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TAX FLASH NEWS

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India releases synthesised text for the application of tax treaty with Slovak Republic as modified by the MLI

Recently, the Government of India has released synthesised text[1] for the application of tax treaty with Slovak Republic as modified by the Multilateral Convention (MLI) to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS). The synthesised text is prepared on the basis of the reservations and notifications submitted to Organisation for Economic Co-operation and Development (OECD).

Key highlights of these synthesised texts are as follows:

Applicability of MLI provisions

The MLI enters into force for India on 1 October 2019 and thus has effect as follows:

- For taxes withheld at source on amounts paid or credited to non-residents, where the event giving rise to such taxes occurs on or after 1 April 2020
- For all other taxes levied with respect to taxable periods beginning on or after 1 April 2020.

The MLI enters into Slovak Republic on 1 January 2019

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Preamble

- The scope of the existing preamble is expanded to include MLI minimum standard (Article 6-Purpose of Covered Tax Agreement). The following preamble text is now included in the preamble of the tax treaty:

'Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)'

Residence

The existing tax treaty provides that where a person other than an individual is a resident of both the states, then it shall be deemed to be a resident of the state in which its place of effective management (POEM) is situated.

The synthesised text provides that where by reason of the provisions of the tax treaty a person other than an individual is a resident of more than one state, the competent authorities of the state shall endeavour to determine by mutual agreement the state of which such person shall be deemed to be a resident for the purposes of the tax treaty, having regard to its POEM, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the tax treaty except to the extent and in such manner as may be agreed upon by the competent authorities of the states.

Permanent Establishment

Spitting-up of contracts

The existing tax treaty provides that the Permanent Establishment (PE) shall include a building site or construction or assembly project or supervisory activities in connection therewith where activity carried out by such site, project, etc., continues for a period of exceeding six months, or where such project or supervisory activity, being incidental to the sale of machinery or equipment, continues for a period not

[1] Source – Taxsutra.com

exceeding six months and the charges payable for the project or supervisory activity exceed 10 per cent of the sale price of the machinery or equipment.

The synthesised text amended the said provision to provide that for the sole purpose of determining whether the period (or periods) referred above (for determination of PE) has been exceeded or not:

- Where an enterprise of a state carries on activities in the other state at a place that constitutes a building site or construction or assembly project, or carries on supervisory activities in connection with such a place, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding specified period or periods; and

- Where connected activities are carried on in that other state at the same building site or construction or assembly project or supervisory activities in connection therewith during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

These different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or assembly project, or supervisory activities in connection therewith.

Specific activity exemptions

The existing tax treaty provides the specific activity exemptions under the definition of PE which provides list of activities[2] that do not amount to a PE if a fixed place of business is used solely for such activities.

The synthesised text provides to modify the said provisions to the extent that (i) all activities currently included in the tax treaty (whether or not they are preparatory or auxiliary nature); (ii) any other activity not already mentioned in the tax treaty and (iii) any combination of activities in (i) and (ii) shall fall within the specific activity exemptions only if such activity (or the overall activity of the fixed place of business from a combination of activities) is of a preparatory or auxiliary character.

Splitting-up of business activities in order to fall within specific activity exemption

Large multinational enterprises splitting up their business activities or altering their structures in order to fall within the specific activity exemptions.

The synthesized text provide that the specific activity exemptions that deem a fixed place of business to not amount to a PE shall not apply where the relevant enterprise, or a closely related enterprise, carries on business activities at the same fixed place or a different place in the same state and

(i) such place constitutes a PE; or
(ii) the overall activity resulting from the combined business activities of either
a) one enterprise or two closely related enterprises operating in two fixed places or

b) two enterprises operating in one fixed place, is not of a preparatory or auxiliary character.

Provided that the business activities conducted by the enterprise or the two closely related enterprises must constitute complementary functions that are part of a cohesive business operation.

Independent Agent

The existing tax treaty provides that a PE is deemed to be established in the other state if an agent acting in such other state, has and habitually exercises an authority to conclude contracts on behalf of an enterprise in the state.

The synthesised text provides to expand agency PE scope by deeming a PE if:

- A person acts on behalf of an enterprise and habitually concludes contracts, or habitually plays a principal role in the conclusion of contracts that are routinely concluded without material modification by the enterprise and

- These contracts are:

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

Unless these activities, if they were exercised by the enterprise through a fixed place of business would not cause that fixed place of business to be deemed to constitute a PE.

Further the existing tax treaty provides that an enterprise shall not be deemed to have an PE in a state merely because it carries on business in that state through a broker, general commission agent or any other agent of an independent status, provided that such persons are not acting in the ordinary course of their business.

[2] Storage or display of goods, collecting of information, purchase of goods, etc.

The synthesised text provides that the above PE provisions shall not apply where the person acting in a state carries on business in the other state as an independent agent and acts for the enterprise in the ordinary course of that business. However, if a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent.

Definition of a person closely related to an enterprises

The synthesised text with respect to PE mentions a phrase 'a person closely related to an enterprises' in various provisions. Accordingly, the synthesised text provides that a person is closely related to an enterprise if, one has control of the other or both are under the control of the same person or enterprises. In any cases, a person shall be considered to be closely related to an enterprise:

- If one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or

- If another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.

Secondary adjustment

The synthesised text provides that:

- Where a State includes in the profits of an enterprise of that State and taxes accordingly profits on which an enterprise of the other State has been charged to tax in that other State and

- the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises,

- then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits,

- In determining such adjustment, due regard shall be had to the other provisions of the Agreement and the competent authorities of the states shall if necessary consult each other.

