Articles on Income from Immovable Property, Capital Gains and Other income

Article 6 – Income from Immovable Property

Article 6 – Overview…

Paragraph	Overview of Provisions
6 (1)	Grants rights of taxation to country where the property is situated
6 (2)	Meaning of Immovable Property
6 (3)	Explains forms of exploitation of property
6 (4)	Explains treatment of property of an enterprise / used for performing services

…Comparative Table – OECD , US , UN Model Conventions…

OECD MC	UN MC	US MC
• May be taxed in source state	• May be taxed in source state	• May be taxed in source state
• Exhaustive meaning to Immovable Property	• Exhaustive meaning to Immovable Property	• Meaning as given in source country laws
• Ships, Boats & Aircrafts not regarded as Immovable Property	• Ships, Boats & Aircrafts not regarded as Immovable Property	• No such specific exclusion
• Form of exploitation is not relevant	• Form of exploitation is not relevant	• Form of exploitation is not relevant
		• Option to compute income on gross or net basis

Both OECD and UN Model are identical - Most Indian DTAA's are based on UN Model

…Article 6 – Paragraph 1 (Applicability)…

Article 6(1) applies if the following conditions are satisfied:

A resident of Contracting State (State of Residence) derives income;

Such income is derived from immovable property or agriculture* or forestry*; and

Such immovable property is situated in other Contracting State (State of Source)

Does not extend to income earned by a resident from property situated in State of Residence or any third State.

* The States may decide interse to tax the income from agriculture and forestry under Article 7 i.e. Business Profits

…Article 6 – Paragraph 2 (Right of Taxation)…

- **Grants primary right but *<u>not</u>* exclusive right of taxation to the country wherein property is situated**
  - Depends on existence of close economic connection between source of income i.e. the property and State of Source

- **Income from agriculture and forestry included**
  - May be taxed under Article 7 if agreed between two States
  - Indian tax treaties show a mixed trend

- **No mechanism for computing taxable income**
  - Article deals with attribution of taxable income from use of immovable property
  - Domestic regulations should apply
  - Para 2 of UN Model Commentary – taxable on net basis

Income 'MAY' be taxed – Interpretation by Indian Courts

…Article 6 – Paragraph 2 (Meaning of Immovable Property)…

- **Shall have the meaning which it has under the laws of the Contracting State in which the property is situated**

- **Meaning of immovable property – In India**
  Definition as per Section 269UA of Income Tax Act
  - Land or building or part thereof;
  - Plant & Machinery, furniture, fittings and other things transferred along with land or building; and
  - Including rights pertaining to above .

- **Reference to domestic law**
  - Tax laws as well as other laws prevailing in the country where the property is situated
  - Conflict of meaning in different laws – definition in tax laws to prevail

* Section 269UA formed part of Chapter XX-C which has been omitted in relation to transfer of immovable property on or after 1 July 2002

…Article 6 – Paragraph 2 (Inclusions and Exclusions)…

General Rule – Whatever is affixed or attached to land becomes a part of the land

- **Inclusions as per Treaty**
  - Property accessory to Immovable Property
  - Livestock used in agriculture and forestry
  - Equipment used in agriculture and forestry
  - Rights to which the provisions of general law respecting landed property apply
  - Usufruct of Immovable Property
  - Rights to variable or fixed payments as consideration for the working of , or the right to work, mineral deposits, sources and other natural resources

- **Exclusions as per Treaty**
  - Ships, boats and aircrafts

Domestic law irrelevant if items specifically included or excluded in Treaty

…Article 6 – Paragraph 2 (Case Studies)…

Indebtedness secured by immovable property

Facts

Company A, a foreign company has given a loan to Company X, an Indian company, repayment of which is secured by the property owned by company X. Alongwith the loan amount, Company A will also earn interest income.

Query

Whether such interest income earned will be taxed under Article 6?

By specific inclusion of the income from such indebtedness in the definition of 'interest' in Article 11, such interest will not be taxed under Article 6 but under Article 11.

…Article 6 – Paragraph 2 (Case Studies)…

Right to enjoy immovable property on a time sharing basis - whether considered as 'immovable property' for the purposes of Article 6

Would be dependent primarily on the meaning of 'immovable property' in the domestic laws of the Contracting State in which the property is situated.

