Double Tax Avoidance Agreements

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Principles

- It only resolves juridical double taxation
  - Economic double taxation continues
- Treaty is basically negotiated document
  - Whereby two government agree on modality to share the taxing rights
- In India, force of treaty flows from the Constitution
  - Section 90 / 90A are only implementing Regulations
  - If the treaty has been ratified, it can be used by taxpayer even if it is not notified
    - Notification of treaty is only for public knowledge and not to make it enforceable

Principles

- Each country negotiates treaty based on their tax framework
  - This leads to peculiarities in Tax Treaties
- Active Income v. Passive income
  - Fees for Technical Services
- Source v. Residence
  - Taxation of Royalties
- Mode of relieving Double Taxation
  - Exemption v. credit methodology
- Treaty can only provide relief
  - It cannot enhance tax liability

Article 1 - Resident

- Treaties apply to persons who are residents of one or both the countries
  - Person must be resident of at least one country to invoke treaty
    - Exception: Non Discrimination Article 24(1)
- Example
  - Payment of interest to Singapore Branch of Citibank NA
- Treaty can be invoked by Resident in their own country
  - India's old treaties do provide residence country exemption

Article 2: Taxes Covered

- Generally, income tax is covered
- In certain treaties wealth tax is also covered
- Taxes which are substantially similar are also covered
  - Surcharge and education cess is covered based on this
- Taxes which are levied in substitution of existing taxes, would also be covered
  - Whether DDT covered?
    - Arguable but no precedence available
- India – US DTAA does not cover state taxes
- Relief from R&D Cess
  - India – Netherlands through MFN
  - India – France through MFN

Article 3: Definitions

- Company
  - Any body corporate or any entity that is treated as a body corporate for tax purposes
  - Limited Liability Partnership?
- National
  - Individual possessing nationality or citizenship
  - Any legal person, partnership or association deriving its status as such from the laws in force

Article 3: Definition

- Definition of country very important
  - Northern Ireland is covered in India – UK DTAA
    - And not under India – Ireland DTAA
  - India – China DTAA does not cover Hong Kong
  - India – US DTAA does not cover Peurto Rico, Virgin Island, Guam, etc.

Article 4: Residence

- Resident
  - Person who is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of similar nature
  - It does not include person who is liable to tax in the country only in respect of income sourced in that country
    - Resident but Not Ordinarily Resident
- Dual Residency
  - Tie breaker rule in case of Individuals
  - PoEM in case of companies
- Pass-through entities
  - India’s reservations to OECD Commentary

Article 4: Residence

- India – US DTAA
  - US Citizen
    - No DTAA Relief
  - Dual resident Company
    - No DTAA Relief
  - US LLP
    - Pass-through but covered as Resident
  - US LLC
    - Pass-through
- India – UAE
  - Individual
    - Presence Test
  - Company
    - Control & Management Test

Article 5: Permanent Establishment

- Fixed Place PE
  - Permanency Test (more than 6 months)
  - Disposal Test
  - Business Activity Test
- Other items of PE specifically mentioned in Article 5(2) / 5(3) are regarded as PE
  - Controversy over Article 5(2) is subsidiary to 5(1) or independent
- Construction PE
  - Generally based on period for which project continues but multiple variations found
- Supervision PE
  - Generally based on sun-days threshold but multiple variations found

Article 5: Permanent Establishment

- Service PE
  - Rendering of service exceeding period threshold
  - Period threshold may be low in case where services are provided to AE
    - 1 day in case of India – US DTAA
    - 30 days in case of India – UK DTAA
- Dependent Agent PE
- Subsidiary is not PE

Article 7: Business Profits

- Items covered by Article 7 only if not covered by other specific article dealing with such income
- Only profits attributable to PE are taxable
  - Force of Attraction Rule may tax other income as well
    - US, UK, Belgium DTAA does provide Force of Attraction Rule
    - Explanation to Section 9(1)(i) may help
- Section 44C limits not applicable unless specifically provided for in DTAA
  - India – UAE DTAA before amendment

