Understanding tax treaties

WIRC of ICAI - Student Webinar
21 April 2020

Outline of Learning Objectives

Certain basic concepts

What? Why ? & How? (of tax treaties)

Components of a tax treaty

What is the Multilateral Instrument (MLI)?

Certain basic concepts

Tax residence [1/2]

Section 6 of the Income-tax Act

Individuals

Resident

- => 182 days in India **OR**
- => 60* days in India **AND** => 365 days in India in 4 preceding years
- A stateless Indian Citizen (> 15 Lakhs India Source Income)

Not Ordinarily Resident (NOR)

- NR in 9 out of 10 previous years **OR**
- Stay in India <= 729 days in 7 PYs **OR**
- Deemed resident of India (under 120-day rule or a stateless Indian Citizen deemed to be resident in India)

Ordinarily Resident

(If a resident individual does not fulfill NOR conditions then he is regarded as Ordinarily Resident in India)

*60 days is substituted by –

- 182 days if leaving India as a member of a crew on Indian ships or for employment abroad or an Indian Citizen /PIO comes on a visit to India
- 120 days if an Indian Citizen/PIO comes on a visit to India and has >15 Lakhs India Source Income

Stateless = Not liable to tax in any other country by reason of his domicile or residence or any other criteria of similar nature

Tax residence [2/2]

Section 6 of the Income-tax Act

HUF, Firm, AOPs

- Resident in India unless control and management of its affairs is situated wholly outside India

Companies

- Resident in India if an Indian Company or its Place of Effective Management (POEM) is in India

Scope of total income

Section 5 of the Income-tax Act

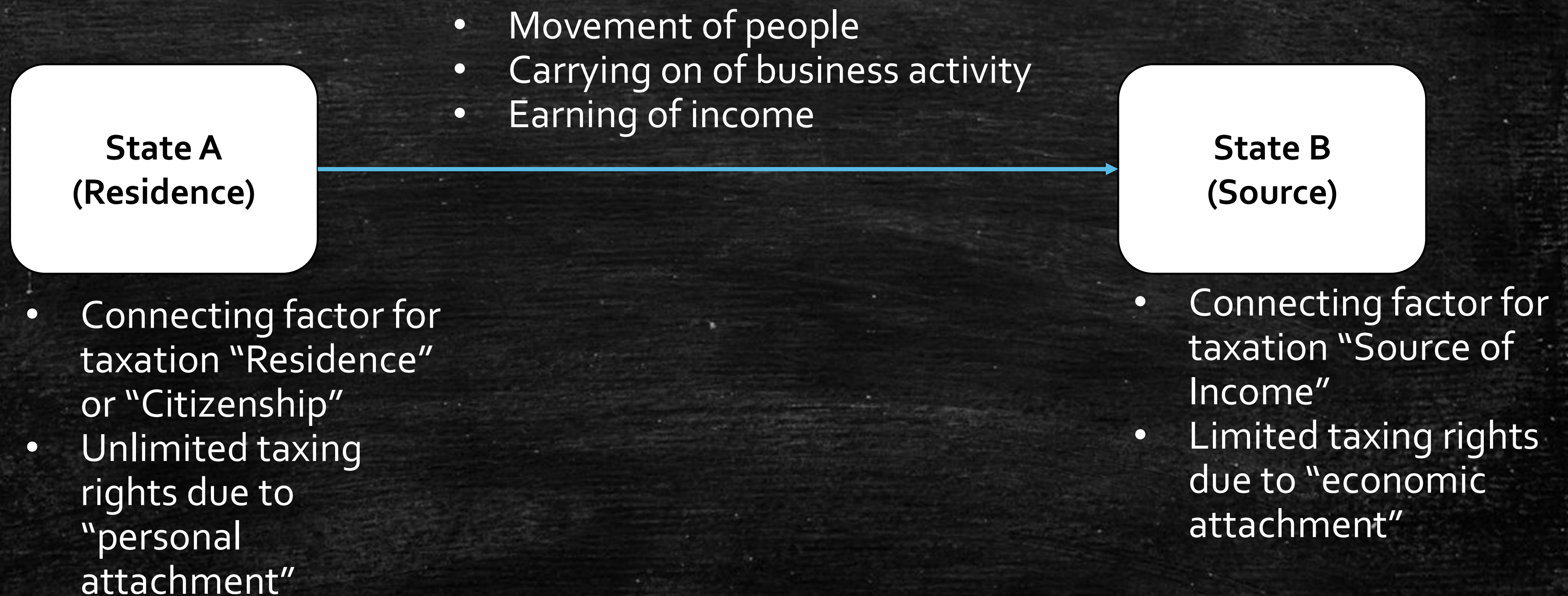
Ordinarily Resident	Not Ordinarily Resident	Non-resident
• Received/ deemed to be received **<u>in</u>** India • Accrues or arises or is deemed to accrue or arise **<u>in</u>** India • ***<u>outside</u>*** ***India*** — ***Accrues or arises <u>outside</u> India***	• Received/ deemed to be received **<u>in</u>** India • Accrues or arises or is deemed to accrue or arise **<u>in</u>** India • ***Accrues or arises <u>outside</u> India if from business controlled or profession set-up in India***	• Received/ deemed to be received **<u>in</u>** India • Accrues or arises or is deemed to accrue or arise **<u>in</u>** India

