India- US Double Taxation Avoidance Agreement (DTAA)

16 April 2014
Preface

DTAA’s (tax treaties) are international agreements entered into between Governments, for the allocation of fiscal jurisdiction so as to avoid double taxation of the same income.

Benefits/Objectives of a tax treaty

• Elimination of double taxation;
• Non discrimination of nationals of other state;
• Rational and equitable allocation of income/tax between 2 countries;
• Promotion of trade and investment between two trading partners;
• Certainty of tax regime faced by the investors and traders;
• Exchange of information to combat tax avoidance/ tax evasion.
Steps by which a DTAA comes into force

• Negotiation of treaty
• Drafting of the articles
• Signing - Step towards initiating binding conclusion
• Ratification- Formal confirmation by each contracting state, that the constitutional requirements for implementation of DTAA is fulfilled
• Notification
• Entry into force - Generally computed from the date of notification in the official gazette.
• Effective Date - The date on which the DTAA comes into effect (usually corresponds to beginning of the tax year).
India- US Tax Treaty: An overview

- The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (‘The India- US Treaty’) was signed at New Delhi on September 12, 1989.

- Date of entry into force: with effect from December 18, 1990.

- The India- US treaty follows the pattern of the United States Model Tax Convention (US Model) and is different from the other treaties entered by India.

- Technical explanation by the US Treasury department, protocol and the Memorandum of Understanding acts as an aid to the interpretation of the DTAA.
## Articles of India- US Tax Treaty

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### India US treaty

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5. Article 11 - Interest
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12. Article 19 - Pensions
13. Article 20 - Government service
14. Article 21 – Students
15. Article 22 – Professors
16. Article 23 - Other income
Scope provisions

Article 1 - General Scope

- Applies to persons who are residents/citizens of one or both countries
- Taxpayer may always rely on more favourable code treatment.
- Article 1(3) – Saving clause.

Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents [as determined under Article 4 (Residence)], and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term “citizen” shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.
Definition provisions

Article 3 - General definitions

- Contracting state -- India or the US.
- Tax – Indian tax or US tax, does not include interest or penalty.
- Person -- Individual, company, an estate, trust, Partnership, Any Taxable unit.
- National- Individual possessing nationality or citizenship of a contracting state.
**Definition provisions contd....**

**Article 4- Residence**

- Resident means any person who is **liable to tax** under the laws of any state by virtue of factors such as domicile, place of incorporation etc.

- Tie breaker rules to be applied to resolve cases of dual residence.

- **Example**

  - P is partnership firm established in **USA (Fiscally Transparent)**.  
  - A and B are partners who reside in **USA**. US treats partnership as transparent where as India treats it as taxable.  
  - P derives income from India that is not attributable to PE in US.  
  - Will India grant treaty benefits?
Article 5- Permanent Establishment (PE)

PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

- **Inclusions**
  - Furnishing of services, other than included services for a period aggregating 90 days within any twelve month period;
  - Construction, installation, assembly project or supervisory activities for a period of more than 120 days within any twelve month period;
  - Dependent agents (extends to agents securing orders also), etc.

- **Exclusions**
  - A fixed place for the purpose of advertising or for preparatory and auxiliary activities or for purchase of goods and merchandise;
  - Independent agents, etc.
Service PE in Article 5(2) vis-à-vis Article 5(1)

- Independently as part of Article 5(3) – UN Model OR as part of example in Article 5(2) as India US treaty.
- Whether the above restricts/ expands the scope of PE definition.
- There are 2 views possible:
  View A: Article 5(2) is subject to fulfillment of condition as mentioned in Article 5(1). Even if services are rendered for more than threshold period, if conditions for fixed base are not met then there is no Service PE. This could limit scope of PE definition.
  View B: Article 5(2) is of independent of Article 5(1). This could expand scope of PE definition. This is consistent with UN model. If other PE’s (examples) in Article 5(2) are also considered independent of Article 5(1) then this may not be consistent with OECD view.
- The opening language of Article 5(2) of India US treaty is similar to UN model article.
Service PE in Article 5(2) vis-à-vis Article 5(1)

- Thus as per UN model and OECD model, Article 5(2) is not independent of Article 5(1).
- India does not agree with this position and has always followed rule of ‘Specific overriding General’. Service PE being special provision will override Article 5(1).
- India US Technical Explanation to Service PE clause under Article 5(2) –

  *Subparagraph (l) provides the rule for determining the conditions under which the activity of furnishing services, through employees or other personnel, constitutes a permanent establishment........ Under the U.S. Model such activities would constitute a permanent establishment only if they are exercised through a fixed place of business or by a dependent agent.*

  Gives an impression that view at the time of entering India US treaty was to follow View B.
- View emerging out of judicial precedents is that Article 5(2) would prevail irrespective of the conditions of Article 5(1).
Definition provisions contd....

