INCOME TAX TREATIES V. DOMESTIC LAW: AN INTERNATIONAL LOOK AT THE CURRENT SCORE

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Income tax treaties are said to promote international trade and investment, primarily by minimizing double taxation. Double taxation arises when more than one jurisdiction asserts taxing authority over the same income. Under an income tax treaty, double taxation may be eliminated or reduced in several ways. One important way is by allocating, to one of the contracting states, the sole authority to tax certain items of income by exempting the income from taxation in the other contracting state. For example, under an income tax treaty, a contracting state may exempt from taxation income of its residents that is sourced within the other contracting state and permitted to be taxed in that other contacting state on the basis of source.[1]

Another way that income tax treaties promote international trade and investment is by reducing or even eliminating source-based taxation. Many countries impose withholding taxes on investment income, such as interest and dividends, earned by nonresidents. Withholding taxes can be significant because they generally are applied on gross investment income, without an allowance for expense deductions.[2]

As the world's economies have become more connected, income tax treaties have become more prevalent and more important, especially for developing countries seeking to attract investment. At the same time, there are examples of contracting states reducing an income tax treaty's effectiveness at eliminating double taxation or source-based taxation through domestic law measures.

This article will describe three instances in which treaties are overridden by a country in order to preserve a power to tax that has not been clearly granted. The countries are the U.S., Brazil, and India.

- In the U.S., one of the most important ways that domestic tax law retains the power to impose tax on U.S. citizens is through the "saving clause" found in all U.S. income tax treaties. A recent U.S. Tax Court decision illustrates the application of the saving clause, which specifically allows the U.S. to impose tax in most instances, notwithstanding the existence of a treaty.
- In Brazil, a recent court ruling interpreted a presidential decree as overriding certain double taxation provisions in Brazil's income tax treaties.
- In India, a domestic tax, known as the Dividend Distribution Tax ("D.D.T."), effectively undermines the provisions in India's income tax treaties by providing for the reduction or elimination of source-based taxation on dividends.

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1 Richard Andersen, *Analysis of United States Income Tax Treaties*, (Thompson Reuters), para. 1.01.

2 *Id.*

THE LONG-ARM OF THE SAVING CLAUSE IN U.S. INCOME TAX TREATIES

The saving clause is a provision in U.S. income tax treaties that preserves – or "saves" – the right of each of the contracting states to tax its own citizens and residents as if the treaty does not exist. The saving clause in a treaty may include one or more exceptions to its scope. That is, certain treaty provisions are not subject to the saving clause. So, for example, the saving clause may not apply to the provision of the treaty that provides relief from double taxation, because to not exclude that provision from the saving clause would render the treaty meaningless. Other treaty provisions that are generally exempt from the saving clause are the article regarding the mutual agreement procedure (designed to provide a process for the resolution of international tax disputes) and articles applicable to certain individuals who are neither citizens nor permanent residents of a contracting state, such as Article 20 (Students and Trainees) or Article 27 (Diplomatic Agents and Consular Officers).[3]

The U.S.-Israel Income Tax Treaty (the "Israel Treaty"), like every U.S. income tax treaty, contains a saving clause. Article 6, paragraph 3 of the Israel Treaty includes the usual saving clause language, as follows:

> Notwithstanding any provisions of this Convention except paragraph (4), a Contracting State may tax its residents (as determined under Article 3 (Fiscal Residence)) and its citizens as if this Convention had not come into effect.

Recently, the saving clause in the Israel Treaty was the subject of litigation involving a U.S. citizen residing in Israel. The conflict was resolved by the U.S. Tax Court, which upheld the application of the saving clause. The parties in *Cole v. Commissioner*[4] submitted the case to the court for decision without trial. According to the facts stipulated in the summary opinion, the petitioner was a U.S. citizen who moved to Israel in 2009. As a result of the move, under local Israeli law, he was entitled to a ten-year "tax holiday,"[5] which provided an exemption from Israeli tax on non-Israeli-source capital gains.[6] When he moved to Israel, the petitioner held U.S. stock, which he later sold in 2010. The petitioner realized long-term capital gains of over $100,000. He reported the sale on his U.S. tax return but did not include it in his taxable income, offering the following explanation: "No tax should be administered on this transaction pursuant [sic] to treaties [sic] between the United States and taxpayers [sic] resident country (Israel)." The I.R.S. issued the taxpayer a notice of deficiency requiring that he pay U.S. tax on the capital gains.

