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Income from Immovable Property under Tax Treaties

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Contents

Taxation in India

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Taxation in India

- In the case of a resident?
- In the case of a non-resident?

9. *(1) The following incomes shall be deemed to accrue or arise in India :—*

[27]*(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.*

History of Taxes on Income from Immovable Property

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History of Taxes on Income from Immovable Property

- First form of tax imposed was on <u>income arising from immovable property like harvest produced from lands and farms</u>
- Provision of taxation for cross-border income arising from immovable property <u>has been subject to relatively few changes and has remained quite stable since the inception</u>
- History of Article 6:
  - Draft Convention for the Prevention of Double Taxation 1927 – Article 2
  - Fiscal Committee of the League of Nations (1929-1935)
  - The Mexico Model (1943) and The London Model (1946) – Article 2
  - OEEC: Reports of the Fiscal Committee (1957-1959) – Article 6
  - The OECD Draft (1963) – Article 6
  - The OECD Draft (1977) – Article 6

Article 6 - OECD, UN and US Model Tax Convention

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Income from Immovable Property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

Article 6 – UN MTC

<u>**Income from Immovable Property**</u>

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, <u>***boats***</u> and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise <u>***and to income from immovable property used for the performance of independent personal services***</u>.

Article 6 – US MTC

<u>Income from Immovable Property</u>

1. Income derived by a resident of a Contracting State from ***<u>real property</u>*** (immovable property), including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other Contracting State.

2. The term <u>"real property" or "immovable property"</u> shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property (immovable property), livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property (immovable property) and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships and aircraft shall not be regarded as real property (immovable property).

3. The provisions of paragraph 1 of this Article shall apply to income derived from the direct use, letting, or use in any other form of real property (immovable property).

Article 6 – US MTC (Contd.)

<u>**Income from Immovable Property**</u>

4. The provisions of paragraphs 1 and 3 of this Article shall also apply to the income from real property (immovable property) of an enterprise.

5. <u>***A resident of a Contracting State that is liable to tax in the other Contracting State on income from real property (immovable property) situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other Contracting State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election.***</u>

Comparative Analysis – OECD, UN & US MTC

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Comparative Analysis – OECD, UN & US MTC

OECD MTC	UN MTC	US MTC
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 and Aircrafts not regarded as Immovable Property	Ships, Boats and 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

OECD and UN Models are similar. Most Indian DTAAs are based on UN Model

Application of Article 6

Application of Article 6(1) – Charging Provision

- For the application of Article 6(1), the following conditions have to be satisfied:

A resident of the Contracting State (State of Residence) derives income	Such income is derived from immovable property or agriculture or forestry	Such immovable property is situated in other Contracting State (Source State)

- Article 6(1) gives the right to tax to the source state.
- Grants primary right but not exclusive right of taxation to the country wherein property is situated. The term used is ‘may’.
- Application of *situs principle* – Existence of close economic connection between source of income i.e. the property and State of Source.
- **Point to note is that Article 6(1) will not extend to income earned by a resident from property situated in the State of Residence or any third State.**

Application of Article 6(2) – Meaning of Immovable Property

- Article 6(2) provides for meaning of "immovable property" – as per the law of the Contracting State where the property is situated.

- 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

- The term "immovable property" though not defined, will include
  - property accessory to immovable property
  - livestock and equipment used in agriculture and forestry
  - rights to which the provisions of general law respecting landed property apply
  - usufruct of immovable property and rights to variable or fixed payments as consideration for the working of or the right to work, mineral deposits, sources and other natural resources.

Application of Article 6(2) – Meaning of Immovable Property (Contd.)

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- "Immovable property" shall exclude
  - Ships
  - Aircrafts
- Domestic law is irrelevant if items specifically included or excluded in Treaty
- 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
- Meaning of immovable property in Indian domestic law:
  - 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 building; and
  - Including rights pertaining to above.
  - Section 194-IA- "immovable property" means any land (other than agricultural land) or any building or part of a building;

Application of Article 6(3) – Scope of Article 6(1)

- Income covered under 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"

- Income not covered under Article 6 shall include
  - Interest paid on a mortgage on immovable property (Article 11)
  - Capital gains from transfer of immovable property (Article 13)
  - Income from immovable property by virtue of holding of shares in a company, owning the immovable property

Application of Article 6(4) – Additional Scope

- 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

Immovable Property & Capital Gains – Article 13

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Article 13 – Capital Gains

•Article 13(1)

•Grants rights of taxation to country where immovable property is 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(1) – OECD/UN/US Comparative Analysis

OECD MTC	UN MTC	US MTC
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.	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.	Gains derived by a resident of a Contracting State from the alienation of real property (immovable property) situated in the other Contracting State may be taxed in that other Contracting State.

Article 6 and Article 13(1) – Interplay

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Article 6 and Article 13(1) – Interplay

- As per OECD commentary "Alienation of Property" includes
  - Sale or exchange or 'Gift 'or inheritance
  - Sale of a right
  - Partial alienation
  - Expropriation
- Article 13(1) of OECD and UN MTC specifically addresses the alienation of immovable property
- Article 13(1) and 6(1) based on the *'situs principle'* addresses the income and gains arising from immovable property
- Article 13(4) of OECD and UN MTC addresses the gains arising from sale of shares which derive more than 50% of their value from immovable property – taxable in the Contracting State where the immovable property is located *(Situs principle)*
- 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

Case Studies

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Case Study - 1

Facts

Mr. A is a non-resident in India settled in UK. He has a ancestral house property in India which he wants to sell off for buying a property in UK.

Query

What will be tax implications in the hands of Mr. A in the Indian Law?

India-UK DTAA

ARTICLE 6

INCOME FROM IMMOVABLE PROPERTY

1. Income from immovable property may be taxed in the Contracting State in which such property is situated.

2.(a) The term "immovable property" shall, subject to the provisions of sub-paragraph (*b*) of this paragraph, be defined in accordance with the law of the Contracting State in which the property in question is situated.

(*b*) The term "immovable property" shall in any case include property accessory in immovable property, livestock and equipment used in agriculture and forestry, rights, to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payment as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 of this Article shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 of this Article shall also apply to the income from immovable property of a enterprise and to income from immovable property used for the performance of independent personal services.

India-UK DTAA

ARTICLE 14

CAPITAL GAINS

1. Except as provided in Article 8 (Air Transport) and 9 (Shipping) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Case Study - 2

Facts

X Pvt. Ltd. is an Indian company having operations in Malaysia. It owns land in Malaysia from which operations are carried out and income is earned. The company pays tax on its operations in Malaysia.

Query

Whether X Pvt. Ltd. is liable to pay tax on such foreign income in India?

Case Study - 3

Immovable property as security for loans

Facts

Company A, a non-resident company, has given loan to Company I, an Indian resident company, and the loan has been secured via an immovable property situated in India and owned by Company I. Along with the loan amount, Company A will also earn interest income.

Query

Whether such income will be taxable under Article 6?

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THANK YOU!

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