Foreign Tax Credit

at

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Contents

- Introduction
- Methods and Types of relief
- Rule 128
- FTC Variants
  - Underlying Tax Credit
  - Tax Sparing
  - Deemed Tax
- Certain Issues and Landmark decisions
  - FTC outside India
  - FTC in India

Introduction

Inherent conflict between Source rule and Residence rule

- **Worldwide taxation systems:** Residence State (RS) taxes residents on their global income, including income that arise outside RS in a Source State (SS)
- **Foreign Tax Relief:** Relief for tax paid in SS, against taxes to be paid in RS

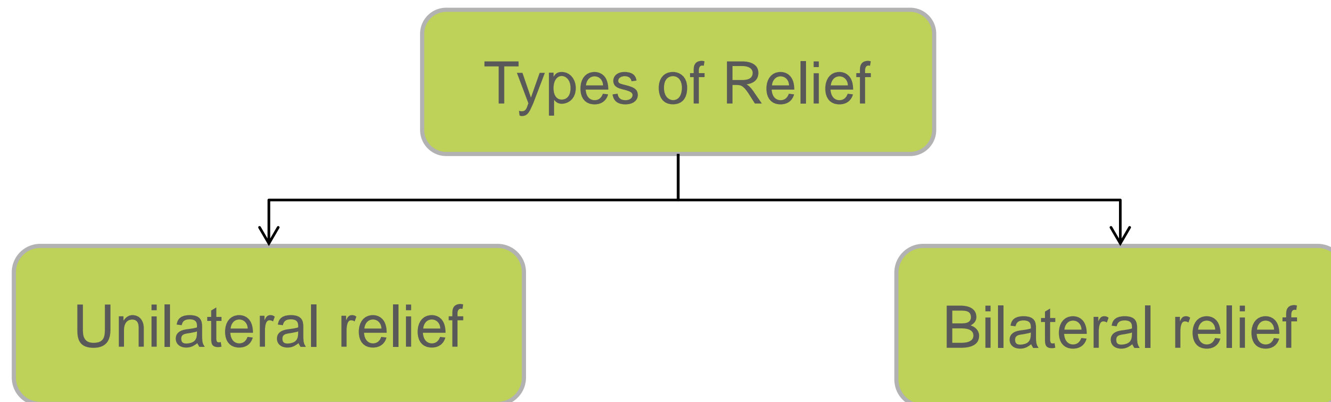
Juridical & Economic Double Taxation

- Juridical Double Taxation
  - When two or more states tax the **same taxpayer** on the same income
- Economic Double Taxation
  - When same economic transaction / item of income is taxed in two or more states, but in the hands of **different taxpayers**

General Conditions for Grant of FTC

- FTC is available only in the RS
  - *Exception in sec. 91: Where a firm 'R' in India earns income outside India, and has a NR partner, then such partner can claim FTC in India*
- Certain income has accrued / arisen in SS in same year
- In respect of such income, taxpayer has paid taxes in SS
  - *Is it necessary that such payment should have been made in the same year?*
- Such income is also taxed in RS

Methods of Relief



Unilateral relief

- Applicable where DTAA does not exist
- Given under domestic tax laws of that country
- Enabling provision: **Sec. 91**

Bilateral relief

- Applicable where DTAA exists
- Enabling provisions: **Sec. 90, 90A**
- Mechanism: Art. 23 of DTAAs

FA2015: Amendment in Sec. 295 of Act.
CBDT empowered to make FTC rules on procedure for grant of FTC

Unilateral Relief - Relevant Provisions

- Sec. 91

  *"(1) If any person who is resident in India in any PY proves that, in respect of his income which accrued / arose during that PY outside India (and which is not deemed to accrue / arise in India), he has paid in any country with which there is no agreement u/s 90 for the relief / avoidance of double taxation, income-tax, by deduction / otherwise, under the law in force in that country, he shall be entitled to the deduction from the Indian income-tax payable by him of a sum calculated on such doubly taxed income at the **Indian rate of tax** or the **rate of tax of the said country**, whichever is the lower, or at the Indian rate of tax if both the rates are equal."*

