International Journal of Advanced Research in Commerce, Management & Social Science (IJARCMSS)
ISSN :2581-7930, Impact Factor : 7.270, Volume 08, No. 01(I), January-March, 2025, pp 89-94

INTEREST INCOME AND INTERNATIONAL TAXATION: PERSPECTIVES FROM INDIA'S JUDICIAL SYSTEM

Dr. Naveen Mittal*

ABSTRACT

Taxation of interest income by a resident of one country from investments in India requires the application of Article 11 of the Organisation for Economic Co-operation and Development Model Convention (OECD MC) 2017 as well as the United Nations Model Convention (UN MC) 2021 and the domestic provisions of the Income-tax Act, 1961, India. This article looks at the Indian judicial system's view of Article 11 of the OECD MC and the UN MC. It concludes that the Indian judicial system has sided with the assessees by giving them the benefit under sub-section (2) of Section 90 of the Income-tax Act, 1961. This section says that taxpayers and assessees can use either the provisions of the Double Taxation Avoidance Agreement (DTAA) or the provisions of the Income-tax Act, 1961, India, whichever is better for them. Peoplewho were resident in a country other than India and earned interest from the source in India were taxed at the rate set out in their DTAAs instead of the rate required by the Income-tax Act, 1961, India. This article looks at some cases where this happened.

***KEYWORDS**: Article, Court, Judgement, Tax, The Income-Tax Act, 1961, OECD MC, and UN MC.*

Introduction

Taxation of interest income by a resident of one country from investments in another country requires the understanding of domestic direct tax law provisions as well as the Double Taxation Avoidance Agreement (DTAA) treaty between the concerned countries. Article 11[1] of the Organisation for Economic Co-operation and Development Model Convention (OECD MC) 2017, as well as the United Nations Model Convention (UN MC) 2021, deals with “Interest”. As per Paragraph 1 of Article 11of both the Model Conventions, “Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.”. However, Paragraph 2 of Article 11 of both the Model Conventions also gives the taxing rights of interest income to the resident of the interest-paying country but puts a restriction on the maximum amount of tax charged on such interest income. This limit is 10% as per OECD MC or any other percent as agreed by the countries signing the DTAA as per the UN MC. Section90(2)[2] of the ITA 1961 (IND)[3] is a beneficial provision for the assessees who are earning

* Associate Professor, Department of Commerce, Shri Ram College of Commerce, University of Delhi, Delhi, India.

1 Available at https://www.oecd.org/en/publications/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en.html and https://financing.desa.un.org/sites/default/files/2023-05/UN%20Model_2021.pdf

2 The Income-tax Act, 1961, No. 43 of 1961 (IND), s. 90:

“ Agreement with foreign countries or specified territories.

90. (1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India,—

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

income outside India. This section allows the assessees to apply the provisions of the ITA 1961 (IND)[1] or the DTAA, whichever is more beneficial to them.

This article analyses the viewpoint of the Indian judicial system on the income from interest earned by a resident of any country (other than India) from the source/investment that is made in India.

Exploring Indian Jurisprudence: Key Judgments on Article 11

This section discusses the judgments given regarding the applicability of tax rates on the interest income earned. The first part discusses the cases where it has been ruled that the interest income is to be taxed as per the rates mentioned in the DTAA and not as per the provisions of the ITA 1961 (IND). The second part discusses the case where it has been ruled that some interest income is to be taxed as per the rates mentioned in the DTAA while some is to be taxed as per the provisions of the ITA 1961 (IND).

Part 1: Interest income is to be taxable as per the tax rates mentioned in the DTAA

The following cases are covered under this part:

- *Adobe Systems Software Ireland Ltd. vs. ACIT (International Taxation) (2023) – Country involved in Ireland*

Adobe Systems Software Ireland Ltd. vs. ACIT (International Taxation)[2](2023) case, heard by the Income Tax Appellate Tribunal (ITAT) Delhi, concerns a tax resident of Ireland that had earned an interest income on an income-tax refund from the Government of India that was taxed at a different rate by the Assessing Officer (AO) than the rate at which the assessee was willing to pay the tax.

The AO taxed the said interest income @ 40% *plus* surcharge *plus*cess as per the provisions of the ITA 1961 (IND).

