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“Subject to Tax”, “Liable to Tax” and LOB Clause

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LIABLE TO TAX UNDER TREATY

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Steps to determine Treaty Eligibility

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- For terms not defined in the Treaty, domestic laws of contracting states can be referred.

Article 4 (OECD) – Residence

"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, 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 2 (OECD) – Taxes Covered

If the subject matter is not covered under the scope of "tax" here, the liability to tax will not be covered by the Treaty.

"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."

LIABLE TO TAX UNDER DOMESTIC LAW

“Liable to Tax” – Meaning

Section 2(29A) of the Income Tax Act, 1961 (Inserted by FA, 2021)

‘liable to tax’, in relation to a person and with reference to a country, means that there is an income-tax liability on such person under the law of that country for the time being in force and shall include a person who has subsequently been exempted from such liability under the law of that country.

“The term ‘liable to tax’ should be defined to say that there should be tax laws in force in the other State, which provides for taxation of such person, irrespective that such tax fully or partly exempts such persons from charge of tax on any income in any manner”.

Azadi Bachao Andolan v. UOI

OECD Commentary

- Where a State disregards a **partnership** for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State.

- An individual has his **permanent home in State A**, where his wife and children live. He has had a **stay of more than six months in State B** and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the Convention.

Illustrations – Whether the following situation will qualify ‘Liable to Tax’ condition

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

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

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

“Liable to Tax” – Features

- “Liability to Tax” not the same as “Subject to Tax”.
- Inherent relationship between “Liable to tax” and eligibility for claiming treaty benefits.
- No need of actually paying tax to be “Liable to Tax”.
- “Liable to Tax” is agnostic of exemption granted under Domestic Law.
- Mere ‘payment of tax’ by an Individual would not make him a resident in India.

Linklaters LLP v. ITO
[2010] 40 SOT 51 (MUM.)

Facts: Taxpayer was a UK-based LLP, which is a fiscally transparent entity i.e., the income is taxed in the hands of its partners and not LLP. The Tax authorities took a position that taxpayer constituted 'business connection' in India. However, Taxpayer contended treaty benefit to claim no PE is being formed.

Whether fiscally transparent entity can claim Treaty benefit in the present case?

Held: For claiming treaty benefit, a person's income should be subjected to residence-type taxation, on account of some locality related attachment, in that Contracting State. Thus, as long as partnership firm is taxable in respect of its profits not in its own right but in the hands of the partners, as long as entire income of the partnership firm is taxed in the residence country, treaty benefits cannot be declined.

SUBJECT TO TAX

"Subject to Tax" – Azadi Bachao Andolan v. UOI (2003) 263 ITR 706

'Subject to Tax' means the 'Actual payment of Tax', the term 'Subject to Tax' has a narrow meaning and it refers to the amount of income (net of deductions) on which tax has been levied

Being "Liable to Tax" and "actually taxed" are two different things

It's possible for a person to be "Liable to Tax" under statute but may not be "actually taxed".

Actual payment of Tax is not necessary for "Liable to Tax" but relevant for "Subject to Tax"

Income which is statutorily exempted from taxation cannot be said to be 'Subject to Tax'

Every person who is 'Subject to Tax' in a state is necessarily 'Liable to tax' in the state. However, every person who is 'Liable to tax' may not be 'Subject to Tax' in that state.

LIMITATION ON BENEFITS CLAUSE

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Limitation on Benefits - Objective

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To exclude conduit/shell companies from availing tax benefits under the treaty arrangements by recognising considerable nexus between the Contracting States.

To discourage Treaty shopping

The term ‘conduit/shell’ has been used in the LOB clause of DTAA between India – Mauritius under Article 27A which provides conditions for recognition or identification of such companies.

Similarly, in the LOB clause of DTAA between India – Singapore under Article 24A provides conditions for recognition or identification of conduit/shell companies.

Limitation of Benefits - Purpose

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Prevention of Treaty Shopping

"'Treaty shopping' is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States."

