different countries has the advantage that high-tax income and low-tax income from different countries are pooled together and the total amount of foreign taxes paid on such pooled income is available for offset against the India tax payable on

such pooled income from each source. However, different types of income from the same country cannot be pooled together for offset.

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. This is to further facilitate the remittance of foreign income to Singapore by resident taxpayers. 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. A summary of Singapore laws relating to FTC is provided below:

Singapore laws relating to FTC:

Current FTC system:

A resident taxpayer in Singapore is subject to tax on the foreign income received in Singapore unless the foreign income qualifies for tax exemption under the Singapore Income Tax Act. Where the foreign income is also subject to tax in the foreign jurisdiction from which a taxpayer derives the foreign income, the ITA allows a credit for the foreign tax paid against the Singapore tax payable on the foreign income. This mitigates the double taxation on the same income.

FTC in Singapore is provided through the following mechanism:

a. Section 50: Double taxation relief (DTR) is given on foreign income derived from a foreign tax jurisdiction with which Singapore has concluded a DTAA. The grant of DTR is governed by the terms of the tax treaty in force.
b. Section 50A: Unilateral tax credit (UTC) is given on foreign income derived from a foreign jurisdiction with which Singapore does not have a tax treaty concluded, or where the foreign income is not covered in a limited tax treaty concluded between that foreign jurisdiction and Singapore.

Regardless of the type of FTC (DTR or UTC) claimed on any source of foreign income from any country, the amount of FTC to be granted is the lower of the foreign tax paid and Singapore tax payable on the income computed on a "source-by-source and country-by-country" basis.Under this FTC computation, any excess of foreign tax paid over the Singapore tax payable on one type of foreign income from a country (e.g. dividend from China) is not available for offset against the Singapore tax payable on another type of foreign income from the same country (e.g. interest from China). Similarly, any excess of foreign tax paid over the Singapore tax

payable on one type of foreign income from a foreign country (e.g. dividend from China) is not available for offset against the Singapore tax payable on the same type of income from another foreign country (e.g. dividend from Malaysia). Any such excess foreign tax paid is disregarded for tax purposes.

New FTC Pooling System

Singapore has introduced a new FTC pooling system from the Year of Assessment("YA") 2012. This is to further facilitate the remittance of foreign income to Singapore by resident taxpayers. The FTC pooling system provides greater flexibility to resident taxpayers in FTC claims, thereby reducing their Singapore tax payable on the remitted foreign income.

Taxpayers 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.

To qualify for the FTC pooling system, foreign income must meet all the following conditions:

a. Income tax must have been paid on the income in the foreign jurisdiction from which the income is derived;
b. The headline tax rate of the foreign jurisdiction from which the income is derived is at least 15% at the time foreign income is received in Singapore. The headline tax rate of the foreign jurisdiction refers to the highest corporate tax rate of the foreign jurisdiction.
c. There must be Singapore tax payable on the taxpayer's foreign income; and
d. Taxpayers are entitled to claim for FTC under sections 50, 50A or 50B of the Income Tax Act on their foreign income.

If the taxpayer's foreign income does not qualify for the FTC pooling system or the taxpayer does not wish to claim FTC under the FTC pooling system, the current "source-by-source and country-by-country" basis for computing the amount of FTC on the taxpayer's foreign income continues to apply. The current method of computing the amount of Singapore tax payable on the taxpayer's foreign income continues to apply under the FTC pooling system.

Suggestion:

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.

5. Carry forward of excess foreign tax paid

The purpose of providing FTC is to prevent double taxation of the same income in two countries. The amount of FTC that can be claimed in India 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 if the amount of income tax paid in the foreign country is lower than the amount of income tax payable in India on that foreign source income. However, a taxpayer will not be able to claim full FTC in India if the amount of income tax paid in the foreign country is higher than the amount of income tax payable in India on that foreign source income. The effective tax rate of such companies will be higher. Companies that do not receive full 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 rate country during a financial year is high. The payment of Branch Profits Tax 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 rate country is higher.

On a review of the domestic tax regulations in a few countries, the following countries allow carry forward of excess foreign tax paid in the following manner:

Country	FTC carry forward	Carry-back	Reference
Canada	Carry forward for 10 years	Carry-back for 3 years	Section 126(2)(a) of the Canada Income Tax Act
Japan	Carry forward for 3 years	Carry-back for 3 years	Code No. 12007 of National Tax Agency
Singapore	No time limit for carry forward		Section 50 of the Singapore Income Tax Act
UK	No time limit for carry forward	Carry-back for 3 years	Sections 72 to 74 of the Taxation (International and Other Provisions) Act 2010
U.S.A	Carry forward for 10 years	Carry-back for 1 year	IRC Section 904 (c)

Singapore

Singapore permits carry-forward of excess or deficit credits indefinitely under section 50 of the Income Tax Act.