Service PE in Article 5(2) vis-à-vis Article 5(1)

- Rulings:

  Morgan Stanley (SC) – SC touched upon this aspect remotely by stating that the definition of PE under Article 5(1) of India US treaty is not inclusive and hence Article 5(2) refers to places included as PE of the foreign enterprise.

  Linklaters LLP – Mumbai ITAT – Clauses consisting Article 5(2) of the India UK treaty are homogeneous and these clauses do not belong to the same genus.
**Definition provisions contd....**

**Contract split over different years:**

- Construction and Installation project spread over 2 years period
- Whether continuous period or split period in each fiscal year to be considered for PE
- This depends on language of treaty – India Germany treaty reads as ‘*project or activity continuous for a period exceeding 6 months*’. Where as India USA treaty reads as ‘*project or activity continue for a period of more than 120 days in any 12 month period*’.
- As per India US treaty, PE could exist in both fiscal years.
- Protocol to India US treaty and Article 5(2)(k), PE not to exist in the year in which project is continues for less than 30 days.
Definition provisions contd....

Contract split over different years:

Example

U.S. enterprise provides the services of its employees in India for a period of more than 90 days in a 12-month period.

Employees are performing services in India from December 20, 2013 through March 20, 2014 i.e for 91 days in a twelve-month period.

Whether there could be Service PE implications for the year 2013 and 2014?
Definition provisions contd....

Liaison Office

- Columbia Sportwear Co established LO in India. Engaged in vendor identification, review of cost data, vendor recommendation, quality control and uploading of material prices into management system of foreign entity. Moreover, monitoring vendors for compliance with its policies, procedures, and standards related to quality control, delivery and pricing etc.

  Held by AAR that activities are not in nature of ‘Preparatory or Auxiliary’ in nature and thereby PE under Article 5 of India US DTAA.

- A US Co had its authorised country manager in India for the purpose of collection marker information, notices inviting tenders relating to US Co’s products and services from various institutions and supplying such information to the US Co, submitting bid proposals to the respective customers and executing contracts on behalf of US Co and performing other tasks as authorised by US Co.

  Held by AAR that US Co had BC in India even though the proposal were prepared and signed in the USA. – Sutron Corporation
Definition provisions contd....

Supervisory activities:

- Under the US treaty, if the services for installation and commissioning are ancillary and subsidiary as well as inextricably and essentially linked to the sale of equipment, such services are not covered under FIS where supplier of equipment/ machines provides the installation and commissioning services; and that such services do not constitute Construction PE.
Substantive provisions

DTAA categorizes income under different heads, some of which are as follows:

- Business income
- Capital gains
- Fees for included services
- Royalty
- Dividend
- Interest
- Other income
Article 7- Business profits

• Business profits of an enterprise is taxable in the state of residence, unless it carries on business in the other state through a PE.
  • Profits may be taxed in the state of PE but only to the extent attributable to PE
    - Arising from the sale of goods or merchandise in the country which are same or of a similar to those sold though the PE
    - Arising from other business activities carried on in the country which are the same or of a similar kind as those effected through the PE (Force of Attraction).
  • Attribution rule- Profits it might be expected to make if it were a separate and distinct enterprise.
  • Deduction of allocable head office expenses allowed subject to provisions of the domestic law.
  • Deduction/income for royalty, commission, management services, interest on moneys lent (except in the case of banking enterprise) not to be considered in computing profits.
Article 10, 11 and 12- Dividend, interest, Royalties and Fees for included services

• Grants the source state to tax the income, however this right is limited to the rates prescribed.

• Recipient must be the beneficial owner.

- Anti-avoidance measures –”Substance over form”

• Taxable on a gross basis.

• Income from dividends, interest, royalty and fees for included services, if attributable to a PE shall be taxable on a net basis as business profits/independent personal services.
### Article 10, 11 and 12- Dividend, interest, Royalties and Fees for included services

<table>
<thead>
<tr>
<th>Income</th>
<th>Rate</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>15%/25%</td>
<td>Lower rate if holding &gt;=10%</td>
</tr>
<tr>
<td>Interest</td>
<td>0%/10%/15%</td>
<td>Lower rate for payments to specific institutions, banks or financial institutions</td>
</tr>
<tr>
<td>Royalty</td>
<td>10%/15%</td>
<td>Lower rate for use of industrial, commercial or scientific equipment</td>
</tr>
<tr>
<td>FIS</td>
<td>10%/15%</td>
<td>Lower rate for services ancillary and subsidiary to the lease of equipment.</td>
</tr>
</tbody>
</table>

### Article 13- Gains

Capital gains taxable as per the provisions of the domestic law of the respective countries.
Article 11 - Interest

Interest received on income tax refunds taxable as ‘Interest’ or ‘Business Income’?