Machinery embedded in the earth to constitute a fertilizer plant – whether considered as immovable property for the purposes of Article 6

Indian Supreme Court has held that it is important to consider the intention for such embedment. In this case, definitely embedded permanently and hence, an immovable property.*

To be noted that in view of explicit mention, it is irrelevant that the domestic law meaning of 'immovable property'

* Duncans Industries Ltd. vs. State of UP (2000) (87 AIR 355) (SC)

…Article 6 – Paragraph 3 (Scope of Income from Immovable property)…

- **Income specifically covered by Article 6**
  - Income derived from direct use, letting or use in any other form (Article 6(3))
  - Capital gains derived from transfer of immovable property in absence of Article 13(1)
  - Payments for grant of license to extract natural resources – not covered by 'Royalty" **OECD and UN Commentary**

- **Income not covered by Article 6**
  - Interest paid on a mortgage on immovable property (Article 11)
  - Capital gains from transfer of immovable property (Article 13)
  - Distribution of dividends by a company referred to in Article 13(4)
  - Income from immovable property by virtue of holding of shares in a company, owning the immovable property

Scope of income to be covered within Article 6 or otherwise depends upon negotiation between contracting states

…Article 6 – Paragraph 3 (Meaning of ‘use’)…

- **Forms of Exploitation**
  - Direct use
  - Letting Out
  - Use in any other form

- **No specific definition of term ‘letting out’**
  - Can also include sub-letting?

- **No specific definition of term ‘used in any other form’**
  - Governed by the local laws of the country where the property is situated

Situs based taxation from Immovable Property irrespective of form of exploitation of property

…Article 6 – Paragraph 3 (Case Studies)…

Capital Gains on disposal of Immovable Property

Facts

Indian Company has earned income from disposal of rubber fields at Malaysia*

Query

Whether such capital gains earned from transfer of the immovable property would be taxable under Article 6?

* CIT vs. S R M Firm (1994) (208 ITR 400) (Madras HC)

In absence of Article 13 regarding Capital Gains in the erstwhile India-Malaysia treaty, it was held that disposal of Immovable Property is also a form of use as 'direct use…or use in any other form' is wide enough to cover transfer, sale or exchange of the property

…Article 6 – Paragraph 4

- **Extends scope of situs based taxation**
  - Income earned by an enterprise (Permanent Establishment of non resident in source country) from immovable property
  - E.g. relinquishment of property for use by a third party

- **Income from immovable property used for the purpose of Independent personnel services (under UN Model)**

- **Exception Consequences on computation of income**
  - Principles laid down in Article 7 do not apply
    - This is an exception to the general rule under Article 7 that income must be attributable to a PE in order to be taxable in the Source State
  - Principles of domestic tax law would prevail

Article 13 – Capital Gains

Article 13 – Capital Gains…

- Article 13(1) – Grants rights of taxation to country where immovable property situated
- Article 13(2) – Grants rights of taxation to source country where movable property forms part of business of PE
- Article 13(3) – Movable Property – Ships, Aircrafts or boats
- Article 13(4) – Shares deriving 50% or more value directly or indirectly from immovable property situated in source state
- Article 13(5) – Shares representing substantial shareholding in Company **(Only UN Model)**
- Article 13(6) – Any other property

…Article 13 - Capital Gains…

- Taxability of Capital Gain – governed by Article 13 in OECD & UN models
  - Capital Gain not defined under either models
    - Meaning given in domestic tax laws will apply

  - The phrase used is 'Alienation of property'
    - As per OECD commentary "Alienation of Property" includes
      - Sale or exchange or '**Gift** 'or inheritance
      - Sale of a right
      - Partial alienation
      - Expropriation
    - Alienation also defined in India – Mauritius DTAA as
      - Sale or exchange or transfer
      - Relinquishment of the property
      - Extinguishment of any right therein
      - Compulsory acquisition thereof under any law

  - Article covers both kinds of Capital Gains i.e. Long term as well as Short term Gains

  - Method of computation is left to the domestic laws

…Article 13 – OECD Commentary…

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

…Article 13 – OECD Commentary…

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of __ percent (the percentage is to be established through bilateral negotiations) in a company which is resident of a Contracting State may be taxed in that State. (‘UN Model’)

6. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

…Article 13 – Paragraph 1…

Gain on alienation of
any Immovable Property "May"
be taxed in
the Source State

…Article 13 – Paragraph 2…

Article 13 – Paragraph 2 - **Movable Property** - Forming part of business of PE / FB

Taxability

- MAY be taxed in the State of PE

Gains Covered

- Alienation of movable property of PE / PE itself (alone or with whole enterprise)

