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Scope of liable to tax & LOB clause

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Contents

Liable to Tax under Treaty

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Article 4 (OECD) – Scope of Application

- *"For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is* ***liable to <u>tax</u>*** *therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."*

Article 4 read with Article 2

- The scope of taxation is covered under Article 2.
- *"There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation."*
- If the subject matter is not covered under the scope of "tax" here, the liability to tax will not be covered by the Treaty.

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Illustrations for Liable to Tax

Where the source of income is not taxable in Resident State.

Where the entity is exempt from tax in the Resident State.

Where the entity is not overed by tax law in Resident State.

A. Where the source of income is not taxable in Resident State – Azaadi Bachao Andolan

- CBDT clarified that FII and investment funds that are incorporated in Mauritius and operating from there are "liable to tax" under Mauritius Tax Law and are "resident" there under India-Mauritius Treaty.
- Just because there is an exemption from income-tax in a contracting state, it cannot said that the taxable entity is not "liable to tax".
- "liability to tax" (Subjective) is not the same as "payment of tax" (Objective).
- Offshore companies incorporated in Mauritius are liable to tax under Mauritius Income-tax Act under the Treaty even though they are not liable under the domestic law.

Where the source of income is not taxable in Resident State.

- Pension funds, charities and other organisations are exempted from tax.
- However, they are exempt only if they meet all of the requirements for exemption specified in the tax laws.
- So although they are not required to pay taxes by virtue of exemptions provided, They are subject to the tax laws of that Contracting State, which is why they can avail those exemptions.
- Correspondingly, if they do not meet the standards specified, they are also required to pay tax.
- These entities would be regarded as “residents” under the treaty law.

Where the entity is not overed by tax law in Resident State.

- No personal income-tax in UAE.
- Individuals are excluded from definition of “person”.
- No statutory liability to pay tax.
- Thus, individuals who are not taxable entities under UAE Law cannt be regarded as residents of UAE under India-UAE Treaty.

Setting the Context

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The MLI – Basic Propositions

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3 Classes: Opt-out provisions (reservations), opt-in provisions and alternative provisions:

- Opt-out Provisions (or reservations)
- Alternative Provisions
- Opt-in provisions supplement the application of a primary operative clause

SLOB provisions are opt-in provisions.

Action 6 Report (min std.) states that countries, at a minimum, should implement:

- a PPT only;
- a PPT and either a simplified or detailed LOB provision; or
- a detailed LOB provision, supplemented by a mechanism either that would deal with conduit arrangements not already dealt with in tax treaties or a PPT.

(Detailed LOB has not been defined – left for countries to agree bilaterally)

Where one Party chooses to apply the Simplified Limitation on Benefits Provision pursuant to paragraph 6 and the other does not, the Simplified Limitation on Benefits Provision would not apply, and by default, the PPT in paragraph 1 would apply symmetrically.

The MLI – Basic Propositions

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Paragraph 16	Paragraph 7	Subparagraph a)	Subparagraph b)
Parties that choose to apply the Simplified Limitation on Benefits Provision are, however, permitted under paragraph 16 to opt out of the entirety of Article 7 in the cases in which the other Party chooses not to apply the Simplified Limitation on Benefits Provision.	Paragraph 7 provides two optional ways for Parties that do not choose to apply the Simplified Limitation on Benefits Provision to remove the risk that this interaction would result in Article 7 not applying with respect to a given bilateral relationship.	Subparagraph a) allows Parties that choose to apply the PPT alone to agree that the Simplified Limitation on Benefits Provision would apply symmetrically for the purposes of granting benefits in the case of Covered Tax Agreements with Parties that choose to apply the Simplified Limitation on Benefits Provision	Subparagraph b), in contrast, allows Parties that choose to apply the PPT alone to permit the Simplified Limitation on Benefits Provision to be applied asymmetrically with respect to a Covered Tax Agreement. Subparagraph b), in contrast, allows Parties that choose to apply the PPT alone to permit the Simplified Limitation on Benefits Provision to be applied asymmetrically with respect to a Covered Tax Agreement.

SLOB – Symmetrical vs Asymmetrical Application

Symmetrical Application – Both parties agree to apply the SLOB, even if not originally opted - Article 7(7)(a)

Asymmetrical Application – one party to a Covered Tax Agreement applies only the PPT and the other applies the PPT + SLOB - Article 7(7)(b)

Asymmetrical application peculiar to Articles 5 (measures to prevent double non-taxation – however asymmetrical application seen even in OECD Model Tax convention) and Article 7 (prevention of treaty abuse – this is new)

SLOB – Symmetrical vs Asymmetrical Application

Where a contracting jurisdiction chooses to adopt the SLOB in addition to the PPT article, it may opt-in for articles 7(6) or 7(7), whose texts are given below:

"A Party may also choose to apply the provisions contained in paragraphs 8 through 13 (hereinafter referred to as the "Simplified Limitation on Benefits Provision") to its CTA by making the notification described in subparagraph c) of paragraph 17 (Article 7(17)(c)). The SLOB Provision shall apply with respect to a Covered Tax Agreement only where all Contracting Jurisdictions have chosen to apply it."