Sub section 10 of Section 50 states the following:
(10) Where the amount of any credit given under the arrangements is rendered excessive or insufficient by reason of any adjustment of the amount of any tax payable either in Singapore or elsewhere, nothing in this Act limiting the time for the making of assessments or claims for relief shall apply to any assessment or claim to which the adjustment gives rise, being an assessment or claim made not later than 2 years from the time when all such assessments, adjustments and other determinations have been made, whether in Singapore or elsewhere, as are material in determining whether any, and if so what, credit falls to be given.

The United Kingdom

The United Kingdom permits carry-back of excess foreign tax credits for 3 years or carry-forward indefinitely under sections 72 to 74 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010).

For UK resident companies, any unrelieved foreign tax can be carried back or forward if it arises in respect of any of the company's qualifying income from an overseas permanent establishment of the company (Sec 73 of TIOPA 2010),

Qualifying income is defined as the profits of an overseas permanent establishment which are chargeable to tax under Chapter 2 of Part 3 of CTA 2009 or profits which are included in the profits of gross roll-up business chargeable under section 436A of ICTA (Sec 72(2) of TIOPA 2010).

An amount of unrelieved foreign tax on profits of an overseas permanent establishment arises when the amount of the credit for foreign tax which would (if section 42 were ignored) be allowable against the UK corporation tax liability on that income exceeds the amount of credit for foreign tax which is actually allowed against the UK corporation tax liability on that income (Sec 72(1) of TIOPA 2010). For example, unrelieved foreign tax may arise where the foreign tax rate exceeds the UK tax rate or the UK measure of taxable profits is less than the foreign measure. It can also arise where the trade is loss-making overall.

Unrelieved foreign tax can be generally carried forward indefinitely for future offset unless the permanent establishment that gave rise to the unrelieved foreign tax ceases to exist (Sec 73(2) of TIOPA 2010).

The carry-back of unrelieved foreign tax is permitted in respect of accounting periods beginning not more than three years before the accounting period in which the unrelieved foreign tax arises (Sec 73 of TIOPA 2010). Unrelieved foreign tax may be partly carried back and partly carried forward if necessary (Sec 73(1)(c) of TIOPA 2010).

Where unrelieved foreign tax is carried back to previous accounting periods, relief is given on a “Last In, First Out” basis, i.e., the carry-back is to a later accounting period in priority to an earlier one. In addition, credit is first given for foreign tax of that accounting period and second to unrelieved foreign tax brought forward from an earlier accounting period before credit is given for unrelieved foreign tax carried back (Sec 74 of TIOPA 2010).

The United States of America

The United States of America permits carryback of excess credits for 1 year and carry forward for 10 years under section 904(c) of the Internal Revenue Code (IRC) of 1986. IRC Sec. 904 states the following:

(a) Limitation

The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

c) Carry back and carryover of excess tax paid

Any amount by which all taxes paid or accrued to foreign countries or possessions of the United States for any taxable year for which the taxpayer chooses to have the benefits of this subpart exceed the limitation under subsection (a) shall be deemed taxes paid or accrued to foreign countries or possessions of the United States in the first preceding taxable year and in any of the first 10 succeeding taxable years, in that order and to the extent not deemed taxes paid or accrued in a prior taxable year, in the amount by which the limitation under subsection (a) for such preceding or succeeding taxable year exceeds the sum of the taxes paid or accrued to foreign countries or possessions of the United States for such preceding or succeeding taxable year and the amount of the taxes for any taxable year earlier than the current taxable year which shall be deemed to have been paid or accrued in such preceding or subsequent taxable year (whether or not the taxpayer chooses to have the benefits of this subpart with respect to such earlier taxable year). Such amount deemed paid or accrued in any year may be availed of only as a tax credit and not as a deduction and only if the taxpayer for such year chooses to have the benefits of this subpart as to taxes paid or accrued for that year to foreign countries or possessions of the United States.

Suggestion:

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

6. 'Deemed tax credit' 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 who 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.

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).