Movable Property

- Property not being Immovable Property and includes intangibles like goodwill, licence etc
- Not applicable to movable property forming part of stock- in trade
    - May not apply to movable property of PE engaged in preparatory and auxiliary activity

…Article 13 – Paragraph 2 (Some Important Aspects)…

- Slump sale, i.e. sale of undertaking / PE
  - PE State has right to tax
  - Taxable as per domestic law

- What if in the state of PE enterprise has a movable property unrelated to business of PE?
  - Will be taxed under residual category of Article 13

…Article 13 - Paragraph 3…

Movable Property - Ships, Aircrafts or Boats

Taxability

SHALL only be taxed in the State where the place of effective management is situated

Movable Property

- Ships or Aircraft operated in international traffic
- Boats engaged in inland waterways transport
- Other movable property pertaining to operation of above
- Could be for its own use or leased on Charter fully equipped, manned & supplied

Emphasis on “place of effective management”

…Article 13 – Paragraph 4…

- Alienation of shares deriving more than 50 % value directly or indirectly from Immovable Property (“IP”)
  - INCLUDES entity engaged in business of “Management of IP” (UN model)

- Percentage determined = $\dfrac{\text{Value of immovable property}}{\text{Value of all the property}}$

- Value to be calculated without taking into account debts or other liabilities of the Company

- Gains taxable in the state where immovable property is situated

…Article 13 – Paragraph 5 (UN Model only)…

- Alienation of shares representing a substantial shareholding in the company
  - Substantial holding not defined
  - Left to bilateral negotiations
- Taxable where company (whose shares are transferred) is situated
- Not present in OECD Model Convention

…Article 13 – Paragraph 6 (Residuary)…

Gain on alienation of
any other property
“SHALL ONLY”
be taxed in
the State of Residence

…Capital Gains – Some Thoughts

- Factors not considered to be relevant while applying Article 13(6)
  - Sale agreement signed within or outside State
  - Property situated in one of the Contracting States (State R or State S) or in a third state
  - Beneficial Ownership of the alienated property
  - Capital Gains are exempt in State R
  - Assets were acquired before or after the treaty is signed
  - Assets were acquired before or after becoming a resident of State R

