# Income from Capital, Borrowing & Property

# ARTICLE 6 INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

- Paragraph 1 gives right to tax income from immovable property to the source state i.e. the state in which the property producing such income is situated. This is because there is very close economic connection between the source of this income and state of source. It also includes income from agriculture and forestry.
- The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property i.e. the right to enjoy the use and advantages of another's property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft shall not be regarded as immovable property.
- It will include income derived from the direct use, letting, or use in any other form of immovable property.
- Income from immovable property of an industrial or commercial enterprise and income from immovable property used for the performance of independent personal services will also be included within the scope of Article 6.

# ARTICLE 6 INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

- Hon'ble Madras High Court in the case Income-tax Officer *v.* A.K.N. Govindaswamy Chettiar - [1993] 44 ITD 138 (MAD.) and Commissioner of Income-tax *v.* Vr. S.R.M. Firm - [1994] 208 ITR 400 (MAD.) has held that Art. 6 of the Agreement between India and Malaysia lays down that income from immovable Property *may be taxed* in the contracting State in which such property is situated." (Emphasis supplied). The focus of this Article thus is the situs of the property, and the situs of the property in its turn determines contracting State which is empowered to levy tax. In the case before us the property in question being situated in Kuala Lumpur, it is the Malaysian Government, which is competent to levy tax on the Income from property.
- True, the Article uses the term "may be taxed". As we see it, the term "may be taxed" has been advisedly used. It is one thing to identify the contracting State which will levy tax on income from immovable property, but it is totally a different thing to say that that contracting State should invariably levy tax on income from immovable property. The choice is with the contracting State in question. Even if that contracting State should decide not to levy any tax on income, it does not follow that the other contracting State gets a right to levy tax on the income from immovable property by that reason alone. Once the Agreement vests the right to levy tax on income from immovable property in the contracting State in which the property is situated, the matter ends there. There is no call either in law or in logic to draw an inference that since the term "may be taxed" will also mean "may not be taxed", the other contracting State gets a right to tax income from immovable property. It was therefore held that no tax is exigible in India under the Indian Income-tax Act on the net rental income from the building situate at Kuala Lumpur.
- This view has been subsequently affirmed by the Hon'ble Supreme Court in the case of CIT vs. P.V.A.L. Kulandagan Chettiar - [2004] 137 Taxman 460 (SC).

# ARTICLE 6 INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

- Artilce 6(1) does not grant an exclusive tax right to the source state in my opinion and the protocol signed on 14th May, 2001 expressly provides that state of residence can also tax income under Article 6(1).
- Hon’ble Chandigarh Tribunal in the case of Sumit Aggarwal *v.* Deputy Commissioner of Income-tax, Circle - VII, Ludhiana - [2014] 45 taxmann.com 345 (Chandigarh - Trib.) held that where assessee, a resident of India, earned negative rental income from property situated in Australia as interest paid on loan taken for construction of house property was more than rent derived, in view of provisions of section 5, said negative income was to be included while computing assessee's taxable income in India.
- In this case the assessee purchased a house property in Australia and let it out on rent. The assessee had also obtained a loan from 'A' bank Australia for construction of said property. Since the amount of interest paid on loan amount was higher than rental income, the assessee incurred loss under head 'Income from house property'. The assessee filed its return declaring income which included loss from house property. Plain reading of Sec 90(2) shows that wherever DTAA is applicable in case of an assessee then the assessee has an option to apply either Indian Tax Laws or provisions of DTAA if same are more beneficial to the assessee. Therefore, the assessee had right to file the return of global income in India and the Revenue is bound to give effect to such return.

# ARTICLE 10 - DIVIDEND

- Paragraph 1 states that dividend paid by a company may be taxed in the state of beneficiary's residence. The term paid has very wide meaning, since the concept of payment means the fulfilment of obligation to put the funds at the disposal of the shareholder in the manner required by the contract or custom.
- Paragraph 2 reserves a right to tax to the state of source of dividend i.e. to the state of which company paying the dividend is a resident. However, this right is limited to the extent of 10% to 25% of the of the gross amount of the dividends if the beneficial owner of the dividend is not the resident of state of source of dividend. The rate of tax is lower if the beneficial owner is a company which owns shares or voting power exceeding a percentage.
- The term "dividends" as used in this Article means income from shares (not being debt-claims). However if rights of participating in profits of an entity or partnership firm is subjected to the same taxation treatment as as income from shares by the taxation laws of the State of which the company making the distribution is a resident company than benefit of this article will also be given to share in partnership or any other entity which is treated as a company for tax purposes.

# ARTICLE 10 - DIVIDEND

- Paragraph 4 says that the benefit of this article shall not apply if the beneficial owner of the dividends, carries on business in the state of source of dividend through a permanent establishment or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case, Article 7 or Article 14, as the case may be, shall apply. It means that dividend will be taxable as part of profits of permanent establishment. Paragraph 4 relieves the state of source of dividend from any limitation under this article.
- Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). Certain States, however, tax not only dividends paid by companies resident therein but even distributions by non-resident companies of profits arising within their territory. Each State, of course, is entitled to tax profits arising in its territory which are made by non-resident companies, to the extent provided in the Convention (in particular in Article 7). The shareholders of such companies should not be taxed as well at any rate, unless they are residents of the State and so naturally subject to its fiscal sovereignty.
- Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits. Some countries seeks to tax profits which have not been distributed.