- Bechtel International – Mumbai ITAT held that interest on income tax refund would be taxable as Interest income on gross basis.

- Phrase ‘attributable to’ as appearing in US MC has to be construed as equivalent to ‘effectively connected’.
Article 12 - Fees for included services

- Payments for rendering of any technical or consultancy services, if such services:
  - are ancillary and subsidiary to application or enjoyment of right, property, or information for which royalty is received, or
  - make available technical knowledge, experience, skill, know-how, or processes, or consist of development and transfer of a technical plan or technical design.

- Exclusions
  - Services that are ancillary and subsidiary to sale of property;
  - Services for the personal use of individual;
  - Teaching in or by educational institutions; etc
  - to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (IPS).

- The definition does not include the term ‘Managerial Services’.
Fees for included services

- What is make available?
  - Technology will be considered 'made available' when person acquiring service is enabled to apply the technology
  - The fact that the provision of the service requires technical input by the person providing the service does not per se means that technical knowledge, skills, etc, are made available to the person purchasing the service
  - The use of a product which embodies technology shall not per se be considered to make the technology available
Article 12 - Royalty

India US treaty differs from US model in many ways:

Definition includes payments received in connection with the use or right to use cinematographic films or films or tapes used for radio or television broadcasting.

Definitions does not include ‘Other like right or property’ at the end of its listing of the types of rights for which a payment is considered to be royalty.

Payment for online database access – Whether royalty?

- HEG Ltd – Payments made to US Co for obtain data or calculation sheet – Not treated as Royalty – Information should have special features and not merely as pure commercial nature.

- Wipro Ltd - Followed the ruling of HEG Ltd. Reversed by Karnataka HC – Subscription access to journal is a license to use (right to use) journal and hence Royalty
Royalty

Fee for use of satellite – Whether royalty?

• Whether the use of satellite is a ‘Process’ and that use of satellite transponder for uplinking and downlinking of data is a use of ‘commercial, industrial and scientific equipment’.

• Asia Satellite – Delhi Tribunal held as taxable as Royalty in respect of “process”.

• PanAmsat International Systems Inc – Held as term ‘Royalty’ in Article 12 of India US treaty there was a ‘comma’ after the words ‘secret formula or process’, it was only a ‘secret process’ which will qualify as a royalty. Hence not taxable as Royalty.

• Delhi Special bench in case of New Skies Satellite reversed decision of PanAmsat and held that transponder which uplinks and downlinks the data is a “Process” and it is not necessary that it should be a ‘secret process’. Consideration paid is for use of process.
Royalty

Fee for use of satellite – Whether royalty?

• Delhi HC – In Asia Satellite – No income is accrued in India from use of satellite outside India to beam signals in India even if major revenues arises due to viewers in India. **Payment for transponder facility is not Royalty.**

  This led to amendment in definition of Royalty under the Indian tax laws.

Payment for leased line connectivity charges – Whether royalty?

• Held as not Royalty : Not a ‘Secret Process’
  - Dell International Services – AAR
  - Cable and Wireless – AAR
  - Infosys technologies – Bangalore Tribunal

• Held as Royalty – Verizon Communications Singapore – Use of a ‘Process’ - Chennai Tribunal
Article 16-Dependent Personal Services

- Salaries taxable in the state where the employment is exercised (source state).
- Not taxable in source state if:
  - Stay does not exceed 183 days;
  - Remuneration paid by non-resident employer; **and**
  - Remuneration not borne/deducted/deductible by PE of employer in source state.
Article 23- Other income

- Covers income not dealt with specifically in any other article of the treaty. Example: Income from gambling, penal damages etc.
- Other income arising in a contracting state, may be taxed in the source state.
- In case income (other than income from real property) is effectively connected to a PE or a fixed base in the state of source, income may be taxable as business profits or as independent personal services.
Anti-avoidance provisions

Article 24- Limitation on Benefits

• Provisions designed to prevent third-country residents from treaty shopping.
• Entities to satisfy ownership test (>50%) and base erosion test to be eligible for treaty benefits.
• Exclusions
  - Income incidental to active trade or business, other than business of making or managing investments unless these activities are carried by a bank or insurance company.
  - Listed entities.
Tests for LOB