Source rule

Section 5 r.w.s 7 & 9 of the Income-tax Act

- Income received/ deemed to be received in India
  - Accretion to recognized provident fund/ contribution to specified pension scheme
- Income accrues/ arises or deemed to accrue or arise in India
  - Business connection in India (including Significant Economic Presence)
  - Property in India
  - Asset or source of Income in India
  - Transfer of a capital asset situate in India (including Indirect Transfers)
  - Salary earned from services rendered in India
  - Dividend paid by an Indian Company
  - Interest/ Royalty/ FTS payable by Govt or a Resident (except for earning income outside India) or a Non-resident (for business or profession carried on in India)

Concept of double taxation [1/2]



Quiz time

- The nature of double taxation described in the previous slide is commonly referred to as -
  - **Economic double taxation**
  - **Juridical double taxation**
  - **Bilateral double taxation**

Concept of double taxation [2/2]

Economic double taxation

What? Why? & How? (of tax treaties)

What is a tax treaty?

- A treaty is an international agreement concluded between two countries and governed by international law
- Bilateral tax treaties confer rights and impose obligations on the two contracting States, but not on third parties such as taxpayers
- However, tax treaties are obviously intended to benefit taxpayers of the contracting States
- Treaties are binding on the contracting States and must be performed by them in good faith

Why do we need a tax treaty?

- Avoidance of double taxation on income and capital
  - 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 tax treaty for the indirect benefit of residents of third jurisdictions
- Development of economic relations, trade and investment
- Enhancing co-operation in tax matters
  - Exchange of information
  - Tax examination/ scrutiny abroad
  - Assistance in collection of taxes

Tax treaties – benefits v. costs

Benefits

- Increased foreign investment
- Increased certainty
- Improved consistency for tax treatment
- Avoidance of fiscal evasion

Costs

- Immediate revenue costs
- Limited operation of domestic tax provisions
- Risk of treaty shopping/ double non-taxation
- Need to meet obligations under tax treaties

How does a tax treaty come into existence and what are its effects?

- Bilateral Negotiations
  - Typically based on an existing model treaty
  - Developing Country – UN Model
  - Developed Country – OECD Model
  - US has its own model treaty
- Section 90 of the Income-tax Act contains the enabling power
  - Provisions of a tax treaty or domestic law whichever are more beneficial can apply
  - Generally, provisions of a tax treaty override the provisions of the domestic law
    - Exception - GAAR