Clause 4 and 5 of Article 23 (Elimination of Double Taxation) of India–Malaysia DTAA states the following:

4. 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.
5. For the purposes of paragraph 4, the term "tax paid in Malaysia" shall be deemed to include the tax which would, under the laws of Malaysia and in accordance with this Agreement, 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 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.

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.

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.

Suggestion:

Many countries have provided 'tax sparing' benefits to their companies under the DTAAs concluded by them with the Government of India. 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 10 A, 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 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.

The deemed tax credit benefits should be reduced from the Indian tax liability in addition to the FTC.

7. Taxation of dividends and Underlying Tax Credits

A. Taxation of dividend income

A company may choose to operate in foreign countries through a branch or a subsidiary structure. A branch is not a 'separate legal entity' and is only a 'functionally separate entity' of the parent company. A branch does not have an independent legal status. A subsidiary is a 'separate legal entity' in which the parent company has made equity investment.

A company is liable to pay income tax on its worldwide taxable income in its residence country. Such worldwide taxable income includes the foreign source income earned by its branches (unless the residence country follows the exemption method for providing relief from double taxation). The company would also be liable to pay income tax in the foreign country on the foreign source income, resulting in double taxation of the same income in two countries. The residence country provides relief from double taxation through FTC, either under the terms of a DTAA or through a unilateral relief under its domestic tax laws.

If a company is operating in a foreign country through a subsidiary, the parent company is not liable to pay income tax in its residence country on its consolidated profits. Instead, the parent company and its subsidiary are liable to pay income taxes in their respective residence countries on their respective taxable income. As a result, foreign source income earned by the parent company in a foreign country through a subsidiary does not suffer double taxation, unlike in the case of a branch.

The profits earned by subsidiaries eventually accrue to the parent company. However, the parent company cannot recognise such profits as its income until it receives it. The subsidiaries distribute their post-tax profits to the parent company in the form of 'dividends' and the parent company recognises it as its income only on the receipt of such dividends. Such dividends ultimately represent the parent company's share of post-tax profits earned by its subsidiaries in those countries.

The foreign country may impose a withholding tax on the payment of dividends to foreign companies. As the parent company is earning income from a foreign country in the form of dividends from its subsidiary, the withholding tax eventually becomes the liability of the parent company. The foreign tax liability of the parent company is discharged by its subsidiary on behalf of the parent company in the form of withholding tax.

The parent company may be liable to pay income tax in its residence country on the dividend income received from its foreign subsidiary. As a result, the parent company may be subject to double taxation on the same dividend income in two countries – withholding tax in the country of payment and income tax in the residence country. This double taxation is mitigated at two levels:

- The rate of applicable withholding tax could be limited by the DTAA between these countries.
- The residence country provides relief from double taxation of the dividend income by means of FTC, either under the terms of a DTAA or through a unilateral relief under its domestic tax laws.

Let us examine the United Nations and the OECD Model Tax Conventions relating to taxation of dividends and elimination of double taxation of such dividends.

Article 10 (Dividends) of the United Nations Model Double Taxation Convention between Developed and Developing Countries states the following:

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
(a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.
The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.
This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Article 10 (Dividends) of the OECD Model Tax Convention on Income and on Capital states the following:

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
b) 15 per cent of the gross amount of the dividends in all other cases.
The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.
This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Both the 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.

Article 23 of the UN and OECD Model Tax Conventions provides the Exemption method or the Credit method for elimination of double taxation in the residence country.

Under the Exemption method, country of residence (Country R) does not tax the income, which according to DTAA may be taxed in the country of source (Country S). Under the Credit method, Country R includes the income from Country S in the total taxable income of the taxpayer and

calculates tax on the basis of such taxpayer's worldwide income (including income from Country S). It then allows a credit or deduction from its own taxes for taxes paid in Country S.

- **The Exemption method:** The principle of exemption may be applied by:

    - **Full Exemption method** wherein the income that is taxed in Country S is exempt (or not considered) by Country R for the purposes of its taxation.
    - **Exemption with Progression method** wherein the income that is taxed in Country S is not taxed in Country R. However, Country R retains the right to include that income (i.e., the income taxed in Country S) for determining the tax to be imposed on the rest of the income.

- **The Credit method:** The principle of credit may be applied by:

    - **Full credit method** wherein Country R gives a deduction of the total amount of tax paid in Country S from the amount of tax payable on worldwide income in Country R;
    - **Ordinary credit method** wherein the deduction given by Country R for the amount of tax paid by the taxpayer in Country S is restricted to that part of the amount of tax payable in Country R (as computed before the deduction is given) that is attributable to the income, which may be taxed in Country S.