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3 See the 1996 U.S. Model Treaty.

4 T.C. Summary Opinion 2016-22, 05/21/2016

5 Section 97(b) of the Israeli Income Tax Ordinance provides new immigrants and certain returning Israelis a ten-year tax holiday from Israeli tax, which would otherwise be imposed on foreign-source income.

6 The case also raises an interesting question that was not addressed by the court: If an Israeli resident is entitled to the ten-year tax holiday, is he/she a "person resident in Israel" for purposes of the Israeli Treaty? Paragraph 3 of the Exchange of Notes provides that this term is understood to refer to persons on whom Israel imposes tax on foreign-source income, pursuant to the Income Tax Ordinance, by virtue of their being Israeli citizens.

The petitioner claimed that Article 15 of the Israel Treaty provides that a resident of one of the contracting states shall be exempt from tax by the other contracting state on gains from the sale, exchange, or other disposition of capital assets. He further argued that disallowing the exemption pursuant to the saving clause is unreasonable because such treatment nullifies the capital gains exclusion under the Israel Treaty. The Tax Court disagreed and ruled that "the saving clause operates to deny certain treaty benefits to U.S. citizens and it is valid." The court explained that the saving clause does not nullify the Israel Treaty. Rather, it prevents certain provisions of the Israel Treaty from applying to citizens and residents of the contracting states. The court noted that the Israel Treaty provides that certain articles take precedence over the saving clause; however, exclusion for capital gains under Article 15, the subject of the litigation, is not among them. The court also stated that the Technical Explanation clearly provides that the saving clause is intended to apply to Article 15.

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BRAZIL'S TAX COURT APPLIES PRESIDENTIAL DECREE TO IMPOSE DOUBLE TAXATION ON PETROBRAS

In a recent Brazilian tax department appeals court ruling, Brazil's state oil company, Petrobras, lost an action involving taxation of profits from certain foreign subsidiaries located in the Netherlands and Argentina. The Brazilian tax authority asserted that Petrobras owed corporate income tax (at a rate of 25%) and social contribution tax (at a rate of 9%) on its profits from foreign subsidiaries, even though Brazil has income tax treaties with the Netherlands and Argentina that prevent Brazil from imposing tax on such profits.

The Brazilian court based its decision on a presidential decree issued in 2011, titled "MP 2158," which stated that "the profits earned by a firm controlled abroad are considered available for the controlling firm in Brazil on the date of the balance for which they were determined."

The *Petrobras* case stands in contrast to the case against Vale, the Brazilian mining multinational. The issue in *Vale* was the same as the issue in the recent Petrobras case. However, in *Petrobras*, the Brazilian tax authority did not argue for direct taxation of the subsidiaries' profits; the availability of foreign earnings merely served to increase Petrobras' value. The court agreed with the Brazilian tax authority, which argued that the taxation of overseas profits should be permitted at the time those profits are made available to the controlling company in Brazil. The court's ruling means that the presidential decree takes precedence over Brazil's income tax treaties, if a reasonable justification is possible.

INDIA'S DIVIDEND DISTRIBUTION TAX MAKES INCOME TAX TREATIES SEEM REDUNDANT

Prior to 1997, the Indian Income-tax Act, 1961 (the "I.T. Act") taxed shareholders on dividends distributed by an Indian corporation[7] at ordinary Indian tax rates. The

[7] Section 2(26) of the I.T. Act defines an Indian corporation as a company registered under the Indian corporate laws.

corporation withheld the tax on dividends, which was allowed as a credit against the shareholder's final tax liability. However, the Finance Act, 1997 brought about a significant transformation to the system of taxing dividends in India. It levied what is known as the D.D.T.[8] on Indian corporations paying dividends, and exempted shareholders from tax on dividends.