Unilateral Relief - Illustration

Particulars		Case I	Case II
		(INR)	(INR)
Income in India		80,000	80,000
Income in foreign country		20,000	20,000
Global income		**1,00,000**	**1,00,000**
Tax rate in India		30%	30%
Tax rate in foreign state		25%	35%
Indian tax on global income	**(A)**	30,000	30,000
Indian tax on foreign income	**(B)**	6,000	6,000
Foreign tax paid on foreign income	**(C)**	5,000	7,000
Unilateral relief as per the Act – Lower of (B) or (C)	**(D)**	**5,000**	**6,000**
Tax payable in India (A) – (D)	**(E)**	25,000	24,000
Total tax outflow (C) + (E)		**30,000**	**31,000**
Tax credit lost (C) – (D)		**nil**	**1,000**
Effective global tax rate		**30%**	**31%**

Unilateral Relief to a NR

- Sec. 91

  *"(3) If any **NR is assessed on his share** in the income of a **registered firm assessed as resident in India** in any PY and such share **includes any income accruing / arising outside India** during that PY (and which is not deemed to accrue / arise in India) in a country with which there is no agreement u/s 90 for the relief or avoidance of double taxation and he proves that **he has paid income-tax under the law in force in that country in respect of the income so included** he shall be entitled to a deduction from the Indian income-tax payable by him of a sum…"*

Bilateral Relief - Relevant Provisions

- Sec. 90

“(1) The C.Govt. may enter into an agreement with the Govt. of any country outside India or specified territory outside India,—

(a) ***for the granting of relief*** *in respect of—*

(i) income on which ***have been paid both income-tax under this Act and income-tax in that country*** *or specified territory, as the case may be, or*

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or…”

Bilateral Relief

- When an income has suffered tax in RS (India), as well as in a SS, where RS and SS have a DTAA
- Provides relief in (either of) following manner:
  - Exemption Method (Art. 23A)
  - Credit Method (Art. 23B)

Extracts - Mutual Convention

- Art. 23A

*Where a **resident of a CS** derives income which may be taxed in the other CS in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other CS solely because the income is also income derived by a resident of that CS), **the first mentioned CS shall**, subject to the provisions of paragraphs 2 and 3 **exempt such income** from tax*

