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Double Taxation Avoidance Agreement – a Study

What is a Treaty (DTAA)

Double Taxation Avoidance Agreement (DTAA) is a treaty between two countries to clarify mutual taxation policy and avoid double taxation. DTAA becomes part of domestic tax law once notified by government of respective county.

Types of Model Treaties:
Treaties are based either on UN or OECD model treaties. The OECD Model is essentially a model Treaty between two developed nations & advocates the residence principle i.e. taxing the income in the country of residence and not in the country of source. UN model treaty on the other hand is focused on double tax treaties between developed and developing. It gives more weight to taxing the income at its source and then avoid double taxation in the country of residence.

Sec 90 of the Income Tax Act, 1961: Bilateral Relief
When the treaty is more beneficial, the assessee can take umbrage under it. If the assessee can show that under either the Act or the treaty, such income is not taxable in India, it will not be taxed in India; or is taxable at a concessional rate, then it shall be taxed at that concessional rate. Sec 90(2) provides that an assessee can take the beneficial clause of Income Tax Act or DTAA. However, general anti-avoidance rules (GAAR) can nevertheless apply to restrict the application of treaties. The good news is that as of today GAAR rules are not applicable in India.

DTAA - Article Wise Study:

Each Treaty is different and must be read in entirety along with protocol. However we discuss below typical provisions in an Indian treaty and the important concepts which must be remembered while interpreting the same. To reiterate the below is only a general discussion and in practice one must read each treaty in its entirety before reaching to any conclusion.

Article 1: Applicability - provides for application of tax treaty to persons resident of one or both of the contracting states. A treaty does not apply to person who is non-resident of both of the contracting states. (Practically if a non-resident has Tax Residency Certificate, he shall be given treaty benefit with the corresponding company with respect to income originating in India).

Article 2: Taxes covered – DTAA covers direct taxes only i.e. taxes on income and on capital imposed on behalf of a Contracting State. Tax does not include interest and penalty - Harshad Mehta 231 ITR 871 (SC). Where DTAA does not talk about surcharge and education cess, the payer was not required to enhance DTAA rate with surcharge and education cess while withholding taxes – ITO vs. M Far Hotels Ltd. IT Appeal Nos. 430 to 435 (Coch.) of 2011.