# ARTICLE 11 - INTEREST

- Paragraph 1 states that interest paid by a company may be taxed in the state of beneficiary's residence. The term paid has very wide meaning, since the concept of payment means the fulfilment of obligation to put the funds at the disposal of the creditor in the manner required by the contract or custom.
- Paragraph 2 reserves a right to tax to the state of source of interest i.e. to the state of which company paying the dividend is a resident. However, this right is limited to the extent of 10% to 15% of the of the gross amount of the interest.
- However, if the interest is exempt from taxation in the state of source of interest if the interest is paid to the Government or a political sub-division or local authority or Central Bank.
- In order to promote international trade, many States have established export financing programmes or agencies which may either provide export loans directly or insure or guarantee export loans granted by commercial lenders. Since that type of financing is supported by public funds, a number DTAAs provides for exemption from source taxation interest arising from loans covered by these programmes or agencies. For e.g. Export Import Bank of the United States or EXIM Bank of India or United Kingdom Export Credits Guarantee Department.

# ARTICLE 11 - INTEREST

- Paragraph 3 specifies the meaning to be attached to the term "interest" for the application of the taxation treatment defined by the Article. The term designates, in general, income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term "debt-claims of every kind" obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures.
- It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital, even though certain countries assimilate it to income from immovable property. On the other hand, debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest.
- Penalty charges for late payment shall not be regarded as interest.
- Interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company. In situations of presumed thin capitalisation, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with in Article 10 and Article 11 respectively, it should be noted that the term "interest" as used in Article 11 does not include items of income which are dealt with under Article 10.

# ARTICLE 11 - INTEREST

- As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest.
- Any profit or loss which a holder of such a security realises by the sale thereof to another person does not enter into the concept of interest. Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21 i.e. other income.
- Paragraph 4 states that the benefit of this article shall not apply if the beneficial owner of the interest, carries on business in the state of source of interest through a permanent establishment or performs in that other State independent personal services from a fixed base situated therein, and and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. It provides that in the State of source the interest is taxable as part of the profits of the permanent establishment, if it is paid in respect of debt-claims forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the interest from any limitation under the Article.

# ARTICLE 11 - INTEREST

- Paragraph 5 lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. However, if the person paying the interest, has in a Contracting State a permanent establishment or a fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.
- The purpose of paragraph 6 is to restrict the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.
- With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital.

# ARTICLE 11 - INTEREST

- Madras High Court in the case of Ansaldo Energia SPA v. CIT (International Taxation) [2016] 69 taxmann.com 369 had held that income tax refund due and payable to the assessee is debt-owed payable by the revenue and interest paid thereon is covered within the definition of 'interest' as provided under Article 12(4) of the India-Italy Double taxation Avoidance Agreement ('Tax Treaty').

- The Uttarakhand High Court (HC) in the case of B.J. Services analyzed whether interest paid to the assessee on its refund is an income taxable as business profits or as interest in terms of the DTAA between India and United Kingdom. Hon'ble HC held that if there were no other provisions for taxability of interest on tax refund, the taxpayer would be justified in offering 15 per cent to taxation on interest. However, a perusal of clause 12(6) indicates that provision of paragraph 1 shall not apply if the beneficial owner of the interest is resident of a contracting State carries on business in the other contracting state in which interest arises through a permanent establishment situated therein. Article 12(6) contemplates that debt claim in respect of which interest paid is effectively connected with such establishment. The Court witnessed that in the instant case interest is effectively connected with the permanent establishment. The Hon'ble High Court held that Article 12(6) of the India-UK DTAA, which relates to business profits shall apply and the assessee will be assessed at a tax rate of 48 per cent as applicable to relevant assessment year.

# ARTICLE 13 – CAPITAL GAINS

- A comparison of the tax laws of the several countries shows that the taxation of capital gains varies considerably from country to country: —
  - ✓ in some countries capital gains are not deemed to be taxable income;
  - ✓ in other countries capital gains accrued to an enterprise are taxed, but capital gains made by an individual outside the course of his trade or business are not taxed;
  - ✓ even where capital gains made by an individual outside the course of his trade or business are taxed, such taxation often applies only in specified cases, e.g. profits from the sale of immovable property or speculative gains (where an asset was bought to be resold).
- Moreover, the taxes on capital gains vary from country to country. In some countries, capital gains are taxed as ordinary income and therefore added to the income from other sources. This applies especially to the capital gains made by the alienation of assets of an enterprise. In a number countries, however, capital gains are subjected to special taxes, such as taxes on profits from the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostly at special rates, which do not take into account the other income (or losses) of the taxpayer.

# ARTICLE 13 – CAPITAL GAINS

- Many treaties has left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. The Article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law. The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains.
- However, some treaties are more elaborate in determining the taxation right arising from capital gains for e.g. DTAA with South Africa.
- Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6.
- Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise. The term “movable property” means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment is situated, which corresponds to the rules for business profits (Article 7).
- An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships, aircraft. Normally, gains from the alienation of such assets are taxable only in the State in which the place of effective management of the enterprise operating such ships and aircraft is situated.

# ARTICLE 13 – CAPITAL GAINS

- ❖ Gains from the alienation of shares or similar rights in a company, or of an interest in a partnership, trust or estate, the assets of which consist principally of immovable property situated in a Contracting State, may be taxed in the source state.
- ❖ Gains from the alienation of any property other than that referred to in the preceding paragraphs, shall be taxable only in the Contracting State of which the alienator is a resident.
- ❖ The expression "alienation" is not defined in DTAA or the Income Tax Act, but it includes:
  - ✓ Any disposition;
  - ✓ A sale or exchange;
  - ✓ A conveyance or assignment;
  - ✓ A settlement;
  - ✓ A gift.
  - ✓ Protocol to India – Canada treaty provides that alienation includes a "transfer" within the meaning of the Indian Taxation Laws.