It is basically a tool taxpayers used for **tax evasion.**

Denial of Treaty Benefits

With an objective to prevent treaty shopping, this clause aims to restrict the benefits derived under the treaty to be availed only in bona fide transactions.

This clause in the treaties came to be known as the **'Limitation of Benefit'** clause.

EXAMINATION OF LOB CLAUSE AS PER UN & OECD MODEL

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Model Tax Treaties

Model Tax Treaties

- OECD Model
- UN Model

Limitation of Benefits – OECD Model

Setting Minimum standard → Elimination of double taxation → Prevention of Tax Evasion, Tax Avoidance, Treaty Shopping

Through Article 29 of the Convention i.e., Entitlement to Benefits, States will have option to adopt either of the following:

- Simplified Manner (PPT)
- Detailed Manner
- Or a combination thereof

No LOB clause in India’s DTAA with Germany, Italy, Turkey, etc

ARTICLE 29 (9) – Simplified Version (PPT)

Notwithstanding clause

Benefit denied in respect of the item of income or capital

If it is reasonable to conclude that obtaining benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit

Unless granting that benefit was in accordance with the object and purpose of Convention

EXAMPLE

Indian DTAAs having only PPT in their LOB Clause:

1. **Austria**
2. **France**
3. **Netherlands**
4. **UK**
5. **UAE**

Detailed Version of OECD Model

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ARTICLE 29

- **Para 2** – Qualified Person
  - Individual, Contracting states, Publicly Traded Co., Publicly Listed , Ownership & Base Erosion, CIVs
- **Para 3** – Active Conduct of Business test
- **Para 4** – Ownership Benefits
  - If the entity is not qualified person but it owned by qualified person, then Treaty benefits will be granted
- **Para 5** – Headquarters company
- **Para 6** – Competent Authority
  - Competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied
- **Para 8** – Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions

UN MODEL

Limitation of Benefits – UN Model

Implement Common Intention → Elimination → Tax evasion / Tax Avoidance / Treaty Shopping

Through Article 29 of the Convention i.e., Entitlement to Benefits, the UN Model Adopted Detailed version of the Article.

Features – UN Model

Article 29

- Para 2

  Qualified Person

  - Includes Ownership test
- Para 3

  Active Conduct of Business test
- Para 4

  Derivative Benefits

  - The Question of how the D.B. paragraphs should be drafted in a convention that follows a detailed version.
- Para 5

  Headquarters
- Para 6

  Competent Authority
- Para 8

  Anti-abuse Rule for PE Situated in Third Jurisdictions

Variants of LOB clauses in India's DTAA with different Countries

India-Hong Kong DTAA

Article 28: Miscellaneous Rules

1. Contracting states can apply domestic GAAR as well as LOB clause.

2. If main purpose or one of the main purposes of any persons concerned is for the non-taxation or reduced taxation through tax evasion or avoidance, then benefit not granted.

3. Legal entities must have bona fide business activities

India – Chile DTAA

Article 28- Limitation of Benefits

- **Para 2** – Qualified Person
  - Individuals, Public companies, NPOs, and Entities having 50% of their ownership held by qualified persons.
- **Para 3** – Active Conduct of Business test
  - Not Considered when:
    - -Operating as Holding Company
    - - Providing Overall Supervision
    - - Providing Group Financing
    - - Managing Investments
- **Para 4** – Derivative Benefits
- **Para 5** – Competent Authority
- **Para 8** – Anti-abuse Rule for PE Situated in Third Jurisdictions
- **Para 9** – PPT Condition
- **Para 10** – Application of Domestic Laws over Treaty anti-abuse measures

The Combined Version

India – Singapore DTAA

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Article 24A (Specific to Capital Gains)

- **Para 1**

  PPT Condition

- **Para 2**

  Shell Companies

  - Negligible/nil business operations/with no real and continuous business activities carried out in a state