Dividend transfer transactions

The existing tax treaty provides that dividend shall be chargeable to tax at the rate of 15 per cent of the gross amount of the dividends if the beneficial owner is a company which owns at least 25 per cent of the shares of company paying the dividends.

The synthesised text provides that the above provision shall apply only if the ownership conditions described in the provisions are met throughout a 365 day period that includes the day of the payment of the dividends (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividends).

Capital gains

The existing tax treaty provides that capital gains derived by a resident of a state from the alienation of any property shall be taxed in the country in which the property is located.

The synthesised text expands the scope and applicability of capital gains Article. It provides that gains derived by a resident of a State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other state if, at any time during the 365 days preceding the alienation these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property situated in that other State.

Elimination of double taxation

The synthesised text provides that where a resident of a state derives income which may be taxed in the other state in accordance with the provisions of the agreement (except to the extent that these provisions allow taxation by that other state] solely because the income is also income derived by a resident of that other state), the first-mentioned state shall allow as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other state. Such deduction shall not, however, exceed that part of the income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in that other state.

Where income derived by a resident of a state is exempt from tax in that state, such state, in calculating the amount of tax on the remaining income of such resident, may not take into account the exempted income.

Prevention of treaty abuse

The synthesised text introduced simplified LOB provisions in the tax treaty.

Further the synthesised text provides that a benefit under the tax treaty shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that 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 Agreement.

Anti-abuse rule with respect to PE in third state

The synthesised text also provides a provision of an anti-abuse rule for PE situated in third state. It deals with situations where an enterprise of the country of residence derives income from the country of source, and such income is considered by the country of residence as being attributed to a PE of the enterprise in a third state.

If the profits attributable to the PE are exempt in the country of residence, the benefit of the tax treaty will not be available in respect of any income in which the tax in the third state (i.e. where the PE is located is less than 60 per cent of the tax would be imposable in the country of residence if the PE hand been situated there.

It also provides that anti-abuse provisions shall not apply if the income derived from the country of source is derived in connection with or is incidental to the active conduct of business carried on through the PE (other than the business of making, managing or simply holding investments for the enterprise's own accounts, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer).

Further, it is provided that even if tax treaty relief is denied due to the satisfaction of the 60 per cent test, the competent authority of a country of source has the authority to grant the tax treaty relief as a response to a request by the taxpayer in the country of residence on the basis of justified reasons for not meeting the 60 per cent test. In such situations, the competent authority of the country of source shall consult with the competent authority of the country of residence before arriving at a decision.

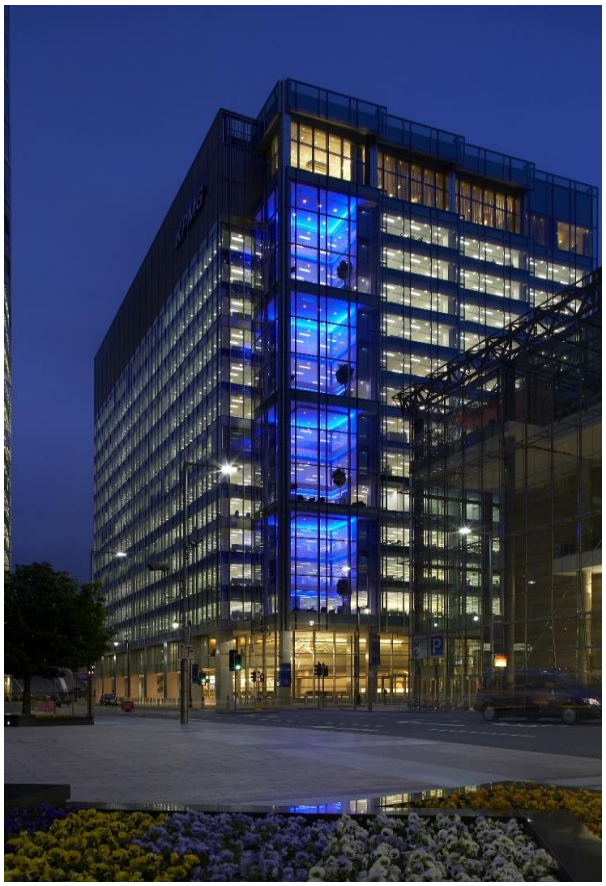
Our comments

The MLI has made changes in the PE Article of the India-Slovak Republic tax treaty. The changes with respect to specific activity exemptions are likely to impact Slovak multinational companies who have been availing specific activity exemption under the tax treaty. Further the segregation of business activities within the group company will also be impacted.

The synthesised text introduced simplified LOB provisions in the tax treaty. Further the PPT under the synthesised text of the India-Slovak tax treaty is broader in scope than the General Anti-Avoidance Rule (GAAR) under the Income-tax Act, 1961 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 of the principal purposes. Further the GAAR provides threshold for its applicability which is absent in PPT. The LOB clause also has not provided grandfathering provisions like GAAR.

The synthesised text introduces a new tie-breaker test for companies and in the absence of any agreement between the competent authorities, the company shall not be entitled to any relief or exemption of the tax treaty. This may result into a long-drawn litigation and an additional cost for the taxpayer.

In view of above, the transactions/arrangements between the Slovak and Indian entities need to be relooked at and appropriate steps should be taken to avoid tax litigations.



home.kpmg/in

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road,
Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2,
Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
1st Floor, Lodha Excelus,
Apollo Mills,
N. M. Joshi Marg,
Mahalaxmi,
Mumbai – 400 011.
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000