"In cases where some but not all of the Contracting Jurisdictions to a CTA choose to apply the SLOB Provision pursuant to paragraph 6, then, notwithstanding the provisions of that paragraph, the SLOB shall apply with respect to the granting of benefits under the Covered Tax Agreement:

a) by all Contracting Jurisdictions, if all of the Contracting Jurisdictions that do not choose pursuant to paragraph 6 to apply SLOB agree to such application by choosing to apply this subparagraph and notifying the Depositary accordingly; or (symmetrical application)

b) only by the Contracting Jurisdictions that choose to apply the SLOB, if all of the Contracting Jurisdictions that do not choose pursuant to paragraph 6 to apply the Simplified Limitation on Benefits Provision agree to such application by choosing to apply this subparagraph and notifying the Depositary accordingly." (asymmetrical application)

Operation of the SLOB

A Covered Tax Agreement of India – XYZ

India - PPT + SLOB; Country XYZ - only PPT

Country XYZ can opt to make an election under Para 7(a) or (b):

- (a) Both Country XYZ and India would apply SLOB - SLOB would apply symmetrically in both cases
- (B) Country XYZ would not apply SLOB but is agreeable to India applying SLOB – asymmetrical application

In case country XYZ selects neither, India can choose to apply only PPT or opt out of Article 7 altogether. Para 16 requires India and XYZ to endeavor to reach a mutually satisfactory solution which is in line with the minimum standard, should India opt out of Article 7.

SLOB – Application Permutations

- PPT + SLOB – Matching principle (Both countries have opted eg, India – Bulgaria, India – Kenya, India - Russia)
- PPT + SLOB - Symmetrical Application (One country has Opted for 7(a)); India-Denmark. Icleand and Norway have opted for (a) but not are not CTAs for India)
- PPT + SLOB - Asymmetrical Application (one country has opted for 7(b)); India-Greece; Cote D'Ivoire has also opted for (b) but not CTA with India)
- PPT + SLOB – Only PPT applies since one country has opted for neither 7(a) or 7(b); India-Australia, India-Canada; India-France
- PPT + SLOB – Opt Out of Article 7 - (Option when only one country to CTA has opted for SLOB; and other has opted for neither symmetrical or asymmetrical application)

14 countries have opted for SLOB – Argentina, Armenia, Bulgaria, Chile, Columbia, India, Kazakhstan, Kenya, Mexico, Pakistan, Russia, Senegal, Slovak Republic, Uruguay

Illustration:

(Asymmetrical Clause (Article 7(7))

Under Article 7 of MLI

India has opted for PPT + SLOB	Greece has opted for PPT clause opted for application of Article 7(7)(b)

Implications

Indian tax authorities for denying the tax benefit to Greek resident will invoke **PPT + SLOB** under the treaty	Greek tax authorities for denying the tax benefit to Indian resident will invoke **PPT clause**

Anti Abuse Provision -An overview

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SLOB – An Overview

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It is treaty specific anti-abuse rule (SAAR) which provides objective conditions for determining entitlement of treaty benefits.

SLOB is optional in addition to PPT.

A person will not qualify for treaty benefit if it does not satisfy SLOB test.

Even if SLOB is fulfilled, the treaty benefit may still be denied in relation to a designated transaction or arrangement, if PPT is not fulfilled.

Active Business Test (ABT) – Article 7(10)(a)

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Eligibility to be based upon ABT:

- Where an entity is a resident of a contracting state (say Russia) actively carries on business in that state, and
- Derives income from the other contracting state (say India)
- In connection with or incidental to such business activities (activities conducted in Russia)
- Granting treaty benefits on such income shall not be view as a treaty abuse
- Regardless of the nature or ownership of entity

Exclusions to ABT:

- Operating as a holding company
- Providing overall supervision or administration of a group of companies
- Providing group financing (cash pooling)
- Making or managing investments, unless performed by bank, insurance company or registered securities dealer

ABT Concept – BEPS AP 6

Business activity in residence state considered part of a business activity in source state:

- Both activities involve - design, manufacture or sale of same or same type of products, provision of similar services
- Line of business - upstream, downstream or parallel to activity conducted in source state

Complimentary Business Activities: same overall industry and success or failure of one activity will tend to result in success or failure for other (factual connection).

Glossary of Terms

- **BEPS:** Base Erosion Profit Shifting
- **AP:** Action Plan
- **CTA**: Covered Tax Agreements
- **DTAA:** Double Taxation Avoidance Agreement
- **MLI**: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS
- **OECD :** Organization for Economic Co-Operation Development
- **PPT**: Principal Purpose Test
- **SLOB:** Simplified Limitation of Benefits Clause