Quiz time

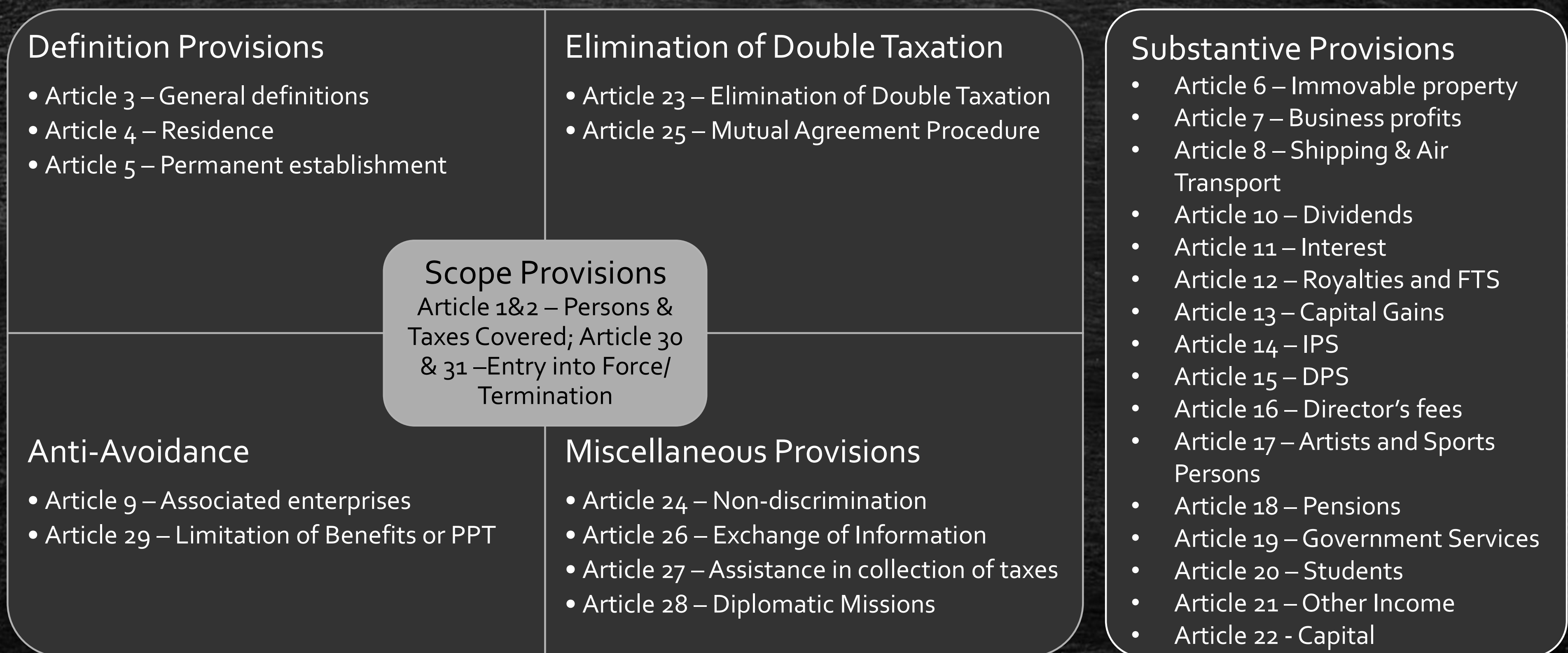
- How many bilateral comprehensive tax treaties India has entered into?
  - 75-80
  - 90-95
  - 100-105

Quiz time

- Can the onerous effects of double taxation be mitigated if India does not have a tax treaty with a country?
  - Yes
  - No
  - Don't know

Components of a tax treaty

A bird's-eye view of a tax treaty



Article 1&4 – Persons covered

- In order to claim treaty benefits a person should be resident of one or both of the Contracting States
- A person is a resident of a country if under the laws of that country he is liable to tax by reason of domicile, residence, place of management
  - Does not include persons who are liable to tax only by virtue of source
  - Certain tax treaties use the words 'subject to tax'
  - In case resident of both countries
    - Individual – Tie-breaker rule
    - Others – Competent authority or Place of Effective Management

Article 5&7 – Business Income

- Business profits can be taxed in the source state only if foreign enterprise has a permanent establishment (PE) in such a state
- PE defined in Article 5(1) to mean - a fixed place of business through which the business of an enterprise is wholly or partly carried on
- PE also includes (illustrative list)
  - Fixed Place PE
  - Construction PE
  - Service PE
  - Agency PE
- Exemption for Preparatory and Auxiliary activities & impact of BEPS