Extracts - Mutual Convention

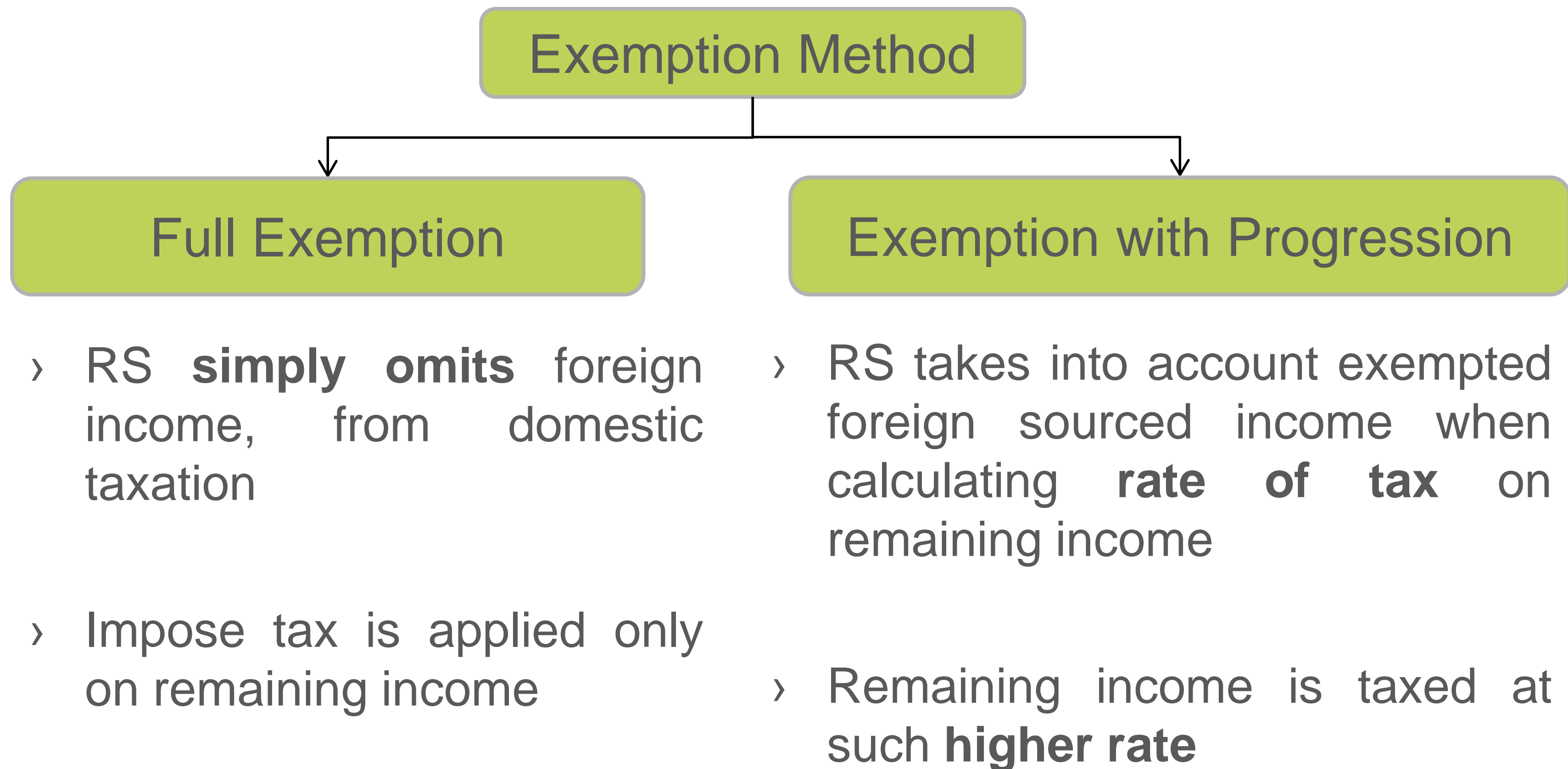
- Art. 23B

*"Where a **resident of a CS** derives income which may be taxed in the other CS in accordance with the provisions of this Convention … the **first mentioned CS shall allow**:*

*a) as a **deduction from the tax** on the income of that resident, an amount equal to income tax paid in the **other CS***

*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 that **other CS**"*

Exemption Method (Article 23A)



Exemption Method – Illustration

Particulars	Full exemption	With progression
	(INR)	**(INR)**
Income in State R (RS)	80,000	80,000
Income in State S (SS)	20,000	20,000
Global taxable income in State R	**100,000**	**100,000**
Slab Rate of tax in State R - for income up to INR 80,000 - for income exceeding INR 80,000	25% 35%	25% 35%
Tax rate in State S	20%	20%
Effective Tax Rate in State R	25%	(80,000*25% + 20,000*35%) / 100,000 = 27%#
Tax payable in State R	80,000*25% = 20,000	80,000 * 27% = 21,600
Tax payable in State S	20,000*20% = 4,000	20,000*20% = 4,000
Aggregate tax	**24,000**	**25,600**
Effective Tax Rate on global income	**24%**	**25.6%**

#The exempt income has been included for ascertaining applicable rate of tax

Exemption – Quantum and timing

› Relief by RS under 'Full Exemption' may be higher than tax levied by SS

› Exemption in RS has to be granted:

  – **Whether or not SS has exercised its right to tax**

  – Even if SS does not actually collect tax due to special circumstances (Eg. Set-off of losses / expiry of statutory limit for assessment, etc.)

› May result in Double non-taxation where SS exempts such income *(How does the MLI affect this outcome)*

Exemption – Treatment of losses

- ‘Income’ includes **losses**
- Losses of SS to be treated in same manner as profits in RS
- Set-off of losses of SS with income of RS (if domestic law permits)
- Divergence on availability of **‘double dip of losses’ – Patni Computers**

Exemption – Difference in interpretation

- Finding of SS to be applied, in case SS has a different interpretation of facts / provisions

  – Lakshmi Textile Exporters Ltd. (Mad. HC)

Exemption Method

Eg. Under **India-Brazil DTAA**

- Art. 23(3): Where a company which is a resident of a CS derives **dividends** which, in accordance with Art. 10(2) may be taxed in the other CS, the **first CS shall exempt** such dividends from tax.