- **Para 3**

  Deeming fiction for Shell Companies

  - **Expenditure Test**

    Aannual expenditure on operations must be more than :
    S$ 200,000 in Singapore
    Indian Rs. 5,000,000 in India

- **Para 4**

  Exclusion for Shell Companies

  - Listed on recognised Stock Exchange; or

    fulfils Expenditure Test

India – USA DTAA

The Detailed Version

Article 24
Limitation on Benefits

- **Para 1**
  Ownership and Base Erosion test
- **Para 2**
  Active Business Conduct test
- **Para 3**
  Recognised Stock Exchange Test
- **Para 4**
  Competent Authority

BG Asia (AAR-Delhi)-2021

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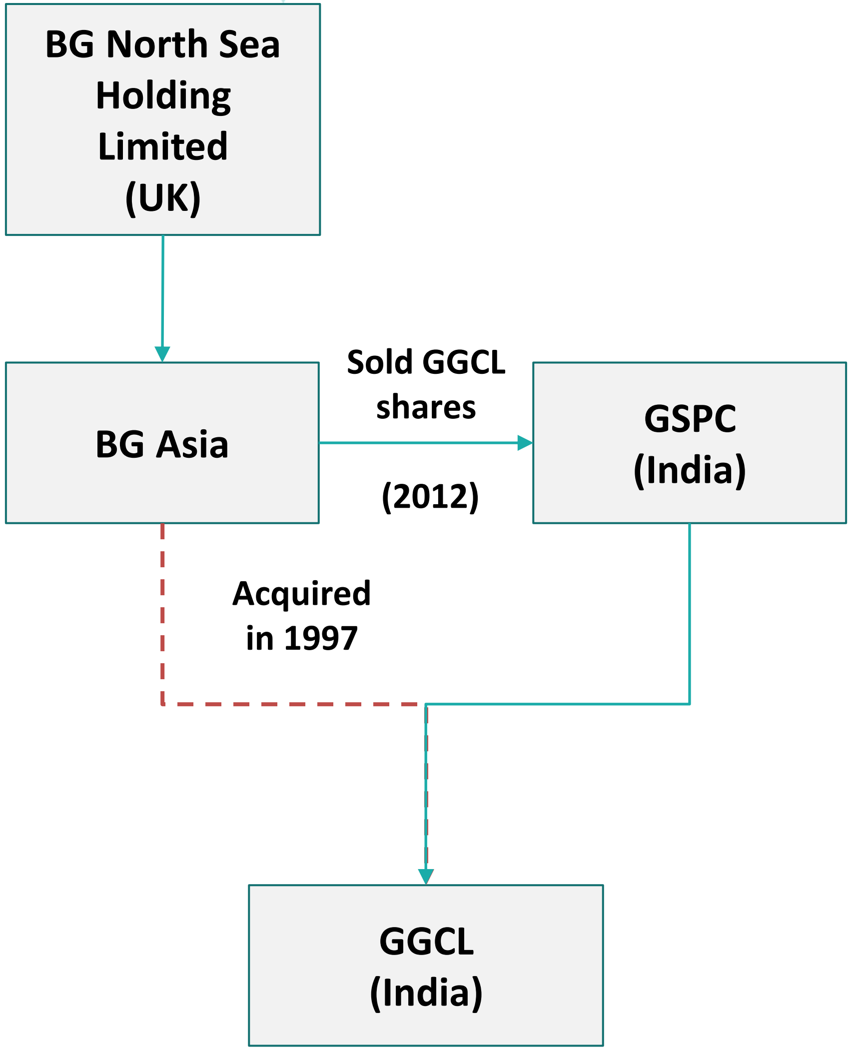
Facts

- BG Asia is a tax resident of Singapore and a 100% subsidiary of UK based company, made significant investments in the group companies situated in India, Singapore, Egypt, etc.
- BG Asia held 65.122% of total issued and paid-up equity capital of GGCL, an Indian company listed on recognised stock exchanges in India. BG Asia proposed to sell the shareholding in GGCL to another Indian company – GSPC (Buyer Co) in an off-market transaction