Article 10-12 – Dividend, Interest, Royalty and FTS

- Source state has the right to tax these income, however, tax treaty typically provides a lower withholding tax rate compared to domestic law
- Recipient must be the "beneficial owner"
- Taxability on gross basis, except, if income is attributable to a PE where net basis of taxation applies
- Source/ characterization rule restricted compared to domestic tax laws (e.g. definition of FTS)

Article 13 – Capital Gains

Nature of property	Right of taxation
Immovable property	Source state i.e. country in which property is situated
Shares of a company, interest in firm, trust estate property which principally consists of immovable property	Source state i.e. Country in which property is situated - Principally > 50% - Certain treaties exempt listed companies
Shares (other than above)	Source state i.e. country in which company (whose shares are transferred) is resident
Property forming part of business property of PE	Source state i.e. where PE is situated
Any other property (e.g. debentures)	Residence country

Article 23 – Elimination of double taxation

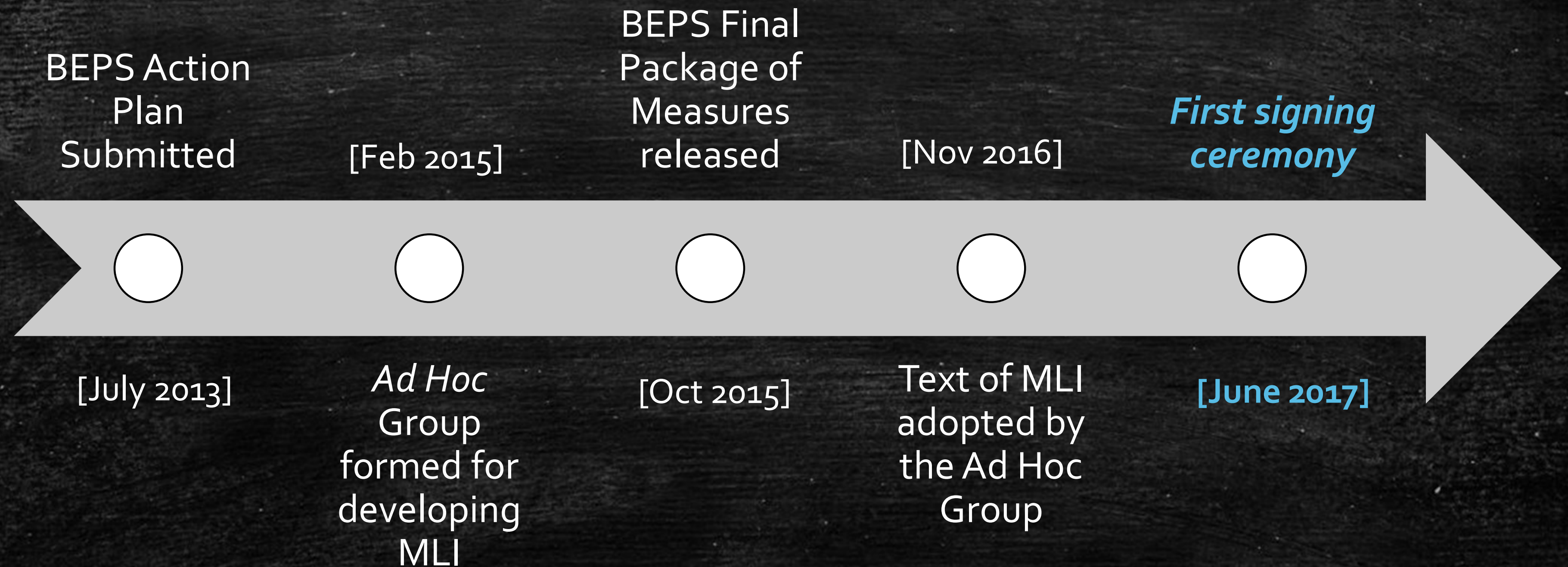
- Relief from double taxation
  - Exemption method;
  - Credit method
- India follows credit method
- Underlying tax credit
  - an indirect credit for the tax levied on the profits of the company out of which the dividends have been paid
- Tax sparing credit
  - a tax credit granted typically under tax treaties by residence countries for source country tax notionally borne on certain kinds of income (in general, dividends, interest or royalties), i.e. in excess of actual tax borne

What is MLI?