Though the D.D.T. is a tax imposed on an Indian corporation, it has the effect of being an indirect tax on the shareholders, since it is paid from the funds identified as dividends. In order to meet its D.D.T. liability, the corporation reduces the dividends payable to the shareholders. Thus, although the D.D.T. is statutorily paid by Indian corporations, the economic burden is borne by the shareholders. Further, unlike withholding taxes, shareholders are not entitled to a credit for the D.D.T., since the tax is paid by the Indian corporation.

The legislative history explained that the D.D.T. was introduced to simplify the tax collection mechanism. The government deemed it administratively convenient to collect tax at the level of the Indian corporation and to reduce paperwork associated with tax returns filed to claim a refund for tax withheld at source in excess of the final tax liability.

The D.D.T. is imposed at a statutory rate of 15%, increased by an applicable surcharge[9] and an "education cess."[10] In 2014, the D.D.T. computation method was amended, requiring Indian corporations to gross up the dividends for computing the D.D.T. by the 15% D.D.T. As a result of this gross up, the maximum effective D.D.T. rate is 20.358% on the amount of the dividend paid, declared, or distributed. The D.D.T. computation,[11] before and after the 2014 amendment, is illustrated in the following table:

	Net Basis	Gross Basis
Profit After Tax	INR 100	100
*D.D.T. at 15%**	$\frac{100 \times 17.304}{100} = 17.304$	$\frac{100 \times 17.304}{85} = 20.358$
Effective D.D.T. Rate	17.304%	20.358%
Dividends Available to Stockholder	INR 82.696	INR 79.642

**Surcharge at 12% and Education Cess at 3%*

8 Section 115-O of the I.T. Act.

9 The surcharge is imposed at 7%, if the taxable income of the Indian corporation exceeds INR 10 million and 12%, if the taxable income of the Indian corporation exceeds INR 100 million.

10 The education cess is chargeable at a flat rate of 3% on the D.D.T. and the applicable surcharge.

11 For the purpose of the calculations, it has been assumed that surcharge is applicable at 12%.

The introduction of the D.D.T. may have reduced certain administrative inconveniences to the Indian tax authorities, but it has resulted in a unique problem in a cross-border setting where the recipient of the dividend is a foreign investor.

The I.T. Act provides that for the purpose of computing taxable income of a nonresident to whom an Indian income tax treaty applies, the provisions of the I.T. Act shall only be applicable if the provisions are more beneficial to the taxpayer. In other words, the taxpayer may elect to be governed by either the Indian income tax treaty or the I.T. Act, whichever results in a lower income tax liability.

Generally, an Indian income tax treaty will provide for a lower withholding tax rate on dividends. Thus, absent the D.D.T., if dividends were taxable in hands of the shareholder under the I.T. Act, a foreign investor from a country with an income tax treaty with India could access certain benefits. First, a lower tax rate on dividends may be available under an Indian income tax treaty (generally 10% or 25%). Second, the foreign taxpayer may be entitled to a credit, for the Indian taxes, against a tax liability in the home country.[12]

However, since the enactment of the D.D.T., the tax on dividends is imposed on the Indian corporation, not on the shareholder. Thus, treaty rates for dividend withholding tax cannot be applied. As a result, the foreign investor suffers an income tax on dividends at a rate of 20.358%, as shown in the table above. Thus, whether or not it was the intention of the Indian government, the domestic D.D.T. provisions have an unfavorable effect of overriding the Indian income tax treaties. Moreover, the D.D.T. provisions are actually detrimental to foreign investors – not only because they are unable to benefit from a lower tax rate under a treaty, but also because, more often than not, they are unable to claim a tax credit for the D.D.T. against a tax liability in the home country.

One can argue that despite the existence of Indian income tax treaties, which provide for lower withholding tax rates on dividends, the Indian government has found a way around the treaty provisions, indirectly taxing foreign investors at a higher rate by imposing D.D.T. on Indian corporations.

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[12] Foreign investors were at par, or in beneficial tax position, when the D.D.T. was originally introduced under the I.T. Act since at that time the D.D.T. rate was only 10%, which was equal to or less than the withholding tax rates for dividends under most Indian income tax treaties.