<u>Article 3: General definitions:</u>

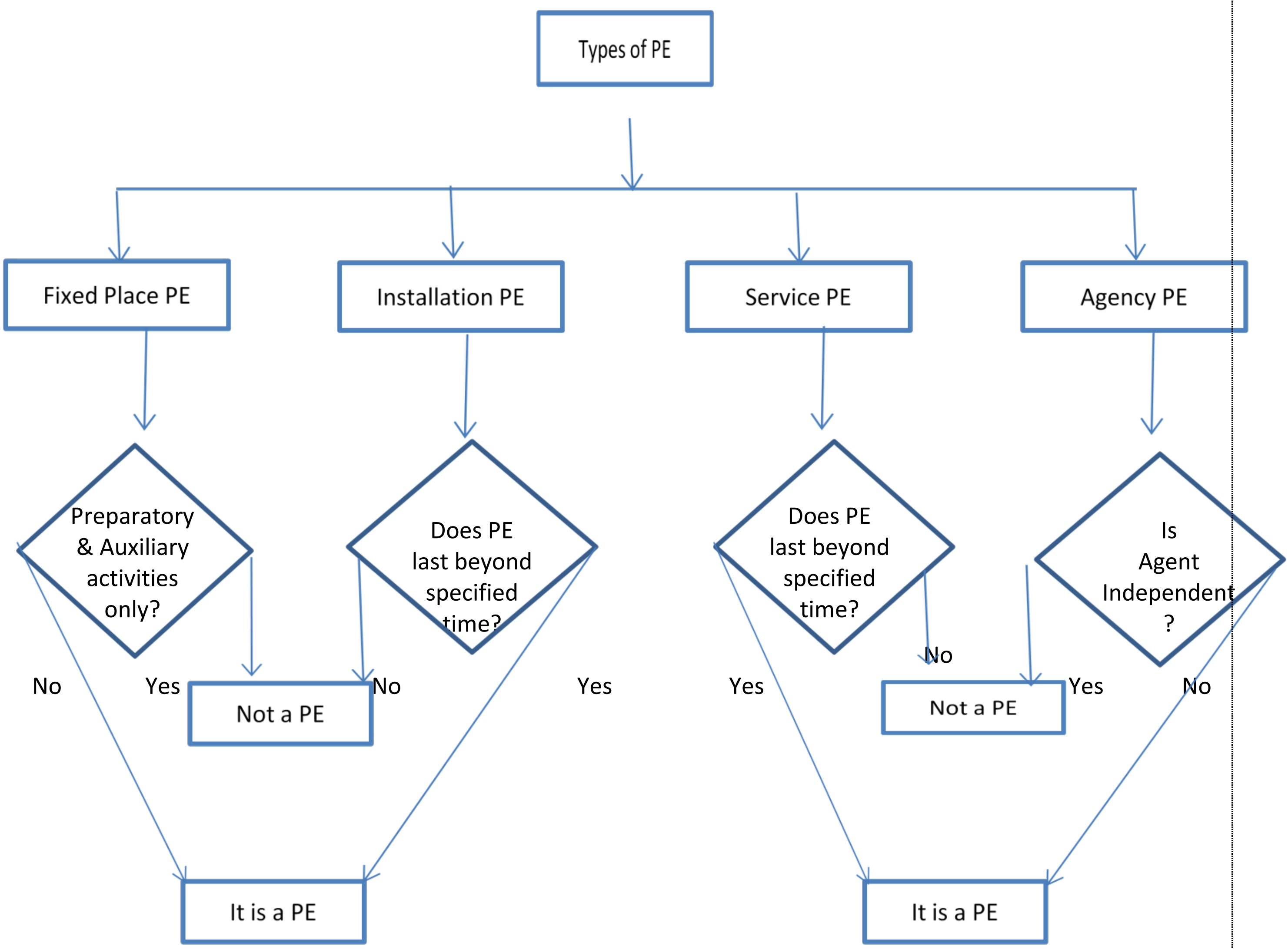
The most important thing while applying a DTAA is to consider whether the entity is a '<u>person</u>' as per definition provided in the treaty. This may be a complex issue in case of partnerships, joint ventures etc. Partnerships are treated as transparent entities in certain countries and the tax is levied on the partners, whereas the countries like India treat the partnership as a taxable entity and exempt the income in the hands of the partners. The question that arises here is should India grant benefit of the DTAA to the 'partner' or the 'partnership' or to neither on the ground that tax is not paid in the country of residence. Mumbai branch of ITAT in **Linklaters LLP** vs. ITO (facts: UK based firm of lawyers providing service in India) held that the tax benefits cannot be denied to a taxpayer even when a partnership firm is taxable in respect of profits, not in its own right but in the hands of the partners, as long as entire income of the partnership firm is taxed in the residence country.

<u>Article 4: Residency</u> - Resident of Contracting State means any Person *liable to tax* (whether or not actually taxed) under the laws of Contracting State because of domicile, residence, place of management or any other criteria of similar nature. This is determined as per local laws of a country. Egs. Sec 6 determines residential status in India.

Tie-Breaker Rules - In the case of a dual resident, the tie-breaker rules shall apply to determine the residential status, viz.

- ❖ In the case of an individual his personal and economic ties determine his residential status (egs. permanent home, centre of vital interest, habitual abode, citizenship etc. in that order.)
- ❖ In the case of others it is the place of effective management (POEM) – i.e. where key management & commercial decisions are taken (substance over form). An entity may have more than one place of management, but it can have only one place of effective management at any one time. However there are exceptions egs. UAE treaty refers to place of incorporation while China treaty refers to place of head office as tie breaker.