The Multilateral Instrument

- A **"turning point"** in tax treaty history
- Key objective to strengthen existing bilateral tax treaties by transposing outcome of the OECD/G20 BEPS Project
- MLI developed by an Ad hoc group of 100+ countries
- Measures include rules against treaty abuse, artificial avoidance of PE status, hybrid mismatch arrangements, MAP
- MLI entered into force on 1 July 2018

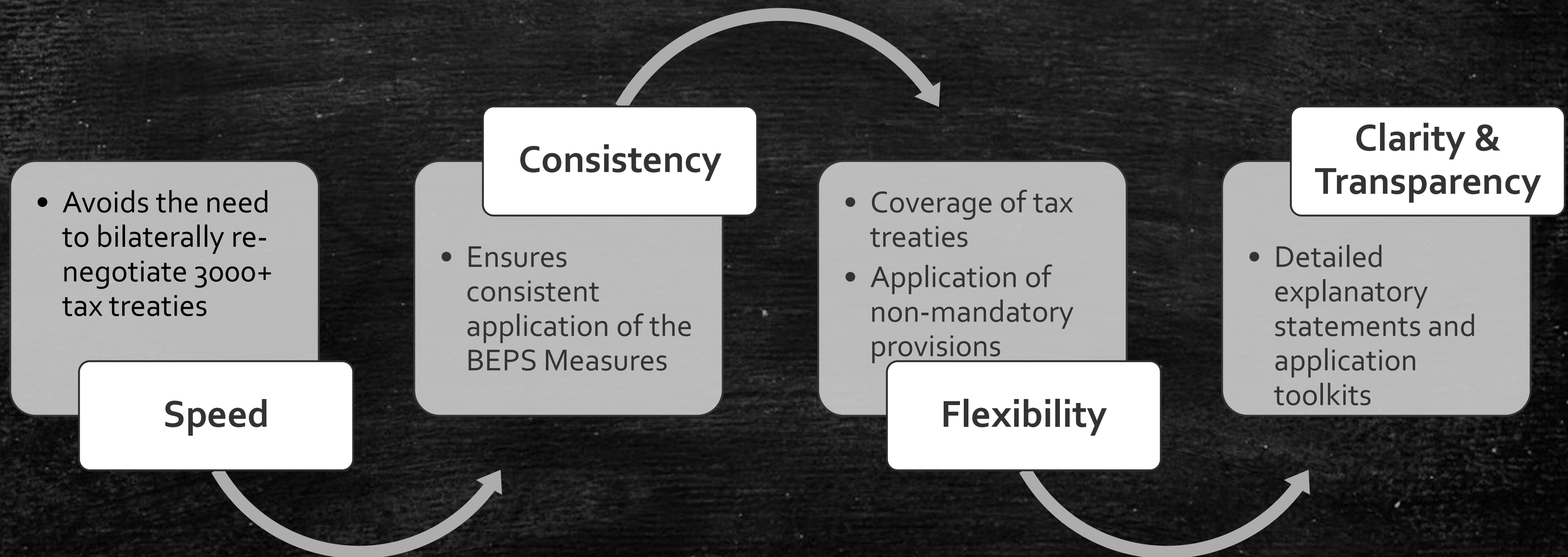
MLI - Timelines



Quiz time

- Has India signed MLI?
  - **Yes**
  - **No**
  - **Don't know**

Why MLI?



MLI – Interplay with bilateral tax treaties

- MLI 'sits' alongside existing treaties, modifying their operation
- Applies by virtue of 'later in time' rule – Article 30(3) of the Vienna Convention
- Not static – countries can opt-in to optional provisions or withdraw reservations
- Does not preclude subsequent bilateral modifications of treaties
- Countries may create consolidated text – Online matching tool prepared by OECD to facilitate impact analysis on existing treaties

Questions

Thank You!

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