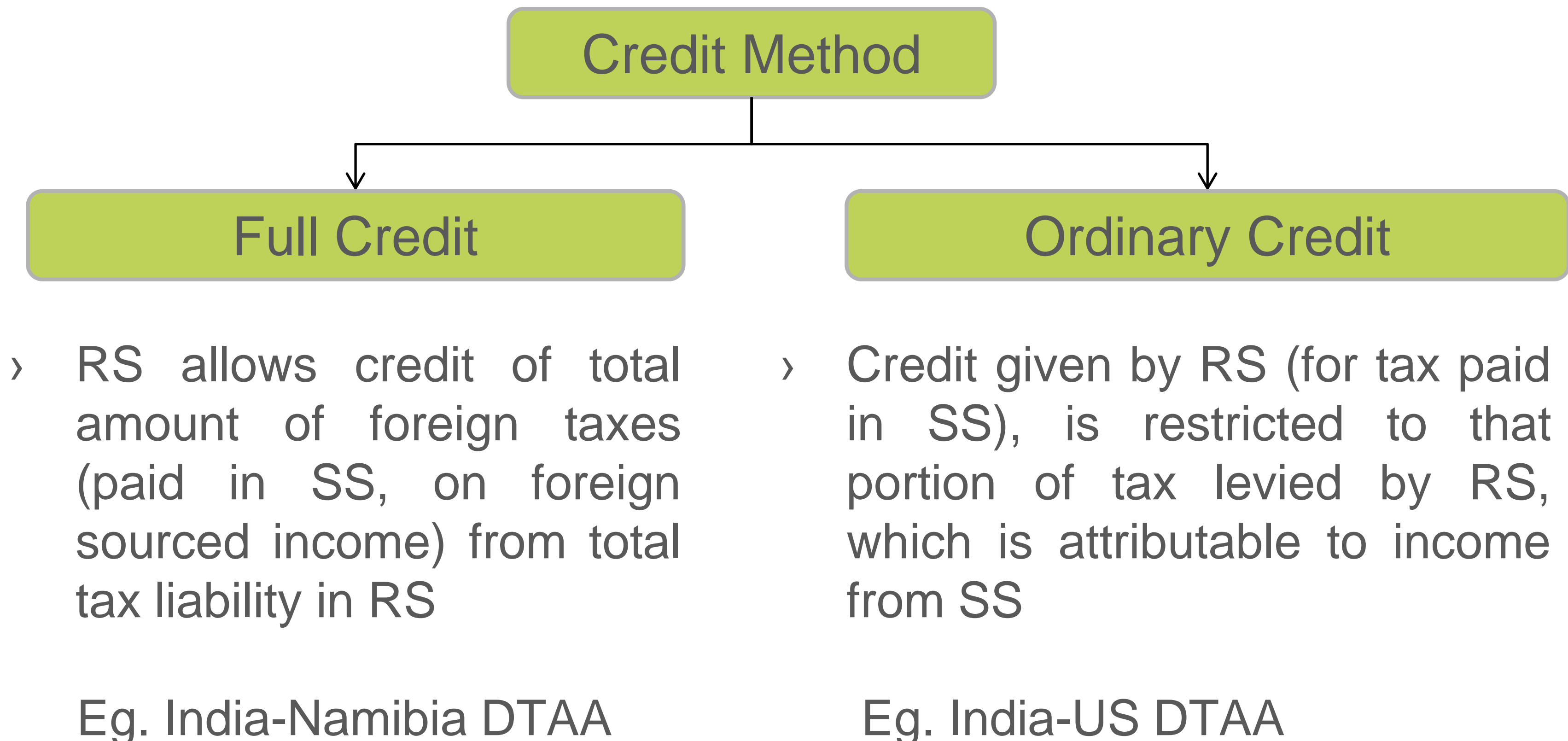
  (4) Where a resident of India derives profits which, in accordance with Art. 10(5) may be taxed in Brazil (i.e. Tax on PE profits at max. rate of 15%), **India shall exempt such profits from tax**.