<u>Article 5: Permanent Establishment (PE)</u> – It is a place of business in the state of source. The concept of PE is narrow than the concept of 'Business Connection' u/s 9. There are following four types of PE: -



Fixed Place PE: It means a fixed place of business through which the business of an enterprise is wholly or partly carried on. An isolated activity cannot lead to establishment of a fixed base PE as the ingredients of regularity, continuity and repetitiveness are essentially missing.

There are **three criteria** embedded in this definition—physical criterion i.e., existence of physical location, disposal criterion i.e., right to use that place or at disposal of, and functionality criterion i.e., carrying out of business through that place. "It is only when these three conditions are satisfied, a PE under the basic rule can be said to have come into existence". [Mumbai ITAT in Airline Rotables Ltd vs. DDIT (44 SOT 368]. For instance a place of management; a branch; an office; a factory; a workshop, and a mine, an oil or gas well, a warehouse providing storage facilities for others etc. could be PE if it satisfies the criterion.

Installation PE: In some project, due to its nature, contractor's activity has to be relocated, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such cases, the fact that the work force is not present in one particular location is immaterial. What is relevant is if the site, project or activities continue for a period of more than six months or as specified.

Service PE: the furnishing of services, other than services as defined in Article 12 (Royalties and Fees for Technical Services), within a Contracting State by an enterprise through employees or other personnel, but only if: (i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or (ii) the services are performed within that State for a related enterprise.

Service PE & Installation PE are an extension of the basic rule & deemed PE, even though they may not necessarily satisfy the tests of fixed place of business.

Dependent Agency: an agent who has and habitually exercises authority to conclude contracts constitutes a permanent establishment. However Agent must be dependent (both legally & economically) on the nonresident. Further contract must relate to the profit making activity of the enterprise - “the business proper of the enterprise.” No requirement for the dependent agent to have a fixed place of business. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an agent of an independent status, provided that such person is acting in the ordinary course of his business.

Exclusions: “Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods belonging to the enterprise;
b) the maintenance of a fixed place of business solely for the purpose of purchasing goods or of collecting information, for the enterprise;
c) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

A company is not deemed to have a PE in the other state merely because it controls, or is controlled by, a company that is resident of the other state. Each company constitutes an independent legal entity. Mere existence or possibilities of existence of close relationships is not sufficient to constitute a PE. However if the activities of the subsidiary on behalf of the parent are within other provisions of Article 5 then the subsidiary may become a PE of the parent. Say, a subsidiary would be regarded as PE of parent, if it has habitually exercised in the other country, an authority to conclude contracts for sale of goods on behalf of the parent.

The existence of a mere machinery or equipment does not automatically result into the establishment of PE, other tests, like ‘fixed’, ‘disposal’ and ‘carrying on of business’ should also be fulfilled. If lessor supplies personnel after installation to operate equipment – No PE provided role is limited to O&M under the direction, control and responsibility of lessee.

<u>Article 7: Attribution of Profits to PE</u>

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to the PE. Profits attributable means profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. <u>Transfer Pricing principles should be applied to determine profits attributable to PE (FAR Analysis)</u>.

"May be taxed" vs. "Shall be taxed": CBDT through its notification No. 91/2008, dated 28-8-2008 clarified as under:

"In exercise of the powers conferred by sub-section (3) of section 90 of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby notifies that where an agreement entered into by the Central Government with the Government of any country outside India for granting relief of tax or as the case may be, avoidance of double taxation, provides that any income of a resident of India "may be taxed" in the other state, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of the Income-tax Act, 1961 (43 of 1961), and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement."

<u>Attraction Rule</u>: Once the Enterprises has a Permanent Establishment in India, all profit arising out of the transactions with India, whether routed through Permanent Establishment or not, are taxable in India as Business Profit. However, FoA is generally limited to same or similar kind of transactions as dealt with by PE. Around 30 of 85 Indian DTAAs contain FoA rule.