The DTAAs concluded by the Government of India usually follow the ordinary credit method to relieve double taxation of income taxes paid directly or by way of deduction through withholding tax, in the foreign country. In the case of income arising to a resident of India from countries with which the Government of India has not concluded a DTAA, relief from double taxation of income would be granted under Sec 91 of the Income Tax Act, 1961. Sec 91 also follows the ordinary credit method for providing relief from double taxation of income.

As a result, the parent company would be able to claim FTC in India on the dividend income which is subject to double taxation. Such FTC would be the lower of:

a. The amount of withholding tax payable in the foreign country; or
b. The amount of income tax chargeable on that income in India.

In summary, if an Indian company is operating in foreign countries through a branch or subsidiary, the following tax consequences arise:

a. Income earned by a foreign branch would be liable to income tax in the foreign country and India, resulting in double taxation of the same income in two countries. The DTAAs or Sec 91 of the Income Tax Act, 1961 provides relief from double taxation, under the ordinary credit method.
b. Income earned by a foreign subsidiary would be liable to income tax only in the foreign country. This does not result in double taxation of the same income in two countries.
c. Any remittance of post-tax profits earned by the branch to the parent company is generally not subject to taxation in the foreign country, except in a few countries like the United States of America, Canada, France, Spain, etc. The Branch Profits Tax (BPT) simulates the tax treatment of a company that pays dividends. Such deemed distribution of post-tax profits by a branch is not separately liable to income tax in India.
   However, the aggregate amount of corporate income tax and BPT paid in the foreign country by a branch will increase the total amount of income tax eligible for FTC.

d. Dividends paid by a foreign subsidiary to its parent company may be subject to withholding tax in the foreign country and payment of income tax in India (at a base rate of 15% for the financial year 2012-13), resulting in double taxation of the same dividend income in two countries. The DTAAs or Sec 91 of the Income Tax Act, 1961 provides relief from double taxation, under the ordinary credit method.

Suggestion:

Many Indian companies operate in foreign countries through a subsidiary structure. Many Indian companies also make portfolio investments in foreign companies. Such subsidiaries/investee companies pay dividends to the parent company/investor in India which may be subject to withholding tax in the foreign country and income tax in India, resulting in double taxation of the dividend income. The DTAAs concluded between the Government of India and the Governments of many countries provide relief from double taxation of dividend income. Similarly, Section 91 of the Income Tax Act, 1961 provides relief from double taxation of dividend income received from a foreign country with which the Government of India has not concluded a DTAA.

It would be useful if the FTC rules specify that the withholding tax paid on dividend, interest, Royalty and Fees for Technical Services received from a foreign company would be eligible for FTC under ordinary credit method.

B. Underlying tax credits

As stated earlier, 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 Rs.10,000. The company earns business income of Rs.4,000 in the foreign country either through a branch or subsidiary.
b. The corporate income tax rate in India is 32.45% 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 @ 32.45%	3,245	1,947
Tax payable in India on BPT/dividends received at 15%	NA	390
Total tax payable in India before FTC	3,245	2,337
Amount eligible for FTC in India	1,298	390
FTC claimed in India	1,298	390
Total tax payable in India after FTC	**1,947**	**1,947**
Total worldwide tax payable	**3,737**	**3,737**

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. Both the 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. 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 and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid. 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, the Government of India has not agreed to provide similar relief to an Indian company under that DTAA. Clause 1 of Article XXIV (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 who 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 who 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.

Suggestion:

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 Committee on Foreign Tax Credit constituted by the CBDT should evaluate the need and the form in which underlying tax credit is to be provided to Indian companies under the FTC rules in India.

8. Types of income-taxes in India on which FTC can be claimed

I. Indian companies are liable to pay the following types of income-taxes in India as per the Finance Act 2012:

a. Income-tax in the case of a domestic company at the rate of 30%.
b. Surcharge on income-tax at the rate of 5 per cent in the case of a domestic company having total income exceeding one crore rupees.
c. Additional surcharge called the "Education Cess on income-tax" and "Secondary and Higher Education Cess on income-tax" shall be levied at the rate of 2 per cent and 1 per cent respectively, on the amount of income-tax computed, inclusive of surcharge.

II. Article 2 of the DTAAs concluded between the Government of India and the Governments of various countries specify the taxes covered. As per Article 2, the taxes in India to which the DTAA shall apply are income-tax including any surcharge and surtax. It also applies to any identical or substantially similar taxes.