The assessee argued that charging the tax on such interest income @ 40% by the AO as per the provisions of the ITA 1961 (IND) is not correct. As per the assessee, tax on such interest income is to be charged @ 10% as per the provisions of Article 11(2)[3] of the India-Ireland DTAA.

On an appeal by the assessee, the CIT (Appeals)[4] directed the AO to verify the claim of the treaty benefits made by the assessee and allow the claim of taxing the interest income accordingly. The AO, however, had passed the final assessment order under section 143(3)[5] of the ITA 1961 (IND) and taxed such interest income @ 40% as per the provisions of the said Act.

(*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

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, without creating opportunities for non- taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory), or

(c) …….

(d) …….

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.

(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.

(3) Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf." available at: https://incometaxindia.gov.in/pages/acts/income-tax-act.aspx

3 The Income-tax Act, 1961, No. 43 of 1961 (IND).

1 ITA 1961 (IND), above fn. 3.

2 [2023] 155 taxmann.com 397 (Delhi - Trib.)[12-10-2023]

3 Para 2 of Article 11 of the India-Ireland DTAA states:

"2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation." available at https://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx

4 Commissioner of Income-tax (Appeals) appointed under s. 117(1) of the ITA 1961 (IND), above fn. 3.

5 ITA 1961 (IND), above fn. 3, s. 143:

" Assessment.

143.(1) ……

The ITAT relied upon the provisions of Article 11 of the India-Ireland DTAA and finally held that "It is an undisputed fact that the assessee is a tax resident of Ireland and hence can opt to be governed by the provisions of the India-Ireland DTAA, if more beneficial to it. The taxability of interest income earned by a tax resident of Ireland is dealt with by Article 11 of the India-Ireland DTAA which *inter alia,* provides that interest arising in India and paid to a resident in Ireland maybe taxed in India, but the tax so charged shall not exceed 10% of the gross amount of the interest.". It also held that "It is a well settled position of the law that the provision of the tax treaty shall take precedence over the Act to the extent they are more beneficial to the tax payer. By virtue of the provisions of section 90(2) of the Act, the provisions of the Act are sub-servient to the provisions of the tax treaty entered into by India with various countries.". The ITAT finally ruled that the assessee is rightly entitled to the beneficial rate of tax of 10% on the said interest income as per the provisions of Article 11(2) of the India-Ireland DTAA. The case went in favor of the assessee.

- *Shanmugam Ravi vs. DCIT(2024) – Country involved is New Zealand*

Shanmugam Ravi vs. DCIT[1]*(2024) case,* heard by the ITAT Bangalore, concerns a tax resident of New Zealand who earned interest income from India.

The AO taxed the interest income earned by the assessee as per the slab rates provided under the ITA 1961 (IND) and not as per the lower tax rates provided under the India-New Zealand DTAA. As per the assessee, the basis on which the AO had denied the beneficial rate of 10% tax on interest income of the assessee was his Indian citizenship and that the sources of funds for investment and deposit were of Indian origin.

The assessee argued that he was a tax resident of New Zealand and therefore his global income was taxable in New Zealand. The assessee also argued that as per Article 11(2)[2] of the India-New Zealand DTAA, the interest income earned by him may be taxed in India but subject to a maximum tax rate of 10%. As per the assessee, " ..... on a plain reading of the provisions of section 90(2) of the Act and the relevant DTAA between India-New Zealand, neither the Act nor the DTAA prescribe such preconditions for availing the benefit of the lower tax rates. Further, as per the provisions of section 90(2) of the Act, if the Central Government of India has entered into an agreement with the Government of any other country in which the assessee is Resident, the income earned in India shall be taxable as per Indian tax laws or as per DTAA whichever is more beneficial to the assessee.".

Another relevant argument of the assessee was " .... that Article 11 of DTAA between India-New Zealand states that the interest income earned in India by a Resident of New Zealand may be taxed in New Zealand. However, such interest income may also be taxed in India according to Indian Tax Laws, but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed 10% of the gross amount of the interest. Accordingly, the assessee had disclosed the interest income earned in India amounting to Rs.4,87,50,072/- in Indian income tax return by applying the rate of 10% as per DTAA since the provisions of DTAA were more beneficial to the assessee. However, the learned assessing officer rejected the rate of 10% by stating that the assessee is not eligible for claiming the benefits of DTAA as the assessee has not included any income earned in India in the income tax return filed in foreign jurisdiction which is not correct on the facts of the case.".