<u>Article 6: Income from Immovable Property</u> (capital gain is dealt with separately in Article 13/22). Article includes income from agriculture, forestry & livestock. COS i.e. state in which immovable property is situated gets the primary right, not the exclusive right.

<u>Article 9: Associated Enterprises</u>: Arm's length price principle. 9(2) says that there should be a corresponding adjustment of transfer pricing done in one country into another provided the other country agrees to it. Practically it never happens and hence no way to avoid economic double taxation.

<u>Article 10: Dividend</u>

First right to tax Dividend that is 'paid' by a company lies in the country in which the **recipient is resident**. Besides, dividend may also be taxed in the country of which the payer is the resident. Remember Sec 9(1)(iv) which says dividend paid by an Indian company to a NR shall be deemed to accrue in India. Though, if certain given conditions are fulfilled, then the taxability in the country of source (if the recipient is the beneficial owner; generally it can be understood that recipient acting purely as nominee or agent is not a beneficial owner.) is at a concessional rate. However India exempts the dividend declared/distributed paid by domestic company provided the DDT @15% (add surcharge and cess) is paid.

<u>Article 11: Interest</u> – Similar to Article 10. Taxation is on gross basis.

<u>Article 12: Royalty & Fee for Technical Service (FTS)</u> – Similar to Article 10. Taxation is on gross basis.

Though it is a general rule of taxation that a special article overrides a general article in the case DTAAs' in respect of item like royalty/FTS etc, if it can be attributed to the PE it would be taxed as business profits and not under special Article.

What is important is if the treaty has '**make available**' clause that would make it narrower than Sec 9 definition of FTS (it is generally there in treaties with all developed nations). Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology.

<u>Article 13: Capital Gain</u>

Immovable Property: In the State where it is situated i.e. Country of Source.
Movable Property forming part of the business property of a PE: State of PE
Movable Property excluding shares: Country of Residence
Share: where situs of company is situated

<u>Article 14: Independent Personal Services</u>

Income in respect of <u>professional services</u>, or other activities of an independent character shall be taxable only in **COR** (of person performing them)
› Exception 1: Income attributable to fixed base regularly available to him, for performing his activities
› Exception 2: Income derived from activities in COS, where his stay > 183 days during the FY.
The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

<u>Article 15: Dependent Personal Services</u>

Salaries, wages, other similar remuneration - Place where services are performed is relevant but look for short visit exemptions.

<u>Article 22: Other Income</u>

It only includes income not dealt with in the forgoing articles. So if income in nature of royalty/FTS is excluded from the royalty/FTS article it cannot be taxed in the other income clause.

The royalty/FTS clause is generally there in treaties, barring a few such as Brazil, Thailand, Philippines, Greece, Mauritius and Zambia. When there is no FTS clause at all in the treaty, taxation of the income shall be governed by the Articles relating to 'Business Profits' or 'Other Income' depending on the facts of the case.

Article 23: Method for elimination of Double Taxation

(i) Exemption method: Allocation of exclusive right to tax; sharing taxing rights;
(ii) Tax Credit Method: provisions of giving credit for taxes paid in the source state by the residence state.

Article 24: Non-Discrimination

The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are or may be subjected.

Conclusion

Indian law recognises the right of every person to plan his transaction in manner that would reduce the incidence of tax on him. So long as a legal structure is put in place and instrument of law that are utilised are bonafide and for business purpose, tax laws, in the absence of statutory provisions to the contrary, does not permit an enquiry in to the underlying economic interest. The Apex Court in Azadi Bachao Andolan v UOI (2003) 263 ITR 706 (SC) held that unless the transaction is a sham (one which does not give rise to the legal rights and obligations which arise from its ostensible nature), the legal character of the transactions will not be discharged in the pursuit of substance.