Article 7: Business Profits

- At times, DTAA provides that services fees paid to HO is not deductible
  - Such restriction is not found in the Income Tax Act
  - It is arguable that such expenses (e.g. technical service fees, etc.) be allowed as deduction
    - Circular 649 dated 31-3-1993

Article 9: Associated Enterprises

- Definition of Associated Enterprises much narrower as compared to Section 92A
  - Enterprises directly or indirectly participating in capital, control or management
- Deemed Transactions u/s. 92A
  - Guaranteeing more than 10% of borrowings
  - Granting loan of more than 50% of assets
  - More than 90% raw materials from a particular supplier
- Can be argued that they may not be governed by TP Regulations
  - However, this is not yet tested
  - Participation in ‘control’ may be argued to cover such cases

Article 9: Associated Enterprises

- Corresponding adjustment
  - Available where DTAA specifically provides that
    - India's many treaty provides such adjustment
    - India – Japan, India – US, India – UK, etc.
  - It can be made only upon invoking MAP
    - It requires the other country to make corresponding adjustment
    - But India would not provide corresponding adjustment in AE's Return

Article 10: Dividends

- India generally grants taxing right to both countries
  - With restriction on taxing right with source country
  - Lower tax rate apply in source country where dividend relates to portfolio investment
- However, certain old treaties grant taxing right exclusively to country of residence
  - E.g. Greece, Egypt, etc.
- Not applicable if attributable to PE in India

Article 10: Dividends

- Whether DDT is governed by the restrictions placed in Article 10(2)?
  - In my view, it is arguable case
  - India – Hungary DTAA Protocol
  - India – South Africa DTAA
    - Secondary Tax on Companies covered
  - Decision in case of Demler Chrystler (SA)

Article 11: Interest

- India generally grants taxing right to both countries
  - With restriction on taxing right with source country
  - Lower tax rate apply in source country to interest derived by certain organizations / banks
- Not applicable if attributable to PE in India
  - Indian branches of foreign Banks
- Deeming fiction larger than ITA
  - Interest paid on loans taken for foreign project
  - ITA may be beneficial and therefore treaty should not be invoked

Article 11: Interest

- Section 194LC would substantially ease reliance on DTAA
  - However, PAN & TRC would be required
    - Relaxation of PAN is only with respect to Bonds and not Loans
- Interest on Capital to NRI Partner
  - Whether covered?

Article 12: Royalties

- OECD Model grants exclusive rights to country of residence
  - UN follows tax sharing model
- India follows tax sharing model
  - Source country reserves right to tax at determined %
- Definition of royalty under DTAA could be substantially narrower as compared to ITA
  - Computer software not included
    - In such case, despite amendment in Section 9 for royalty, off the shelf computer software may not be liable to tax in India
  - Equipment rentals not included

Fees for Technical Services

- OECD does not have this Article
  - It treats along with Business Profits
- Mostly found in Indian / developing countries' treaties
  - Treats it as passive income and tax it on gross basis
- Developed countries did not accept the proposition
  - Negotiations with US were dragged on account of FTS
  - Finally, US came out with 'make available' concept
    - However, generally such treaties also provide for Service PE concept
  - Cross-referencing of PE and FTS