Exemption Method and the MLI

Art. 5 of the MLI: Problems arising from inclusion of exemption method w.r.t. items of income that are not taxed in SS

- **Option A:** Exemption method not to apply when SS applies DTAA to exempts the income / limit its tax rate. Credit method to apply instead
- **Option B:** RS of shareholder not to apply exemption method to any such **dividend**, which gives rise to deduction for its payer in SS. Credit method to apply instead (Eg. Hybrid securities such as CCDs)
- **Option C:** Substitution of Exemption Method by Credit Method (Art. 23B of OECD MTC)

Credit Method (Art. 23B)



Credit Method (Art. 23B)

- **India-Namibia DTAA**

  "…India shall allow as a deduction from the tax on the income of that resident an amount equal to the tax on income or capital gains paid in Namibia, whether directly or by deduction."

- **Most DTAAs** (eg. India-US) contain the following **additional** clause:

  "…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 Other CS."

Credit Method – Illustration

Particulars		Full Credit (INR)	Ordinary Credit (INR)
Income in India		80,000	80,000
Income in foreign country		20,000	20,000
Global income		**1,00,000**	**1,00,000**
Tax rate in India		30%	30%
Tax rate in foreign state		40%	40%
Indian tax on global income	**(A)**	30,000	30,000
Indian tax on foreign income	**(B)**	6,000	6,000
Foreign tax paid on foreign income	**(C)**	8,000	8,000
Foreign tax credit available	**(D)**	8,000	6,000
Tax payable in India (A) – (D)	**(E)**	22,000	24,000
Total tax outflow (C) + (E)		**30,000**	**32,000**
Tax credit lost (C) – (D)		**nil**	**2,000**
Effective global tax rate		**30%**	**32%**

restricted to 20,000*30% = 6,000

FTC Rules

Rule 128

- Sec. 295(2)(ha)

  "such rules may provide for… the procedure for granting of relief or deduction"

- Rule 128

  "(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax ***paid by him****… in the year in which the income corresponding to such tax has been offered to tax / assessed to tax in India, in the manner and to the extent as specified in this rule…"*

Rule 128

Particulars	Details
Meaning of foreign tax	› **Treaty Country:** Taxes covered under the Treaty › **Non-treaty Country:** Tax payable under income tax law of that country
Year of availability	› Year in which corresponding income has been offered / assessed in India › If more than 1 year: *Proportionately*
FTC available against	› Amount of **tax, surcharge and cess** › MAT under sec. 115JB / 115JC
FTC not available against	› Payment of any interest, fee or penalty › Any foreign tax **disputed** by taxpayer

Rule 128

Mode of computation

- FTC shall be the **lower** of:
  - Tax payable under the Act on **such income**; or
  - Foreign tax paid on **such income**
- If Foreign Tax paid > Tax payable under DTAA, such **excess** is to be ignored
- Aggregate of amount computed **separately** for **each source of income** arising from **a SS**

Rule 128

- **Forex conversion:** TTBR on last day of month preceding the month in which such foreign tax has been paid / deducted

- **Caution: When utilizing FTC against MAT**

  If FTC available against MAT > FTC against normal tax, then **ignore such excess** while computing MAT credit to be carried forward

Rule 128

- **Documents to be furnished**
  - Form 67
  - Statement of income from SS
  - Certificate / statement *specifying nature of income and tax paid / deducted* from:
    - Tax authority of SS,
    - Person responsible for tax deduction, or
    - Signed by taxpayer (alongwith *challan* / proof of deduction)

Rule 128

- **Timeline:** Furnish on / before ~~due date for filing of return~~ **end of Assessment Year**

- **Impact of delay in filing of Form 67**
  - Possible reason for delay: Eg.