A. Article 2 of the DTAA concluded between the Government of India and the Government of the United States of America states the following:

ARTICLE 2 - Taxes covered *- 1. The existing taxes to which this Convention shall apply are:*

(b) in India:

(i) the income-tax including any surcharge thereon, but excluding income-tax on undistributed income of companies, imposed under the Income-tax Act; and

(ii) the surtax

(hereinafter referred to as "Indian tax").

Taxes referred to in (a) and (b) above shall not include any amount payable in respect of any default or omission in relation to the above taxes or which represent a penalty imposed relating to those taxes.

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention.

B. Article 2 of the DTAA concluded between the Government of India and the Government of the United Kingdom of Great Britain and Northern Ireland states the following:

ARTICLE 2 - Taxes covered *- 1. The taxes which are the subject of this Convention are:*

(b) in India:

the income-tax including any surcharge thereon;

(hereinafter referred to as "Indian tax").

2. This Convention shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of this Convention in addition to, or in place of, the taxes of thatContracting State referred to in paragraph 1 of this Article. The competent authorities of the Contracting States shall notify each other of any substantial changes which are made in their respective taxation laws.

C. Article 2 of the DTAA concluded between the Government of India and the Government of Japan states the following:

ARTICLE 2

1. The taxes which are the subject of this Convention are:

(b) In India:

the income-tax including any surcharge thereon

(hereinafter referred to as "Indian tax").

2. This Convention shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of this Convention in addition to, or in place of those referred to in paragraph 1. The competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws within a reasonable period of time after such changes.

III. The Article relating to 'Relief or Elimination of double taxation' indicates the order in which relief from double tax would be applied.

A. Article 25 of the DTAA concluded between the Government of India and the Government of the United States of America states the following:

Article 25 - Relief from double taxation *-*

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.

(b) Further, where such resident is a company by which a surtax is payable in India, the deduction in respect of income-tax paid in the United States shall be allowed in the first instance from income-tax payable by the company in India and as to the balance, if any, from surtax payable by it in India.

B. Article 24 of the DTAA concluded between the Government of India and the Government of the United Kingdom of Great Britain and Northern Ireland states the following:

ARTICLE 24 - Elimination of double taxation -

2. Subject to the provisions of the law of India regarding the allowance as a credit against Indian tax of tax paid in a territory outside India (which shall not affect the general principle hereof), the amount of the United Kingdom tax paid, under the laws of the United Kingdom and in accordance with the provisions of this Convention, whether directly or by deduction, by a resident of India, in respect of income from sources within the United Kingdom which has been subjected to tax both in India and the United Kingdom shall be allowed as a credit against the Indian tax payable in respect of such income but in an amount not exceeding that proportion of Indian tax which such income bears to the entire income chargeable to Indian tax.

For the purposes of the credit referred to in this paragraph, where the resident of India is a company, by which surtax is payable, the credit to be allowed against Indian tax shall be allowed in the first instance against the income-tax payable by the company in India and, as to the balance, if any, against the surtax payable by it in India.

C. Article 23 of the DTAA concluded between the Government of India and the Government of Japan states the following:

ARTICLE 23

2. Double taxation shall be avoided in the case of India as follows:

(a) Where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in Japan, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Japanese tax paid in Japan, whether directly or by deduction. Such deduction in either case shall not, however, exceed that part of the income-tax (as computed before the deduction is given) which is attributable, as the case may be, to the income which may be taxed in Japan.

Further, where such resident is a company by which surtax is payable in India, the deduction in respect of income-tax paid in Japan shall be allowed in the first instance from income-tax payable by the company in India and as to the balance, if any, from surtax payable by it in India.

Suggestion:

The FTC rules in India should clearly state that FTC can be claimed on income-tax, surcharge on income-tax and similar taxes payable in India. In particular, the FTC rules should mention that FTC can be claimed on Income-tax, Surcharge on income-tax, Education Cess on income-tax and Secondary and Higher Education Cess on income-tax. The FTC rules should also state that FTC can be claimed on any identical or substantially similar taxes if imposed in India at a later date.

The FTC rules should also state the order in which the FTC will be claimed. It should state that the FTC would be claimed first on incometax payable in India. The Surcharge, Education Cess and Secondary and Higher Education Cess on income-tax will be payable only on the balance amount of income-tax payable in India after offsetting the FTC.

The FTC rules should state that FTC cannot be claimed on payments such as penalties, interest, fines, customs and excise duties in India.