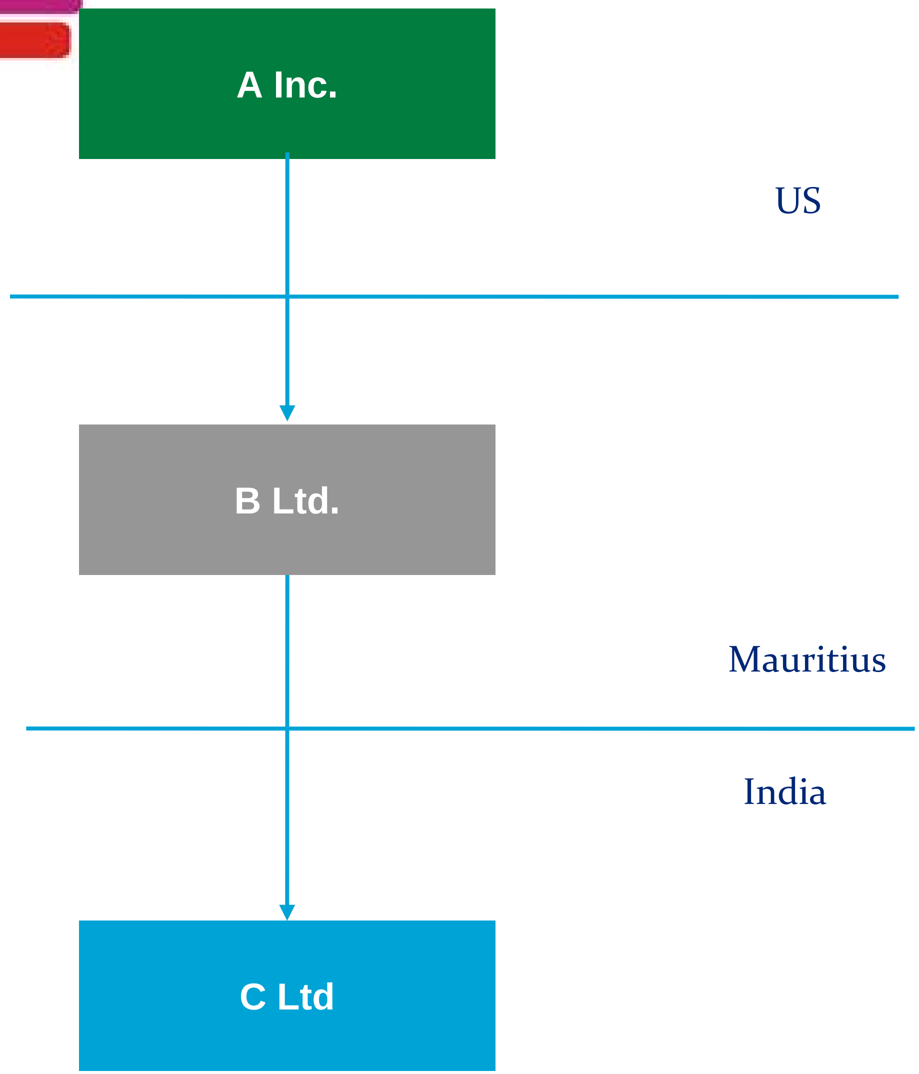
Fees for Technical Services

Variations	Indian DTAAs (examples)
FTS as per ITA	Austria, Germany, Denmark, Ireland, Brazil, China, Japan, Kenya, Korea, Malaysia, Mexico, Luxembourg, Norway, Poland, Russia, South Africa,
Make Available	Australia, Canada, Cyprus, US, UK, Netherland, Singapore, Portugal
Make Available through MFN	Belgium, France, Hungary, Israel, Kazakhstan, Spain, Sweden
No FTS clause	Bangladesh, Greece, Mauritius, Nepal, Mozambique, Myanmar, Philippines, Saudi Arabia, Sri Lanka, Syria, Tajikistan, Thailand, UAE, Egypt
through Protocol	Brazil
through Royalty definition	Australia
through Professional Services	Kenya

Article 13: Capital Gains

- OECD Model grants right of taxing gains on shares to the country of residence
  - Most of Indian treaties grant the right to tax capital gains on shares to both countries
    - Exceptions: Mauritius, Cyprus, Singapore (with Protocol), Greece, Egypt, Poland (current treaty)
  - US, UK DTAA does not grant any relief in respect of capital gains

