NALSAR

Definition in tax treaties and fiscally transparent entities

Key highlights

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Background

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Article 3 - Definition in tax treaties

Article 3 - Definitions

- OECD / UN / US Model have Article 3 as definition section
- Article 3(1) : Defined terms
- Terms defined
  - Person
  - Company
  - Enterprise
  - Enterprise of a Contracting State and the Enterprise of the other Contracting State
  - International traffic
  - Competent Authority
  - National
  - Business
- Article 3(2) : Undefined terms

Article 3 - Definitions

- **Article 3 - General definitions**

  1. For the purpose of this Convention, unless the context otherwise requires:

  (a) the term "person" includes an individual, a company and any other body of persons;

  (b) the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;..

  2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that state for the purposes of taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

- Rules in Article 3(2):
  - Unless the context otherwise requires
  - Domestic tax law meaning vs. domestic general law meaning
  - Ambulatory vs Static approach

	Ambulatory Approach	Static Approach
Meaning	• Applying Law in force when the Convention is applied	• Applying Law prevalent at the time when the Convention is signed
OECD Convention refers the word "at any time….. at that time"		

Approach by Indian judicial authorities

- DIT vs New Skies Satellite BV (Delhi HC) - Static Approach
- CIT vs Siemens AG (Bombay HC) - Static approach for terms already defined in the treaty

Article 3 - Definitions

- **Paragraph 2**

11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed **or** that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly.

12. However, paragraph 2 specifies that the domestic law meaning of an undefined term applies only if the context does not require an alternative interpretation and the competent authorities do not agree to a different meaning pursuant to the provisions of Article 25. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

Article 4 - DTAA coverage for fiscally transparent entities/ Hybrid entities

Article 4 - Fiscally transparent entity

<u>DTAA coverage for Fiscally transparent entities</u>:

- Conditions for eligibility of DTAA benefits are (i) ‘Person’ and (ii) ‘Resident’
- Under some DTAAs, the entities fail the test of Person and few fail the test of Residency.
- As per Article 4 of the Convention and most tax treaties, resident of a contracting state is defined to mean *inter-alia* any person, who under the laws of such contracting state, is ‘liable to tax’ therein by reason of its domicile, residence, place of management or any other criterion of similar nature
- A fiscally transparent entity is not ‘liable to tax’ in it’s own capacity. Since the income flows through to its owners, such fiscally transparent entities, may not be regarded as resident for the purpose of such tax treaties. Therefore, such entities may not be granted relief under the provisions of the relevant tax treaties

The term 'liable to tax' is not defined under the tax treaty; therefore, to interpret undefined terms, Art 3(2) provides recourse to the definitions under the domestic laws of the contracting state. However, the conflict arises as to whether domestic laws of Source state or resident state are to be used to interpret the terms?

<u>Consequences, if not considered as a Resident</u>:

- DTAA benefit for income that is doubly taxed?
- APA and MAP benefit ?

Article 4 - Illustrations

<u>India-Swiss</u>:

- Person is defined to include an Individual, a company, a body of persons, or any other entity which is taxable under the <u>law in force in either of the two countries</u>
- Partnerships are covered under body of persons. While Partnerships are considered fiscally transparent under Swiss laws, they are considered taxable entities in India
- Due to the special construct of the DTAA, one could argue that Swiss partnerships are eligible for availing DTAA benefits. However, this has been a subject matter of litigation in the past

In the case of Schellenberg Wittmer vs DIT (AAR No 1029 of 2010), the AAR vide it's order dated 27th August 2012, ruled that since Swiss Partnerships are not treated as persons in Switzerland and therefore not taxed in Switzerland, income of such Partnership firm in India would not be subject to relief under the India Swiss DTAA.

<u>India-Austria</u>:

- Person is defined to include an Individual, a company and any other entity which is treated as <u>taxable unit under the taxation laws in force in the respective countries</u>
- Partnerships and Investment funds are treated as fiscally transparent entities in Austria and accordingly are not treated as taxable units. Thus, these would not be regarded as 'person' and would not get covered under the India-Austria DTAA

Article 4 - Illustrations

India-UK:

- Before the 2014 amendment, Article 3(f) of India-UK DTAA defined the term ‘person’ to include an individual, a company and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States, but, subject to paragraph 2 of this article, does not include a partnership;
- Para 2 of Article 3 states ‘A partnership which is treated as a taxable unit under the Income-tax Act, 1961 (43 of 1961), of India shall be treated as a person for the purposes of this Convention’
- Thus, Indian Partnership Firms were considered as Persons. However, a UK Partnership Firm, which was treated as fiscally transparent entity in the UK, were specifically excluded from the coverage of DTAA.

In the case of Linklaters LLP v. ITO, [2012] 132 TTJ (Mum.), the Mumbai Tribunal ruled that the mode of taxation of income holds greater significance than the taxable nature of the entity. It basically meant that even though a partnership firm is a kind of fiscally transparent entity, once its income and profit is taxed in the hands of the partners, the treaty benefits should be extended to the partners. The said principle is also followed in A.P. Moller-Mærsk (2015) 235 Taxmann 513 (Mumbai Tribunal).