    Sec. 91 requires *"rate of tax of the said country"* which is

    = Tax actually paid in the said country
    ÷ **Whole amount of income assessed** in the said country

  - Impact of delay: Is the deadline **Directory** or **Mandatory**

Rule 128

FTC claim made after filing of ITR (i.e. not in the ITR)

- Goetze (SC): Fresh claim only through a **revised return**
- **Where FTC is paid after filing of ITR**
  - PwC (Kol Trib.): **Ld. DR agreed** that FTC may be allowed
  - TCG Lifesciences (Kol. Trib.): Claim made through **additional ground**, after payment of tax in Japan, and after expiry of time to file Revised ITR
  - Petroleum India Int'l (Mum.): Sec. 91(1) nowhere provides that foreign taxes shall be paid during relevant year itself

Rule 128

Disputed tax

- Credit available in FY in which corresponding income is offered / assessed to tax in India – **Only if** taxpayer furnishes following *(within 6 months from end of month in which disputed foreign tax is finally settled):*
  - Evidence of **settlement** of dispute
  - Evidence that liability for such foreign tax has been **discharged**
  - Undertaking that **no refund** is / shall be claimed by him

Rule 128

Disputed tax

- **Sec. 155(14A):** Timeline for rectification shall apply from the date of furnishing of the evidences and undertaking
- What can be the **evidence** that the dispute has been **settled**, and that taxpayer will not go in further appeal?
- Can Indian authorities, based upon grounds in the dispute, argue that SS has no taxing right; therefore, Foreign Tax is ***exceeds the tax payable in accordance with the DTAA***
- How will Indian authorities come to know about the dispute, if not declared by taxpayer

FTC Variants

FTC Variants – Underlying Tax Credit

- Credit of tax paid in SS **by a Company** on its own profits, is allowed by RS **to shareholders** against their tax liability against the dividend received out of such post-tax profits

  Eg. USA, UK, Australia, Mauritius, Singapore

- **Rationale:** Effectively dividends are taxed twice. First when company pays tax on profits; then when dividends are taxed

- **Qualifying person:** Co. with substantial shareholding (Ranges from 10% to 25% of voting power)

  Exception: *India-Singapore DTAA, where Singapore grants it to all its residents*

FTC Variant – Tax Sparing

- Credit in RS for such tax that would have been paid in SS, **had there been no exemption** in tax laws of SS
- Key benefit: Credit of **tax that has not actually been paid**

  Eg. Japan, Canada, Singapore, Philippines, Russia
- **Rationale:** To safeguard against **neutralization** of tax incentives offered by SS. **Benefits investors**
- Possibility of double non-taxation

Tax Sparing – Illustration

Particulars		Tax sparing – Absent	Tax sparing – Present
		INR	**INR**
Income in State R		80,000	80,000
Income in State S		20,000	20,000
Aggregate taxable income in State R		**100,000**	**100,000**
Tax rate in State R		35%	35%
Tax rate in State S - normal rate - special rate (when exempted)		 30% 0%	 30% 0%
Tax payable in State R	(A)	35,000	35,000
Tax payable in State S	(B)	-	-
Tax credit (tax charged in State S)	(C)	-	-
Tax credit (tax **exempted** in State S) #	(D)	-	6,000
Total tax credit (C) + (D)	(E)	**-**	**6,000**
Total tax after relief – (A) – (E)	(F)	**35,000**	**29,000**

20,000*30%=6000

FTC Variant – Deemed Tax

› Certain DTAAs provide for credit of certain fixed / minimum tax that is **deemed to have been paid in SS, without stipulations as to any tax holiday**. Eg. India-Brazil

1. …where a resident derives income which may be taxed in the SS, the RS shall allow as a deduction from tax on the income of that resident, an amount equal to the ***tax paid in SS****.*

2. For the deduction mentioned in para 1, the ***tax paid in SS*** *shall always be* ***deemed to have been paid @ 25%*** *of gross amount of interest referred to in Art. 11(2) and of royalties referred to in Art. 12 (2)(b), provided however, that the tax so deemed to have been paid shall not exceed the tax leviable on that income in the RS.*

FTC Variants and Rule 128

- Would FTC of following be available, in light of Rule 128
  - Tax Sparing
  - UTC
  - Deemed tax credit
  - Full credit (Eg. India-Namibia DTAA)