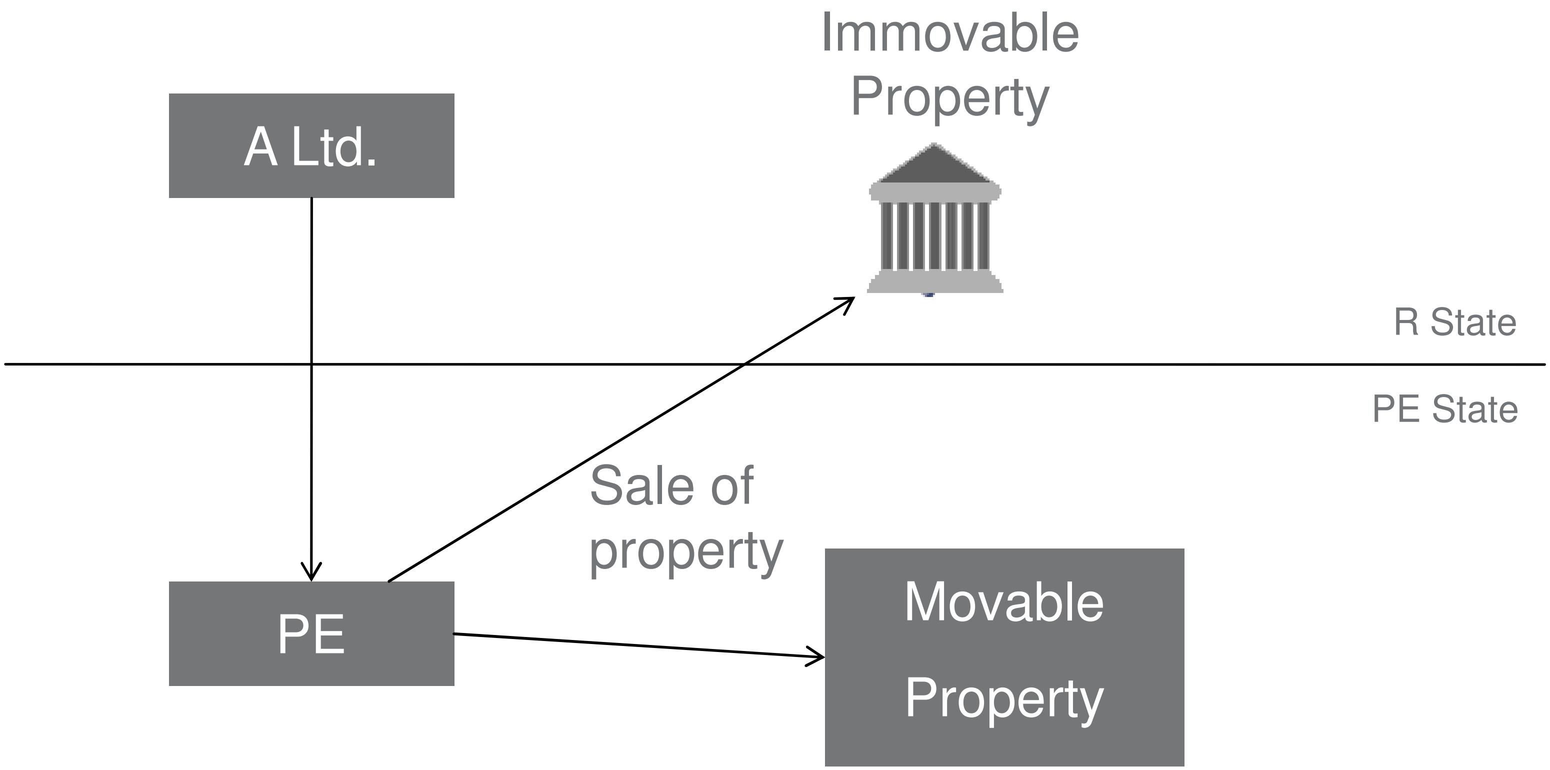
Summary

Capital Gains realized from	Where taxed	Base
Immovable Property ("IP")	Situs of IP	Source base
Movable Property		
Assets of PE	Situs of PE/FB	Source base
Ship, Aircraft Boat etc	Place of Eff. Management	Eff. Mangmt.
Shares of / interest in Property Co / Entity	Situs of IP	Source base
Substantial share holding	Residence of Co.	Source base
Other Assets	Residence of Alienator /as agreed in the treaty	Resi. base

Recent Developments on Capital Gains Taxation front

- Azadi Bachao & Circular No. 682 and 789 dated March 31, 1994 on Mauritius Treaty
- Recent approach of Tax Authorities on investments involving Mauritius
  - Vodafone case
  - E-trade Mauritius
  - Aditya Birla case
  - Sanofi
- Indirect transfer part of definition of 'transfer'

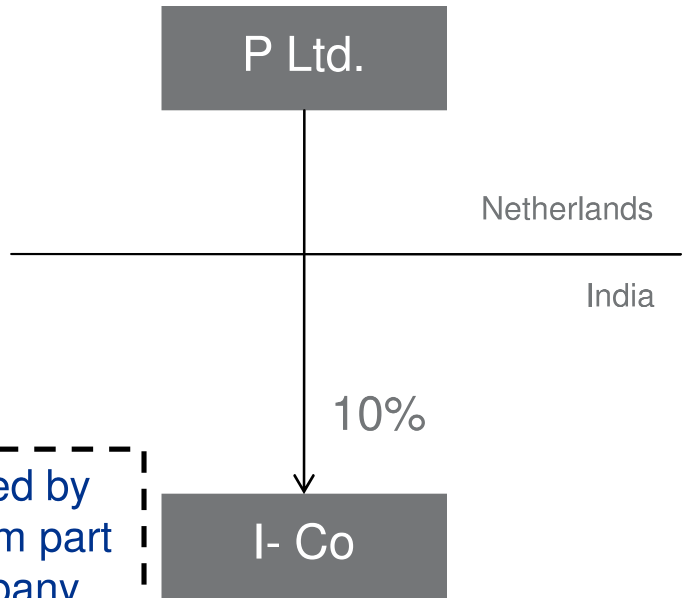
Capital Gains - Case Study 1



- **Article 13 (1) – Not applicable**
- **Article 13 (2) – Applicable only to movable property**
- **Article 13 (6) – only R State may tax the gain**

Capital Gains - Case Study 2…

- P Ltd. set-up in Netherlands
- Picks up a stake of 10% in an Indian Company
- P Ltd now wishes to sell off its stake in I- Co
- It disposes its holdings in two tranches –
  - 4% in the first tranche
  - balance 6% in another tranche in the next financial year



Article 13(5) Treaty - Gains from the alienation of shares issued by a company (I-Co) resident in the other State which shares form part of at least 10 per cent interest in the capital stock of that company, may be taxed in that other State (India) if the alienation takes place to a resident of that other State.

