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# TAX FLASH NEWS

22 July 2019

## The Protocol amending the India-China tax treaty notified

Recently, the Government has notified[1] the Protocol amending the India-China tax treaty (tax treaty). The Protocol was signed on 26 November 2018 and it comes into effect in India in respect of income derived in any fiscal year beginning on or after 1 April 2020. The amendments vide Protocol are mainly in line with the India’s positions on Multi-lateral Instrument (MLI).

Key amendments to the existing tax treaty are as follows:

### Preamble

The amended Protocol included a preamble which states that parties intend to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including treaty-shopping arrangements aimed at obtaining reliefs provided in the treaty for the indirect benefit of residents of third states). The Protocol also includes the additional preamble clause which states that the desire of India and China is to further develop their economic relationship and to enhance their cooperation in tax matters.

This is in line with the preamble as mandated by MLI as minimum standard.

### Permanent Establishment

#### *Construction, installation, assembly, supervisory*

Currently, if a building site or construction, installation or assembly project or supervisory activities continued for more than 183 days, it results into a Permanent Establishment (PE).

The Protocol to the tax treaty provides that for computation of the 183 days threshold, one would need to also aggregate the time spent on connected activities on the same project by one or more closely related enterprise, if exceeds 30 days each.

This is in line with the India’s position in the MLI.

#### *Service PE*

Under the existing tax treaty, if services are rendered through employees or other personnel for more than 183 days, it results into Service PE.

The Protocol to the tax treaty clarifies that the time threshold of 183 days will be computed within any 12 month period beginning or ending in the relevant financial year. Further, the services for same or connected projects need to be aggregated.

#### *Exclusion from PE*

Under the existing tax treaty, the use of facilities or maintenance of stock of goods solely for purpose of ‘delivery’ is exempt from PE definition under the existing tax treaty.

The Protocol to the tax treaty has removed the exemption for ‘delivery’ activity and hence, such activity will no longer be eligible for exemption unless same constitutes a preparatory or auxiliary activity.

#### *Dependent agent PE*

Under the existing tax treaty, if a person, acting on behalf of another enterprise, has and habitually exercises an authority to conclude contracts in the name of such enterprise, it results into an Agency PE.

The Protocol to the tax treaty has widened the dependent agency provisions and extends it to include persons who habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modifications by the enterprise and these contracts are:

- In the name of enterprise,
- For the transfer of the ownership of, for the granting of the right to use, property owned by that enterprise or that enterprise has the right to use, or
- For the provision of services by the enterprise.

[1] Notification No. 54/2019, dated 17 July 2019 – Taxsutra.com

The Protocol also provides that an agency PE shall be created if a person habitually maintains stock of goods from which he regularly delivers goods or merchandise on behalf of another enterprise.

This is in line with the India's position in the MLI.

### *Independent agent*

In the existing tax treaty, a person cannot be considered as independent agent if such person is devoted wholly or almost wholly on behalf of an enterprise.

The protocol provides that a person cannot be considered an independent agent if he acts exclusively or almost exclusively on behalf of one or more enterprise to which it is closely related.

## Business profits

Under the existing tax treaty, any enterprise carrying on business in the other state through a PE, the income which shall be taxable in other state will be the extent of profits of such enterprise which can be regarded as directly or indirectly attributable to the PE in that other state. Further, it will not apply if the enterprise proves that activities could not be undertaken by the PE or have no relation with the PE.

The Protocol has replaced the above provision and now income is to be taxed in India only to extent of profits attributable to the PE.

## Interest

The amended Protocol incorporates the provisions for exemption from interest income on loan guaranteed or insured by government.

## Persons covered

Article 1 dealing with 'persons covered' has been amended to provide that income derived by or through an entity or arrangement that is established in either state and that is treated as wholly fiscally transparent under the tax law of either State shall be considered to be income of a resident of a State only to the extent that the income is treated, for the purposes of taxation by that State, as the income of a resident of that State.

## Resident

The Protocol provides that treaty residency of dual resident entities shall be determined by competent authorities under a Mutual Agreement Procedure (MAP) between countries having regard to its place of effective management (PoEM), place of incorporation or constitution or any other relevant factors. However, in the absence of any agreement between the countries, the dual resident entities will not be entitled to any relief or exemption under the tax treaty, except as may be agreed by the competent authorities.