“(1) An assessee, being a resident shall be allowed a credit for the amount of any foreign tax ***paid*** ***by him*** *in a country / specified territory outside India…”*

“(5) The credit of foreign tax …shall be given effect to in the following manner:

(i) the credit shall be the ***lower of*** *the tax payable under the Act on such income and the foreign tax paid on such income…”*

FTC - Certain Issues

FTC outside India - Certain Issues

Issues expected to be faced by NRs (in their RS):

- Credit of **EQL**
  - Is it income-tax?
  - In accordance with the DTAA?
- Credit of **Buy Back Tax** - Is it a case of Juridical Double Taxation?
- Credit of DDT

FTC outside India - Certain Issues

Issues expected to be faced by NRs (in their RS):

- Specific text in **India-Hungary DTAA**

  "When the company paying the dividends is a resident of India the tax on distributed profits ***shall be deemed to be taxed in the hands of the shareholders and it shall not exceed 10% of the gross amount of dividend****."*

FTC in India - Certain Issues

- Computing **tax on such <u>income</u>** (payable under the Act, and paid outside India) for each source of income
  - Income, **not gross receipt**
  - Treatment of direct and indirect expenses: Proportionate vs. **Segmental** approach

  See: Virmati Software (Ahd.), Reliance Infrastructure (Bom.)

- Treatment of such part of Foreign Taxes, that are not eligible for credit

FTC in India - Gross vs. Net

- **Virmati Software & Telecommunication Ltd. (ITAT Ahd.)**

  Only Net profit (and **not Gross profit**) should be considered while determining the rate of tax in foreign country and same needs to be compared with the rate of tax in India.

  Amount of tax paid in a foreign country which is not eligible for benefit under sec. 91, is expenditure eligible for deduction under sec. 37(1).

Foreign Taxes Not Eligible for Credit

- **Reliance Infrastructure Ltd. (Bom.)**

Tax paid in Saudi Arabia on income which has accrued and / or arisen in India, is not eligible for deduction under sec. 91. Therefore, it is not hit by sec. 40(a)(ii) r.w. its explanation.

…tax paid in Saudi Arabia, attributable to **income arising or accruing <u>in India</u>** would be reduced for the purposes of computing the income on which tax is payable in India

Foreign Taxes Not Eligible for Credit

Deductibility of Foreign Tax (unavailed) under PGBP

Sec. 40(a): *Notwithstanding anything to the contrary in sec. 30 to 38, following amounts shall not be deducted….:*

(ii) ***any sum paid on account of any rate / tax levied*** *on profits / gains of any business / profession or assessed at a proportion of, or otherwise on the basis of, any such profits / gains*

*Expl.: …****any sum paid on account of any rate / tax levied*** *includes… any sum* ***eligible for relief*** *of tax under sec. 90 (or 90A) or, deduction under sec. 91.*

FTC in India – Certain Issues

- **Refund of Foreign Tax by RS**

  Art. 23B(1) **does not allow** refund - Digital Computers I. Ltd.

- **Tax protected contract**

  FTC is available in RS, even if tax liability in SS is discharged by payer in a tax-protected contract

- **Carry forward** of unabsorbed FTC – Not allowed

- FTC is available in RS, basis **provisional assessment** in SS – A.H.M Allauddin (Mad. HC)

Multiple sources, including loss

Particulars	F1	F2	F3	India	Total
Net Income from business	100	100	(90)	40	150
Tax rate	20%	10%	-	30%	
Tax paid outside India	20	10		-	-
Indian tax before FTC	**30**	**30**	**(27)**	**12**	**45**
FTC Allowed	**?**	**?**			

- What part of tax is attributable to the income taxed in SS?
- What part of income from F1, is included in Total Income?
- For the purpose of FTC, should the loss from F3 be set-off against Indian income, or in proportion in which income arises in F1 and F2 (or any other alternative)?