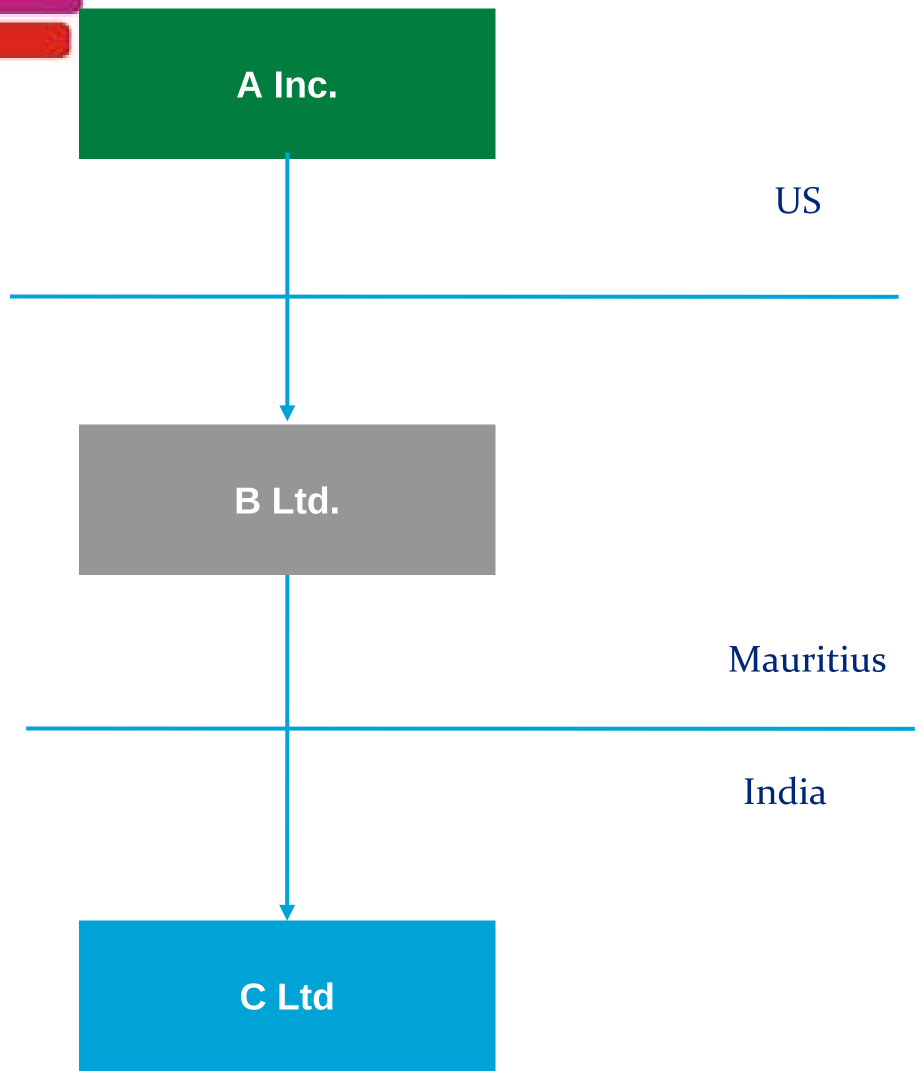
Capital Gains on Indirect Transfer



- A Inc. holds 100% shares of B Ltd and in turn B Ltd holds 100% shares of Indian Company, C Ltd.
- A Inc. transfers share of B Ltd.

Tax Implications?