(1A) ……..
(1B) …….
(1C) …….
(1D) ……
(2) ……..
(3)On the day specified in the notice issued under] sub-section (2), or as soon afterwards as may be, after hearing such evidence as the assessee may produce and such other evidence as the Assessing Officer may require on specified points, and after taking into account all relevant material which he has gathered, the Assessing Officer shall, by an order in writing, make an assessment of the total income or loss of the assessee, and determine the sum payable by him or refund of any amount due to him on the basis of such assessment:]
…….."

[1] [2024] 164 taxmann.com 122 (Bangalore - Trib.)[25-06-2024]

[2] Para 2 of Article 11 of the India-New Zealand DTAA states:
"2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting State shall by mutual agreement settle the mode of application of this limitation." available at https://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx

The assessee also contended that " ..... as long as a person is a resident of contracting state which attracts residence type taxation, the status of being a Resident of the contracting state is independent of the actual levy of tax on that person by that state. Therefore, taxability in one country is not sine qua non for availing relief under the DTAA from taxability in another country.".

The assessee submitted that he was a "Transitional Tax Resident" of New Zealand for the relevant year, and as per the tax laws of New Zealand, such interest income earned by such a resident was eligible for exemption in New Zealand for 4 years, and because of this exemption, the interest income was not shown in the income tax return filed by him in New Zealand.

The ITAT ruled that "the assessee is a non-resident of India and resident of New Zealand and assessee's global income is taxable in New Zealand. As per the Article 11 of DTAA between India and New Zealand income earned by the assessee being a resident of New Zealand may be taxed subject to at a maximum rate of 10%. Admittedly, DTAA has overriding effect over the Income Tax Act. The department is denying the benefit of lower rate of tax as per Article 11 of DTAA on the reason that assessee's income is not subject to tax in New Zealand. It is to be noted that this income is not taxable in New Zealand as the New Zealand has given a benefit to the assessee of temporary exemption for a period of 4 years being the transactional tax recipient. Thus, it was not taxable in New Zealand. Because it was not taxable in New Zealand, the assessee is not disentitled to take the benefit of Article 11 of DTAA, which is the beneficial provision and it would be granted and the rate of the tax to be applied in respect of business income in accordance with Article 11 of DTAA.".

Thus, the tax on such interest income earned by the assessee is taxable @ 10% as per Article 11(2)[1] of the India-New Zealand DTAA. The case went in favor of the assessee.

- *Little Fairy Ltd. Vs. ACIT, International Tax (2023) – Country involved is Cyprus*

Little Fairy Ltd. Vs. ACIT, International Tax[2](2024) case, heard by the ITAT Delhi, concerns a tax resident of Cyprus (a wholly owned subsidiary of a Mauritius-based company) that had earned interest income from Compulsorily Convertible Debentures (CCDs) of an Indian company.

The AO noted that there was hardly any other activity being performed by the assessee at Cyprus. As per the AO, the assessee company was merely a conduit for channelizing the interest funds. Because of this reason, the AO denied the benefit of applicability of Circular 789[3] dated 13.04.2000, which was in the context of the India-Cyprus DTAA, and held that the assessee company was not at all the beneficial owner of interest income earned by it on CCDs issued by the concerned Indian company, but actually the Mauritius company was the beneficial owner of interest income. On this basis, the AO taxed the said interest income at the domestic tax rate of 40% rather than the tax rate of 10% as provided under Article 11(2)[4] of the India-Cyprus DTAA. On appeal, the CIT (Appeals) confirmed the order passed by the AO.

---

1 Para 2 of Article 11 of the India-New Zealand DTAA, above fn. 10.

2 [2024] 162 taxmann.com 766 (Delhi - Trib.)[15-05-2024]

3 Circular No. 789 dated 13-4-2000 under the Income Tax Act, 1961, India, states that:

" CLARIFICATION REGARDING TAXATION OF INCOME FROM DIVIDENDS AND CAPITAL GAINS UNDER THE INDO-MAURITIUS DOUBLE TAX AVOIDANCE CONVENTION (DTAC)

1. The provisions of the Indo-Mauritius DTAC of 1983 apply to 'residents' of both India and Mauritius. Article 4 of the DTAC defines a resident of one State to mean "any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature." Foreign Institutional Investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are 'liable to tax' under the Mauritius Tax law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC.