## Exchange of Information

The Protocol replaced the existing provisions for exchange of information to enable greater transparency among the nations on sharing of information based on international standards.

## Entitlement to benefits of the tax treaty

The Protocol inserted a new article to provide that a benefit under the tax treaty shall not be granted in respect of an item of income if it is reasonable to conclude that obtaining treaty benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the treaty.

This is in line with the PPT clause in the MLI.

## Our comments

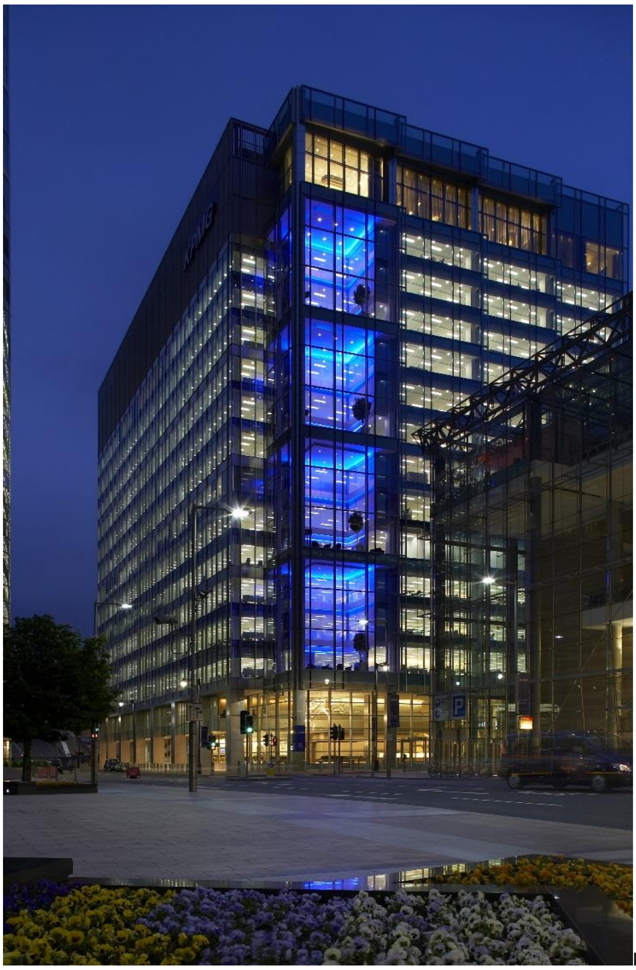
The Protocol has introduced BEPS related amendments in the India-China tax treaty i.e. minimum standards of anti-abuse provisions, Permanent Establishment (PE) related changes to include broader dependent agency PE rule and the aggregation rule in order to compute time thresholds when activities are carried out by affiliates, revised tie-breaker rule for dual resident entities, tax treaty benefits to fiscally transparent entities, etc.

In line with the minimum standard under MLI, the amended Protocol introduced PPT rule in the tax treaty. The intention of the government of both the countries is clear to avoid abuse of tax treaty provisions by taxpayers through treaty shopping and other means. The PPT clause is broader in scope than the General Anti-Avoidance Rule (GAAR) under the Income-tax Act, 1961 (the Act) as the GAAR applies only if the 'main purpose' of the arrangement is to obtain a tax benefit whereas the PPT may apply if obtaining a benefit of the tax treaty was one of the principal purposes. Further the GAAR provides threshold for its applicability which is absent in PPT. PPT provisions also do not provide any grandfathering option.

The protocol provides that in the absence of any agreement between the countries, the dual resident entities will not be entitled to any relief or exemption under the tax treaty, except as may be agreed by the competent authorities. This change is likely to have significant impact.

The Protocol widens the dependent agency provisions and extends it to include persons who habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modifications by the enterprise. Further a person cannot be considered an independent agent if he acts exclusively or almost exclusively on behalf of one or more enterprise to which it is closely related. Indian courts have held that there is no agency PE in the absence of authority to conclude contracts. Further there is no PE if agent is working for multiple principals. However, post this Protocol, substantive activities of agent leading to contract conclusion, even when there is no authority to conclude contract, may result into a PE. Further multiplicity of closely related principals to be viewed collectively for ascertaining independence. India has introduced similar type of provision under the Act.

The Protocol widens the scope of provisions on exchange of information which will enable both the countries to fulfill their respective international obligations on enhancing tax transparency and combating tax evasion.



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