



Change in rules in determining residency of a person as per the Tax Treaty – Are you 'liable to tax'?

Introduction

Determination of 'residency' is the cornerstone for availing benefits of a Tax Treaty. The tax treaties generally provide that a "resident" means any person who is "liable to tax" in a country by reason of his domicile, residence, place of management or any criterion of a similar nature.

The expression "liable to tax" has been a subject matter of controversy before the Indian Courts. The preponderant view which has thus far emerged is that given that a country has a sovereign power to tax a person (individual/partnership firm/company, etc.); the concerned person should be regarded as 'liable to tax' in that country even if no tax is actually paid by him; either:

- (a) on account of the country not levying any income-tax; or
- (b) on account of the person being treated as fiscally transparent wherein the income-tax is actually paid by the shareholders or the members.

The Courts¹ in several cases have thus held that to determine if a person is 'liable to tax', it is immaterial that the person actually pays tax or not. Also, merely because an exemption is granted, it cannot be regarded that the person is not 'liable to tax'. In such cases, a person is generally treated as 'liable to tax' and thereby as a 'resident' of a country for the purposes of availing benefits of a tax treaty.

Changes brought in by the Finance Act, 2021

The Finance Act, 2021 has amended the Indian Income Tax Act to define the expression "liable to tax" as under:

"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.

As can be observed, the expression "liable to tax" is now defined narrowly to include only the following situations:

- (a) There must be a liability of tax on such person under any law for the time being in force in any country; or
- (b) There must be a specific tax exemption provided subsequent to imposition of a tax liability.

These changes are introduced to give relief to foreign pension funds who though are liable to tax but are exempted therefrom.

There could be some unintended consequences arising therefrom.

Impact analysis

- Consider a partnership firm (say, a German / Swiss partnership or a US LLC) receiving professional fees from an Indian company. Assuming that the partnership is regarded as pass-through / fiscally transparent in its home country and hence not 'liable to tax' as per the new definition, it may potentially not be entitled to the Indian tax treaty benefits (even if its partners are liable to tax in the home country). This could lead to consequential withholding tax obligation for the payer, compliance obligations (filing of India tax returns, etc.) for the partnership, etc.².

¹Refer, illustratively, UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC); Abdul Razak Meman [2005] 276 ITR 306 (AAR)

Therefore, the tax treaty benefits which might have been hitherto enjoyed by the partnership firm may now no longer be available as the partnership firm may not strictly fit into the definition of 'liable to tax' and thus may not qualify as a 'resident' for tax treaty purposes.

- Similarly, individuals who are Indian citizens but also residents of UAE³ (given that their stay in UAE exceeds 183 days), may not be regarded as "liable to tax" in UAE, if they are not chargeable to tax in UAE, as per the new definition. Further, assuming that their tax residency tie-breaks⁴ to India, income earned by such persons in UAE from a business controlled in India can potentially be subjected to tax in India.

Concluding remarks

This amendment is a significant one and will have far

reaching impact in determining tax residency for individuals as well as companies /firms who are regarded as fiscally transparent as per the local tax laws governing them or who are situated in a country where there are no corporate or personal taxes (UAE, Saudi Arabia, etc).

Given that the expression "liable to tax" is generally not defined in any of the tax treaties, recourse will thus need to be made to the Indian domestic tax laws to import the definition into the treaty. Given the narrow compass of the proposed definition, there could be several situations where a non-resident may not be regarded as "liable to tax" in the home country and thus not entitled for treaty benefits. It would therefore become imperative to revisit business models/operating structures and make appropriate changes if it is intended to avail tax treaty benefits.



²The tax treaties with Canada, Cyprus Denmark, Finland, France, Germany, Japan, Mauritius, Netherlands, etc. could also get impacted if the persons situated in those countries are not regarded as 'liable to tax' as per the proposed amendment.

³Also applicable to residents of Saudi Arabia, Kuwait, Qatar, etc.

⁴Depending upon the criteria prescribed in the tax treaty (permanent home test, centre of vital interests test, habitual abode test, nationality test, etc.)

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