- The India-UK DTAA was amended and the amending protocol was notified in February 2014, with effect from 27 December 2013.
- As per the protocol, the definition of the term ‘person’ was amended to remove the exclusion of partnerships. Further, the term ‘resident’ was amended to include partnerships, estate or trusts as resident of a Contracting State to the extent the income of such partnership, estate or trust is subject to the tax in the Contracting State as the income of a resident, either in its hands or in the hands of partners or beneficiaries. Circular No. 2 of 2016 dated 25 Feb 2016 was also issued to clarify this position.

Article 4 - Illustrations

<u>India-USA</u>:

- <u>Article 3 - General Definitions</u>:

  (f) “person” includes an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity

- <u>Article 4 - Residence</u>:

  1. 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 tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that

  – this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and

  – in the case of income derived or paid by a partnership, estate, or trust, <u>this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries</u>.

#	Legal entity	Nature of the entity (Tax purposes)
1	C-Corp	Corporations (not eligible for Check the box)
2	S-Corp	• One member - Disregarded entity • Two or more - Partnership firm / corporation (depending on the liability of the members)
3	LLC	• One member - Disregarded entity (if not elected as C-Corp or S-Corp) • Two or more - Partnership firm / corporation (depending on the liability of the members)

Article 4 - Illustrations

Notes:

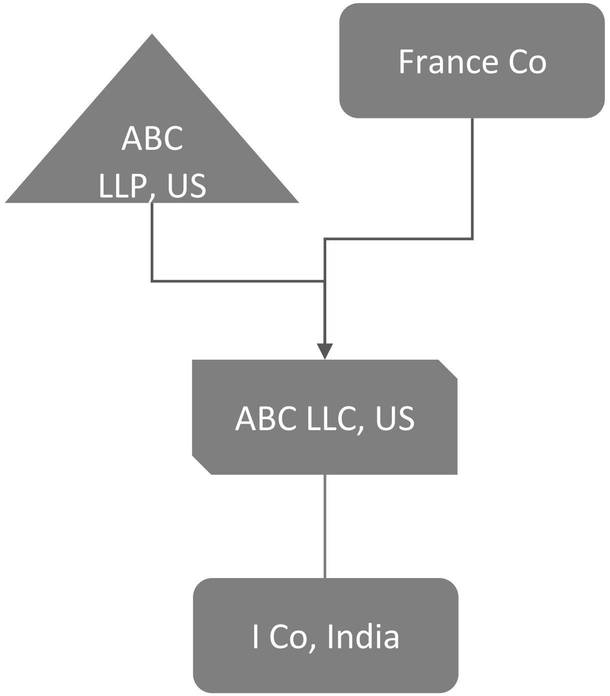
- India has DTAAs with more than 100 countries. But the exception under Article 4(2) to specifically cover partnership firms or fiscally transparent entities is very few. Other than US, only Sweden and UK allows treaty benefit to the income earned by the partnership entity, subject to the conditions similar to those in India-US DTAA
- Hon'ble Mumbai ITAT in the case of **ITO Vs. Shri Mahavirchand Mehta ITA No. 2958/M/09**
  - It is the argument of the revenue authorities that the the ld. CIT(Appeals) erred in holding that the assessee, an Individual, is entitled for the benefit of DTAA between India and UAE and accordingly, the assessee is not liable to pay any tax on the short-term capital gain and long-term capital gain earned from the transfer of securities in India.
  - The Hon'ble Tribunal held that "taxability in one country is not sine qua non for availing relief under the treaty. All that is necessary for this purpose is that the person should be 'liable to tax in the Contracting State by reason of domicile, residence, place of management, place of incorporation or any other criterion of similar nature' which essentially refers to the fiscal domicile of such a person. In other words, if fiscal domicile of a person is in a Contracting State, irrespective of whether or not that person is actually liable to pay tax in that country, he is to be treated as resident of that Contracting State. Therefore, this status of being a 'resident' of the Contracting State is independent of the actual levy of tax on that person. Thus, being 'liable to tax' in the Contracting State does not necessarily imply that the person should actually be liable to tax in that Contracting State by the virtue of an existing legal provision but would also cover the cases where that other Contracting State has the right to tax such persons - irrespective of whether or not such a right is exercised by the Contracting State"

Article 4 - Impact of MLI and India’s position

Impact of MLI:

- Article 3 of the MLI provides for inclusion of application of treaty to fiscally transparent entities.
- It states that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the laws of either contracting jurisdiction to a bilateral tax treaty shall be considered to be income of a resident of either jurisdiction only to the extent that such jurisdiction treats the income as the income of a resident of such jurisdiction.
- India has reserved the right for entire Article 3 to not apply to its covered tax agreements. Thus, regardless of the positions adopted by India’s bilateral tax treaty partners, Article 3 of MLI will not result in any amendment or modification to India’s DTAAs.
- It implies that India has not agreed for the application of tax treaty to fiscally transparent entity in all its treaties. Therefore, the benefit of DTAA is allowed to fiscally transparent entities of only those countries where India and the other country have negotiated and agreed to apply the provisions of fiscally transparent entity.

MLI Text.pdf   MLI - India position.pdf



ABC LLC is fiscally transparent as per the US regulations. Any income earned by ABC LLC from India would be taxed in the hands of its partners, i.e., ABC LLP and France Co.

In this case, India-US treaty would be applicable to the income only to the extent taxable in the US in the hands of ABC LLP. On the income earned by France Co. this treaty will not apply

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