FTC in India – Certain Issues

- Mismatch periods: Varying taxing periods/practices
- **Income basis:** Varying basis of assessment / different domestic laws
- Source rules: **Conflict in determining source**
- Treaty abuse: Double-dipping, Treaty shopping – BEPS Action Plans have made recommendations for both
- Denial of tax credit: Resolution through MAP

Certain Issues on FTC

Carry Backward - Not allowed

- FTC leakage / loss due to **temporary differences** in RS – Unavailed FTC in initial years is not available for credit against tax liability in later years
- Certain countries, such as US, Germany, UK, Canada, Japan, Singapore have provisions to carry forward unutilised FTC

Landmark decisions

› **Krishak Bharati Cooperative Ltd. (Del. HC)**

- Dividend income from Company incorporated in Oman
- Tax credit allowed per Art. 8(bis) of F.Tax Laws r.w.s. 90 of Act
- PCIT issued SCN under sec. 263, considered:
  - Taxes not actually been paid / foregone on dividend income
  - Lapse of period for claiming Royal Decree of 2009
  - Term ‘Tax Incentive‘ is not defined
- Directed AO to **disallow FTC**, and **tax profits pertaining to undistributed dividend**

(Cont’d)

Landmark decisions

- **Krishak Bharati Cooperative Ltd. (Del. HC)**

  On appeal ITAT held:

  - FTC allowed (upheld by HC) as per IFRS 28 and Art. 25(4), read with **letter issued by Ministry of Finance of Oman**
  - PCIT cannot **travel beyond SCN** and issues covered by it
  - SC admitted revenue’s SLP against HC

Landmark decisions

- **Elitecore Technologies (Ahm.)**
  - FTC to be allowed **only to the extent of corresponding income** that suffers tax in India
  - It is not correct to take into account **gross receipts** for computing admissible tax credit
- **Bhavin A Shah (Ahm.)**
  - Where tax has been deducted at a rate higher than rate prescribed in DTAA, taxpayer can claim FTC **only upto the amount computed based on DTAA rates**

FTC of State Taxes

- **TCS (Mum.)**

  State tax is **not covered either under Indo-US or Indo-Canada DTAA**; hence, not eligible for any relief under sec. 90.

  Pertinently, sec. 90 does not provide for inclusion of tax levied by any State / local authority of that country within the expression 'income tax'.

  In view of the aforesaid, the AO is directed to verify whether the **State taxes paid overseas** are eligible for any relief under sec. 90 and if it is not found to be so, Assessee's claim of deduction under sec. 37 should be allowed.

Landmark decision

- **Wipro Ltd. (Kar. HC)**
  - State Taxes

    FTC of **'State Income Tax'** paid in SS, is to be allowed as a **unilateral** tax credit

  - Tax holiday under sec. 10A

    Income which is **eligible for a tax holiday**, **qualifies as *"income chargeable to tax"*.** Foreign taxes paid in respect of such income shall be eligible for FTC (if DTAA allows)

- SLP admitted by Hon'ble SC

FTC of State Taxes

Unilateral Tax Credit: Sec. 91

- *"(1) If any person who is resident in India in any PY proves that, in respect of his income which accrued / arose during that PY outside India (and which is not deemed to accrue / arise in India), he has* ***paid in any country with which there is no agreement u/s 90 for the relief / avoidance of double taxation*** *…*

- Explanation (iv)

  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.*

Landmark decision

- **Tata Sons Ltd. (Mum.)**
  - If one adopts a literal interpretation of sec. 91 (which is undisputedly more beneficial), it will result in a situation that an assessee will be worse off as a result of tax treaties
  - FTC provisions in Indo-US DTAA were less advantageous
  - In such view, it was held that the provisions of section 91 are to be treated as general in application
  - Even though the assessee was covered by India-US DTAA, so far as FTC w.r.t. taxes paid in those countries were concerned, the provisions of section 91, being beneficial, held the field

Q&A

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- Gaurav has an experience of 22+ yrs, specializing in Corporate and International Taxation. He has worked for 10+ years, with organizations such as BMR Associates, KPMG and Ernst & Young.
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- He is a regular speaker in various seminars organized by various forums such as IFA, ICAI, etc. He is frequently invited by companies and law firms, to train their employees on domestic and international taxation.