Determine the taxability of P Ltd.

…Capital Gains - Case Study 2

- Gains from the alienation of shares issued by a company resident in the other State which shares form part of at least a 10 per cent interest in the capital stock of that company, may be taxed in that other State if the alienation takes place to a resident of the other State

- Shares sold in the first as well as the second tranche individually constitute less than 10% interest in the capital of Indian Company

  – Wordings talk of 'Gains from the alienation of shares….which shares form part of at least 10%..."

- Purpose of Article seems to grant taxation rights to the source country, whenever there is alienation of substantial shareholding (irrespective of when the shares are sold)

  - Alternate view of tax office: Capital gains taxable in India even if sale < 10% but cumulatively exceeds 10% across different years

- If the buyer is non- resident – Not taxable in India

Article 21 – Other Income

…Article 21 – Paragraph 1…

Basic rule governing taxability of Other Income

Article 21 of OECD / UN Model and US Model Convention deal with other Income

OECD / UN Model Convention	US Model
• Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State	• Items of income beneficially owned by a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

…Article 21 – Paragraph 2…

OECD/ UN Model Convention	US Model
• The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein (or performs in that other State independent personal services from a fixed base situated therein, in case of UN Convention)and the right or property in respect of which the income is paid is effectively connected with such permanent establishment (or fixed base, in case of UN Convention). In such case the provisions of Article 7 (or article 14, as the case may be, in case of UN Convention)shall apply.”	• The provisions of paragraph 1 shall not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the income is attributable to such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply..”

…Article 21 – Paragraph 3…

Article 21(3) of UN Model Income Tax Convention

Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

Article 21(3) absent in in the OECD and US Model Tax Convention

…Income Inclusions & Exclusions…

Inclusions:

- ✓ Lottery Winnings
- ✓ Prize Money
- ✓ Gambling income
- ✓ Guarantee fees
- ✓ Punitive damages
- ✓ Social security payments
- ✓ Non compete fees etc

Exclusions:

- × Items of Income which are specifically covered under any other Article of the treaty

…Key points…

- Article 21 is a residuary Article
- In order to apply Article 21, there should be an element of “income”
    - –distribution from partnership firms, trusts, do not constitute income and thus not covered
- Para 1 covers:
    - –income not covered in the foregoing Articles
    - –wherever arising
    - –taxable in the state of residence
- Article applies irrespective of whether right to tax is in fact exercised by the state of residence
- Covers items of income not dealt with in other Articles because of their source or some other reason, eg. Article 11 (Interest) covers interest arising in a Contracting State; hence interest arising in third State that is not effectively connected with a PE is subject to Article 21 (Source: US Technical Explanation)
- UN Convention does not confer exclusive right of taxation on the state of residence
    - –para. 3 gives powers also to the source state to tax the other income

… Key Points …

- Paragraph 2 provides an exception to para. 1 and covers:

  – income other than income from immovable property

  – received by a resident of State R

  – resident carries business in State S through a PE, or performs independent personal services from fixed base in State S

  – income connected with such PE / fixed base

  – provisions of Article 7 / 14 to apply

- Income from immovable property follows *situs principle*

- Paragraph 2 also covers the case where the beneficiary and the payer of income are both residents of the same Contracting State and income is attributed to a PE of the beneficiary, situated in other Contracting State.

  –taxable in the Contracting State in which PE is situated

…India's Treaties

- Treaties with Greece, Libya and Netherlands do not contain any provisions on „other income‟.
- In treaties with Germany, Hungary, Ireland, Russia, Sweden, Switzerland, etc., the right to tax income in the State of Source as granted by means of paragraph 3 is restricted to certain types of income derived from lotteries, gambling, betting and similar sources.
- Treaties with Mauritius, Nepal and the UAE have adopted paras.1 and 2 of the UN Model but not paragraph 3.
- Same rights are provided in the treaty with Kenya but its para1 has a "subject-to-tax clause":
- "Items of income of a resident of a Contracting State which are not expressly mentioned in the foregoing articles of this Convention *in respect of which he is subject to tax in that State shall be taxable only in that State."*.

Thank you

Presentation by Nishit Shah