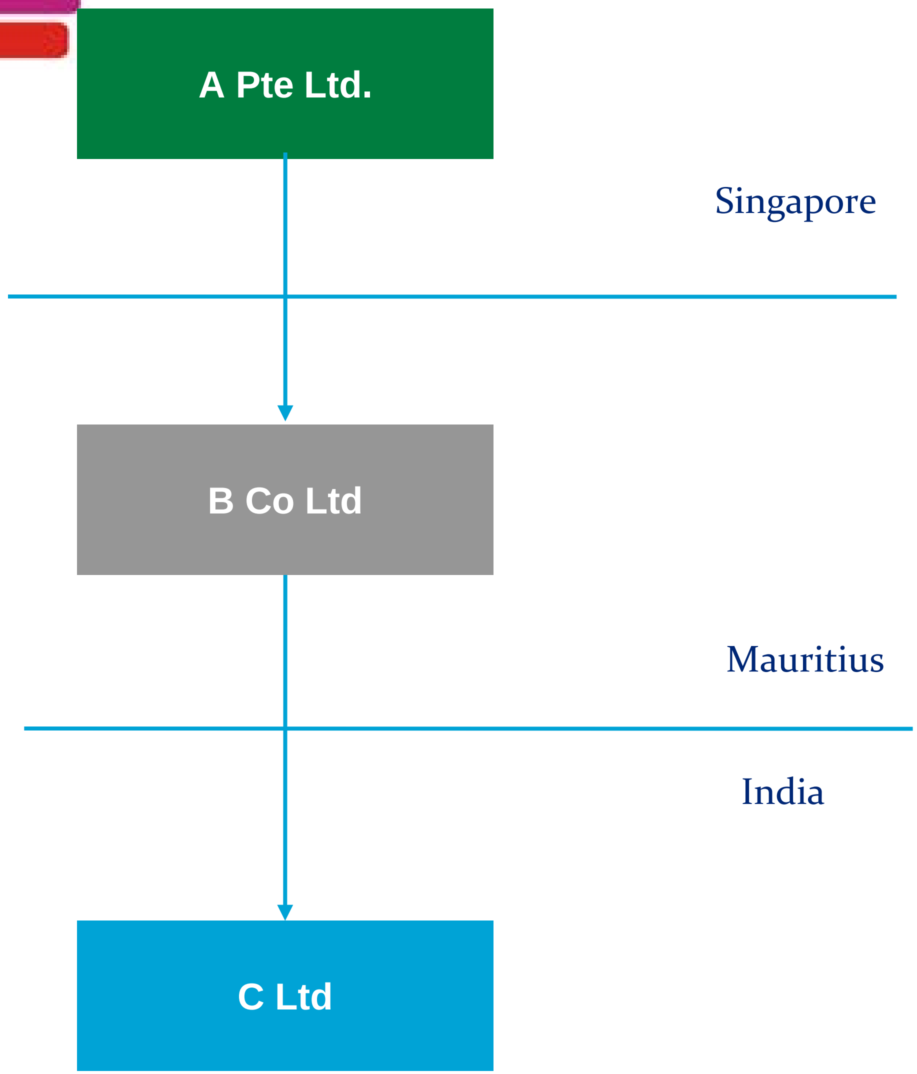
Article 10: Dividends



- A Inc. holds 100% shares of B Ltd and in turn B Ltd holds 100% shares of Indian Company, C Ltd.
- C Ltd pays dividend of INR 100 million to B Ltd. and pays DDT
- B Ltd in turn also distributes dividend of INR 100 million to A Inc.

Tax Implications?