Applicable only to Non-Individuals

Test:

– Para 1: Ownership test and Base Erosion test

– Exceptions to Para 1

– Para 2: Active business connection test

Or

– Para 3: Recognized stock exchange test

Or

– Para 4: Competent authority test
**Ownership test:**

- Non corporate entity would be entitled to relief in the source state only if
  - 50% of the beneficial interest in the entity is owned, directly or indirectly, by one or more of the following entities (‘qualified owners’):
- Corporate entity would be entitled to relief in the source state only if
  - 50% of the number of shares of each class of shares in such entity is owned directly or indirectly, by one or more of the following entities (‘qualified owners’):
- Qualified owners:
  - Individuals, who are residents in India or USA;
  - Government of India or USA or there political sub-divisions or local authorities’
  - Other individuals subject to tax in India or USA on worldwide incomes; or
  - Citizens of USA.
**Base Erosion test:**

Income of the particular entity should not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not “qualified entities”
## Base Erosion Test

<table>
<thead>
<tr>
<th>Income</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>Gross income = Gross receipts - Cost of Goods sold</td>
</tr>
<tr>
<td>Substantial</td>
<td>Payment &lt; 50% of income – generally not substantial</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Deductible for tax purpose in State of Residence</td>
</tr>
</tbody>
</table>

### Gross receipts
- Gross receipts: 180
- 50% of 120 = Rs. 60

### (-) COGS
- (-) COGS: 60
- 50% of 50 = Rs. 25

### Gross income
- Gross income: 120

### (-) P/L A/c exp
- (-) P/L A/c exp
  - Royalty: 40
  - Depreciation: 30 70
- LOB not triggered
- To the extent of Rs. 60 (and not Rs. 25) paid to persons who are not residents of one of the States

### Net income
- Net income: 50
**Business Connection test:**

Para 1 not to apply if income derived from Source State, -

– is derived in connection with, or is incidental to,

– the active conduct of trade or business in State of Residence

– Other than the business of making or managing investments (unless these activities are banking or insurance activities carried on by a bank or insurance company)
**Business Connection test:**

**Income derived in connection with or incidental to**

- Income producing activity in Source State is derived -
  - In connection with, or
  - Is incidental to the trade or business in the State of Residence

- ‘In connection with’
  - if the 2 activities involved the design, manufacturing or sale of same products or same type of products

- ‘Is incidental to’
  - if the 2 activities are part of the same overall industry, and
  - are related in the sense that success or failure of one activity will tend to result in success or failure of the other

- Trade or business
  - Specific unified group of activities,
  - Independent economic enterprise,
  - For profit,
  - employees conducts substantial managerial / operational activities
**Stock exchange test:**

- Para 1 not to apply, if ‘company’ deriving income from Source State:
  - in whose principal class of shares,
  - there is substantial and regular trading,
  - on a recognized stock exchange
- ‘Regular trading’ not defined, reference to domestic laws
- Recognized stock exchange
  - US: The NASDAQ and any SEC registered stock exchange
  - India: Government recognized stock exchange under SCRA
  - Any other stock exchange agreed by mutual agreement by competent authorities
**Competent Authority test:**

- Person not entitled to benefit as paras 1, 2, or 3, may approach competent authority of the Source State for grant of benefits

- Competent Authority
  - India – Ministry of Finance (Department of Revenue)
  - US – Secretary of the Treasury
Article 25- Relief from Double Taxation

- Credit method, subject to domestic laws of the state.
- Underlying tax credit allowable for a US company owning at least 10% of the voting stock of an Indian resident company.

Article 26- Non-discrimination

- Discrimination on grounds of nationality or ownership is forbidden.
- Non-resident enterprises would not be subject to tax or any other requirement which are more burdensome as compared to those levied on resident enterprises.
- No obligation to grant non-resident individuals personal allowances/relief/reductions, that are available only to resident individuals.
Article 27- Mutual Agreement Procedure (MAP)

- Can be invoked by taxpayer if he considers that the actions of one or both of the Contracting States result or will result for him in taxation, not in accordance with provisions of the tax treaty.
- Case to be presented within 3 years of date of receipt of notice of taxation not in accordance with the tax treaty.
- MAP provides for a machinery whereby competent authorities can interact between themselves to resolve issues amicably.
- Limitation rules do not apply once MAP invoked.

Article 28- Exchange of Information and Administrative Assistance

- The competent authorities shall exchange information concerning taxes covered for the prevention of fraud or evasion of such taxes.
Questions
Thank You