2. Prior to 1-6-1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend paid out at the rate of 5% or 15% depending upon the extent of shareholding of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A, etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.

3. The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs, etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13." available at https://incometaxindia.gov.in/Pages/communications/circulars.aspx

4 Para 2 of Article 11 of the India-Cyprus DTAA states:

"2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the interest." available at https://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx

The assessee, however, said that " ..... it would be entitled for the benefit provided inIndia-Cyprus DTAA. The assessee had determined the taxability of the interest income arising in India to a resident of Cyprus to be taxed in India at the rate of 10 per cent of the gross amount of interest if the beneficial owner of the interest income is a resident of Cyprus.".

The ITAT held that it is a well-settled principle that shareholders of a company are distinct and separate from each other. Further, in the present case, the beneficial Mauritius-based shareholder of the assessee company is not getting any rights over the assets of the assessee. Hence, the contention of the AO that the Mauritius-based beneficial shareholder is also the beneficial owner of assets/investments in CCDs held by the assessee company is not sustainable. The ITAT thus, held that " ..... the assessee is indeed the beneficial owner of such interest income and as per Article 11(2) of India-Cyprus treaty, the same would be taxed in India at the rate of 10 per cent as all the conditions stipulated in Article 11(2) are complied with. It is found that the Assessing Officer had denied this benefit to the assessee. It is found that the Assessing Officer had denied the benefit of applicability of Circular 789 dated 13-4-2000 in the context of India-Mauritius Treaty to the facts of the instant case. In this regard, the Assessing Officer stated that the Circular 789 was only regarding India-Mauritius DTAA and the Supreme Court in the case of Union of India v. Azadi Bachao Andolan [2003]132 Taxman 373/263 ITR 706 had decided the issue in the same context, and accordingly, the benefit of the India-Mauritius Treaty cannot be made applicable to India-Cyprus Treaty. The assessee placed reliance on the decision of the coordinate bench decision of Mumbai Tribunal in the case ADIT (International Taxation) v. Universal International Music B.V. [2011] 10 taxmann.com 29/45 SOT 219, wherein, it was held that the tax residency certificate issued by the tax authority of Netherland is sufficient evidence of the beneficial ownership as per Circular No. 789 dated 13-4-2000. This ruling of the Mumbai Tribunal was confirmed by the Bombay High Court which is DIT (IT) v. Universal International Music B.V. [2013] 31taxmann.com 223/214 Taxman 19, wherein it was held that the assessee which is incorporated under the laws of Netherland and being beneficial owner of royalty receipts in respect of music tracks given to Indian companies would be entitled to benefit of concessional rate of tax provided under Article 12 of India-Netherland DTAA. Hence, the objection made by the Assessing Officer in respect of this issue is not sustainable.".

The ITAT also found that the allegations of the assessing officer that the assessee company of Cyprus didn't do anything to carry out the business are also not sustainable in the eyes of the law. In this regard, the ITAT said that the assessee company had already made an investment in CCDs of an Indian company in its own name and that too through proper banking channels. Such an investment would fetch either interest or capital gain to the assessee, and therefore, there was not at all any need to undertake any other business activity, which normally is being done in the case of manufacturing or trading companies.

The ITAT finally concluded that " ..... it is held that the assessee is tax resident of Cyprus and has complete right to receive the interest income on CCDs and that there is no compulsion or contractual obligation to simultaneously pass on the same to another entity. The foreign currency risk as well as counter party risk in relation to the interest income was completely borne by the assessee herein. All these facts categorically go to prove that the assessee is indeed the beneficial owner of the interest income on CCDs from the Indian entity. When itis held to be beneficial owner of the income, it is entitled for the taxability at a concessional rate as provided under Article 11(2) of India-Cyprus Treaty. Hence, the action of the Assessing Officer in taxing the interest income at the rate of 40 per cent as per domestic law by denying the treaty benefit is not upheld and same is hereby reversed.".

Thus, the interest income on CCDs earned by the Cyprus resident in the present case would be taxed at 10% as per Article 11(2) of the India-Cyprus DTAA.