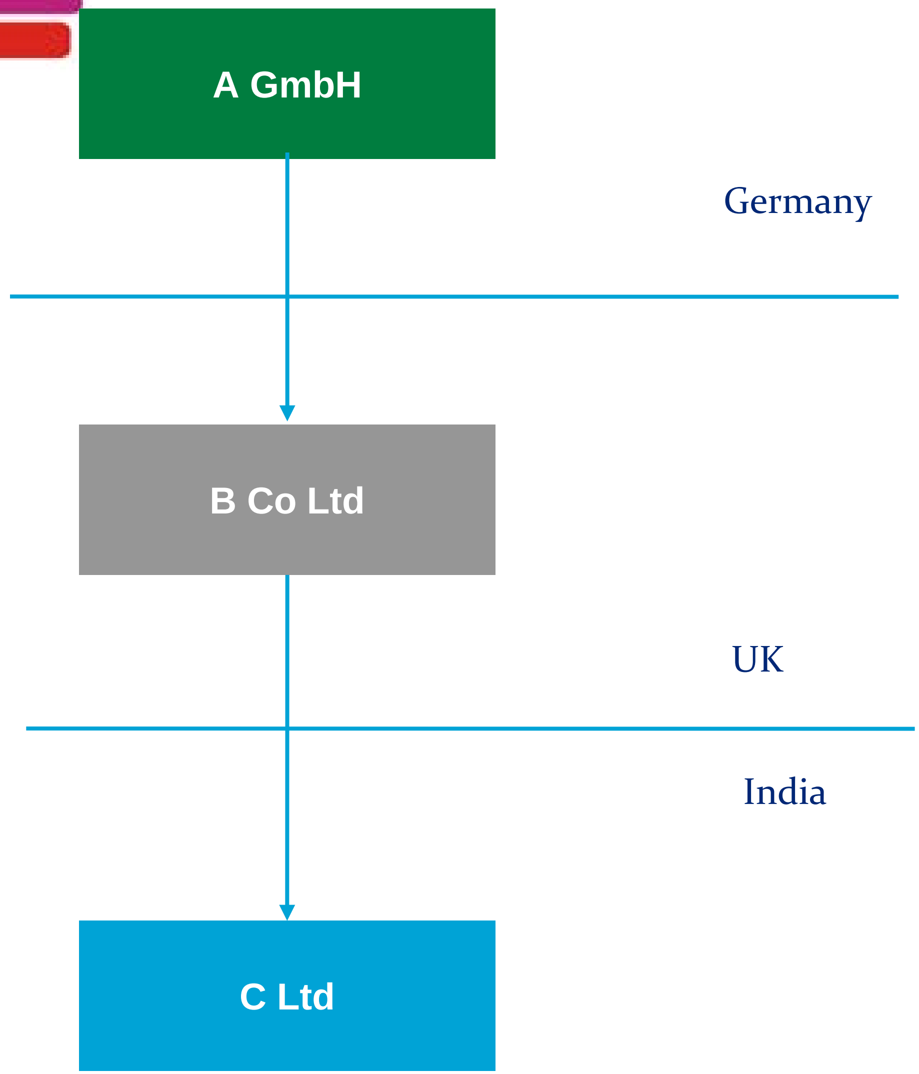
Article 13: Capital Gains on Indirect Transfer



- A Pte Ltd. holds 100% shares of B Co Ltd and in turn B Co Ltd holds 100% shares of C Ltd
- B Co Ltd has no assets other than shares of C Ltd
- A Pte Ltd transfers shares of B Co Ltd

Tax Implications?

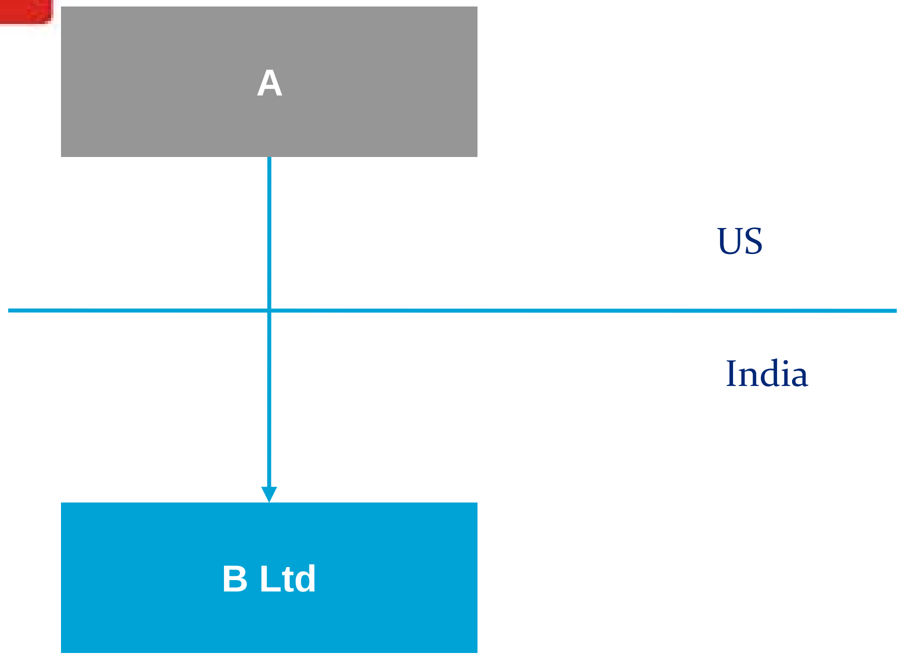
Article 13: Capital Gains on Indirect Transfer