Issue: Whether the taxpayer is liable to capital gains tax in India under the provisions of the Act or treaty

Decision

- AAR held that the affairs of the assessee-company were not arranged with a primary purpose of availing treaty benefits
  - The shares of GGCL were held by BG Asia since 1997, even prior to the introduction of the 2005 Protocol in the India Singapore DTAA exempting capital gains tax;
  - Control & management of BG Asia was located in Singapore;
  - Decision to divest non-core business interest not limited to India but extended to investments in Brazil and Italy pursuant to *bonafide* business restructuring



Key Takeaways – General tests under LOB clauses

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General Tests for Establishing Applicability of LOB Clause

- Object & Purpose – PPT Condition
- Active conduct of Business test
- Qualified Persons test
- Recognised stock exchange test
- Shell or Conduit company test
- Discretionary Determination by Competent Authority
- Stock Ownership & Base Erosion test

Thank you!

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Annexures

Article 28 of DTAA between India – Hong Kong

1. The provisions of this Agreement shall in no case prevent a Contracting Party from the application of the provisions of its domestic law and measures concerning tax avoidance or evasion, whether or not described as such.

2. A Contracting Party is not required to grant benefits under the Agreement if the main purpose or one of the main purposes of any persons concerned is for the non-taxation or reduced taxation through tax evasion or avoidance.

3. Cases of legal entities not having bona fide business activities shall also be covered by the provisions of this Article."

Article 29 of DTAA between India – UAE (Only PPT Condition)

An entity which is a resident of a Contracting State shall not be entitled to the benefits of this Agreement **<u>if the main purpose or one of the main purposes of the creation of such entity was to obtain the benefits of this Agreement that would not be otherwise available</u>**.

ARTICLE 24-LIMITATION OF RELIEF

1. Where this Agreement provides (with or without other conditions) that income from sources in a Contracting State shall be exempt from tax, or taxed at a reduced rate in that Contracting State and under the laws in force in the other Contracting State the said income is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the exemption or reduction of tax to be allowed under this Agreement in the first-mentioned Contracting State shall apply to so much of the income as is remitted to or received in that other Contracting State.

2. However, this limitation does not apply to income derived by the Government of a Contracting State or any person approved by the competent authority of that State for the purpose of this paragraph. The term "Government" includes its agencies and statutory bodies.

PPT clause specific to Capital Gains - **ARTICLE 24A**

1. A resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement if its affairs were arranged with the primary purpose to take advantage of the benefits in the said paragraph 4A or paragraph 4C of Article 13 of this Agreement, as the case may be.

2. A shell or conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement. A shell or conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.

3. A resident of a Contracting State is deemed to be a shell or conduit company if its annual expenditure on operations in that Contracting State is less than S$ 200,000 in Singapore or Indian Rs. 5,000,000 in India, as the case may be: (a) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12 month periods in the immediately preceding period of 24 months from the date on which the gains arise; (b) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.

4. A resident of a Contracting State is deemed not to be a shell or conduit company if:

a) it is listed on a recognised stock exchange of the Contracting State; or

b)its annual expenditure on operations in that Contracting State is equal to or more than S$ 200,000 in Singapore or Indian Rs. 5,000,000 in India, as the case may be: (i) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12-month periods in the immediately preceding period of 24 months from the date on which the gains arise; (ii) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.

5. For the purpose of paragraph 4(a) of this Article, a recognised stock exchange means:

(a) in the case of Singapore, the securities market operated by the Singapore Exchange Limited, Singapore Exchange Securities Trading Limited and The Central Depository (Pte) Limited; and

(b) in the case of India, a stock exchange recognised by the Securities and Exchange Board of India. Explanation: The cases of legal entities not having bona fide business activities shall be covered by paragraph 1 of this Article.