Part 2: Excess interest is taxable as per the provisions of the Income-tax Act, 1961, and not as per the DTAA

The following case is covered under this part:

- *Fairfield Developments Ltd. Vs. DCIT (International Taxation) (2023) – Country involved is Cyprus*
- *Fairfield Developments Ltd. Vs. DCIT (International Taxation)*[1] *(2023) case,* heard by the ITAT (Hyderabad), concerns a company incorporated in Cyprus, which had received interest income

[1] [2023] 152 taxmann.com 91 (Hyderabad - Trib.) [25-04-2023]

on investments made in the form of Fully Completely Convertible Debentures (FCDs) in its subsidiary in India.

The AO had taxed the interest income received by the assessee @ 40%, as per the provisions of Article 11(7)[1] of the India-Cyprus DTAA. Being the transactions of interest between Associated Enterprises, the case was referred to the Transfer Pricing Officer (TPO), who made the Transfer Pricing (TP) adjustment. The AO pointed out that as per the provisions of Article 11(7)[2] of the India-Cyprus DTAA, the special rate of tax will not be applicable to the excess interest paid if the interest is not paid at the ALP, and thus, the excess interest was to be paid at the normal rates prescribed under the Income-tax Act, 1961. The CIT (Appeals) found the assessment of AO taxing the interest income @ 40% as per the provisions of Article 11(7)[3] of the India-Cyprus DTAA correct.

The assessee wanted its interest income to be taxed at 10% as per the provisions of Article 11(2)[4] of the India-Cyprus DTAA. The authorized representative of the assessee also contended before the ITAT that "..... only the interest as computed is required to be charged @10%and the remaining interest, if any, can be charged under the business head, if permissible under law. It was submitted that since no specific finding is given by the lower authorities, the action on the part of the ld.CIT(A) is not in accordance with the law.".

The ITAT after hearing the arguments, finally held that "In our view, the conjoint reading of Clauses 2 and 7 of Article 11 of DTAA made it abundantly clear that interest paid over and above the interest mentioned in clause 7 of Article 11 of DTAA, shall be chargeable at Income-tax rate as applicable in Contracting State namely, India, as mentioned in Article 11(7) of DTAA.".

The ITAT further held that "During the course of argument, the ld. AR had vaguely argued that excess amount of the interest paid/received by the assessee shall be chargeable under the head "Income from business" and thereafter, it may be taxed under the other provisions of DTAA. In our view, the Assessing Officer/ld. CIT(A) cannot be changed the characteristics of "head of income" when the assessee itself has admitted that the amount received by it was in the nature of interest only and hence, it would be improper either on the part of the Assessing Officer or the assessee to change or recharacterize the amount received by it as 'business income' within the meaning of DTAA. Once the assessee itself admits that the amounts received by it on the FCCDs were in the nature of "Interest income", then the same cannot be converted into "income from business" and therefore, the submissions of the ld. AR are without any basis and hence, the same are rejected.".

The case went in favor of the department.

Conclusion

The above decisions given by different Benches of the Income Tax Appellate Tribunal (ITAT) in India related to the application of Article 11 of the OECD MC and UN MC, i.e., Interest reaffirm the importance of understanding the relationship between domestic tax legislation [i.e., The Income-tax Act, 1961] and DTAAs when calculating the tax rate applicable on interest income earned by a resident of any country (other than India) from an investment/source that is in India. Based on the analysis of the above ruling, the author is of the opinion that the rulings are in favor of taxing such interest income at a rate mentioned in Article 11(2) of the DTAAs rather than the rates given in the ITA 1961 (IND). Further, the tax rates on such interest income under Article 11(2) of the DTAAs are less than the tax rates on such interest income provided under the ITA 1961 (IND).

❑❑❑

[1] Para 7 of Article 11 of the India-Cyprus DTAA states:
"7. 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, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Agreement." available at https://incometaxindia.gov.in/Pages/communications/circulars.aspx

[2] Para 7 of Article 11 of the India-Cyprus DTAA, above fn. 16.

[3] Para 7 of Article 11 of the India-Cyprus DTAA, above fn. 16.

[4] Para 2 of Article 11 of the India-Cyprus DTAA, above fn. 14.