- A GmbH holds 100% shares of B Co Ltd and in turn B Co Ltd holds 100% shares of C Ltd
- B Co Ltd has no assets other than shares of C Ltd
- A GmbH transfers shares of B Co Ltd

Tax Implications?

Article 13: Capital Gains



- A is US Citizen and returned to India upon retirement
- Since he spends more than 182 days in India he is Ordinary Resident in India
- Since he continues to be US Citizen, he is resident of US as well
- He has huge investments in US made out of income earned in US
- Taxability of gains from sale of shares in US
- Taxability of gains from sale of share in India

Tax Implications?

Article 14: Independent Personal Services

- OECD Model does not recognize this
  - It taxes them as Business Profits
- Most of Indian treaties recognize IPS
  - Most of them does not tax them in source country unless they have fixed base or crosses presence threshold
  - There are exceptions where they are taxed like FTS
  - Some treaties provide upper value threshold for exemption, beyond which it is taxed
- Individual v. Partnership v. Resident
  - UN Commentary states that services performed by individual should only be qualified

Article 15: Dependent Personnel Services

- Generally, taxed in the country of residence
  - If employment exercised in other country, the other country can tax it.
- However, only country of residence would have right to tax if -
  - Presence is less than period threshold
  - Salaries are paid by non-resident
  - Salaries are not borne by PE in the other country
- Similar provision does exist under ITA
  - Section 9(1)(vi) [90 day threshold]

Article 21: Other Income

- Provides for taxation in respect of
  - items of income not dealt earlier
  - Income dealt but not covered by earlier mechanism
- Generally provide for taxation in the country of residence
  - However, there are number of exception especially US & UK

Article 23: Double Tax Relief

- Exemption v. Credit Method
- India generally follows credit method
  - But exceptions are there
    - E.g. Capital Gains on sale of Poland company shares
- Even if India follows credit method, the treaty partner may provide exemption method
  - India – Germany DTAA
- Ordinary v. Full Credit
  - India grants full credit for taxes paid in Namibia
  - However, many treaty partners provide full credit
- Underlying Tax Credit
  - Outbound: Mauritius & Singapore
  - However, many treaty partners mostly developed countries provide underlying credit

Article 23: Double Tax Relief

- Tax Sparing
  - India grants tax sparing in treaties with many countries
    - Mauritius, Philippines, Singapore and many others
  - However, in absence of underlying tax credit clause, this is effectively of very less use
- Credit for State Taxes
  - Eligible u/s. 91
- Foreign Tax Credit u/s. 91
  - Any tax paid which is not covered under DTAA would be covered

Article 24: Non Discrimination

- Discrimination should not be based on
  - Nationality
  - Permanent Establishment [Section 44C, 80HHE]
  - Payment to Non Resident [Section 40(a)]
  - Ownership [TP Adjustment on Income?]

Key Takeaways

- India does not follow any particular Model
- Each treaty has a variation
  - Each variation has a meaning
- This is not mathematics
  - It is negotiated and therefore variations are based on bargaining power
    - Increase in rate of royalty / FTS to 25%
  - Treaty should be interpreted after careful reading
  - Must ensure that Treaty, Protocol, MoUs are comprehensively considered before reaching to conclusion
- India – US DTAA is materially different
  - Don’t make that as a base for any conclusion

Questions

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