Double Taxation Avoidance Agreement

Introduction

Double Tax Avoidance Agreement (DTAA) is a tax treaty/agreement between two or multiple countries, to prevent double taxation of income earned in both countries.

For example, a company in country A (origin country) invests in country B (source country) for construction, the question which arises is whether such company is liable to pay tax in both the countries?

No, the key objective of Double Tax Avoidance Agreement (DTAA) is to ensure there isno tax evasion, exchange of information between the countries and to prevent double payment of tax. Such agreement ensures that the tax to be paid shall be borne by company in only one of the countries.

Double Tax Avoidance Agreement (DTAA) can either be comprehensive agreement, which covers all sources of income or can be limited to specific areas such as taxing of income from air transport services, shipping etc.

India is signatory of double taxation treaty with more than 80 countries at present which includes comprehensive agreement with countries such as Australia, Canada, Germany, Mauritius, Singapore, UAE, UK, and USA.

The need for Double Tax Avoidance Agreement (DTAA) arises due to improper method incollection of taxes globally. If a person aims to do a business in foreign country, he/she may end up paying taxes in both of the countries, i.e., in country where income is earned and in country to which company belongs to, or in such case in order to avoid double tax, such company may adopt methods of evading tax.

Thus, in order to avoid double taxation and evasion of tax, the need for Double Tax Avoidance Agreement (DTAA) arose, and such agreement also kept both the countries well informed about the activities of such company in the source country.

Advantages of Double Tax Avoidance Agreement (DTAA)

There are various benefits associated with Double Tax Avoidance Agreement (DTAA). The basic benefit includes not paying double tax on income earned, apart from this, benefits such as:

1. Tax Exemption- Let's say country A (source country) imposes 10% tax on capital gains. Now if government of country A (source country) notifies that it shall not collect tax on investment coming from country B (origin country) and exempt country B from tax on capital gains on investment, this is known as tax exemption.

2. Lower Tax Rate- Lets take above example, when country A (source country) imposes10% tax on capital gains, it notifies that it shall collect tax on capital gains at rate of5% on investments coming from country B (origin country), this is known as tax reduction.

3. Refund- Let's say when company X from country A (origin country) invests in countryB(source country) and pays 100$(hypothetical) as tax on income earned in country B (source country). Country A (origin country) may refund the 100$ or part of such tax to company X. This is known as refund in the concept of Double Tax Avoidance Agreement (DTAA)

Hence, the outcomes of such agreements are that

1. As already discussed above, Double taxation on income earned will not take place.

2. Such agreements may promote bilateral investments between both the countries and multiple countries.

3. It will promote more clarity and transparency in terms of investments.

4. Lastly it will promote trading on a global perspective.

Double Tax Avoidance Agreement (DTAA) in India includes following types of Incomes, on which Non-resident Indians need not pay tax twice:

1. Income from Services provided in India,

2. Income from Salary received in India,

3. Income from Immovable property in India,

4. Income from Capital Gains,

5. Income from fixed deposits in India,

6. Income from Savings bank account in India.

Misuse of Double Tax Avoidance Agreement (DTAA)

Treaty Shopping- Where national or a resident of third country seeks to obtain benefit double tax avoidance agreement (DTAA) between two or multiple countries by impersonating as a company or other entity in one of the countries. Thus, this concept is known as treaty shopping, which is one of the misuses of double tax avoidance agreement (DTAA).

Let's take an example, when an investor of country A (origin country) invests in country B (source country), makes certain amount of income. Now, ideally country B shall pay tax at rate of 10% (hypothetical) on this particular income.

Now let's say that there is another double tax avoidance agreement (DTAA) between country C and country B, in which country C is exempted from paying tax on income earned from investment by country C. Thus, country C will not be paying any kind of tax.

Now, when company of country A routes his investment into country B via country C, he will pay tax at 0% on the income earned, because country C is exempted from tax by the agreement between country B and country C.

Thus, when an investor from a third country routes his investment from a country which has got the agreement with the source country, where investor ends up paying very less tax or no tax at all, this concept is known as treaty shopping.

To reduce this misuse, the countries include a clause in their agreement, which is known as Limitation of Benefits (LOB clause), which will determine, which of the investments are done only to get the benefit of double tax avoidance agreement (DTAA) or which are true investments.

For example, in case of double tax avoidance agreement (DTAA) between India and Singapore, the Limitation of Benefits (LOB clause) mandates that, the particular investor making investment in India, should have incurred expenditure of at least 2 Lac Singapore dollars, in a period of 12 months, preceding this investment being done in India.

Thus, putting a limitation of benefits clause, such clause aims to prevent misuse by methods such as treaty shopping.

Five Important Clauses to be taken care of in Double Tax Avoidance Agreement (DTAA)

Type of relief method

It is important to know and decide what type of relief method shall be there. There are two types of relief method:

Bilateral Relief

Under this method, the Government of two or more countries can enter into an agreement to provide relief against double taxation by deciding mutually, which relief is to be granted. Bilateral relief maybe granted in either of following methods:

Exemption method- Under this method the income earned is exempted by either of two countries.

Tax relief method- Under this method the country of origin pays tax in credit for amount to be taxed in the foreign country.

Unilateral Relief

This relief is by the country of origin for tax paid by the company of origin company, even if there is no mutual agreement for same among both the countries.

Section 90 and Section 91 of Income tax act deals with the double tax relief provisions.

Type of Agreement

It is very important to have discussion among both the countries whether to make the agreement a comprehensive agreement or a specific agreement

Having a comprehensive agreement would mean covering all sorts of income from investment between the country of origin and source country.

Having a specific agreement would mean agreement applicable on only that income which is specifically from investment for which the agreement is made between both the countries.

Tax on Dividend, Interest, Royalty and fees from technical services

Tax on Dividend, Interest, Royalty and fees from technical services shall be levied where receipt of such dividend, interest and royalty resides. However, the question which arises is that whether such tax treaties would override the Income tax act? The Karnataka High Court settled the matter in Vodafone South Ltd. case and held that tax treaties will have overridden effect over Income Tax Act.

Provision of Limits of Benefits (LOB) clause

To reduce the misuse of double tax agreement, the countries include a clause in their agreement, which is known as Limitation of Benefits (LOB clause), which will determine which of the investments are done only to get the benefit of double tax avoidance agreement (DTAA) or which are true investments. For example, in case of double tax avoidance agreement (DTAA) between India and Singapore, the Limitation of Benefits (LOB clause) mandates that, the particular investor making investment in India, should have incurred expenditure of at least 2 Lac Singapore dollars, in a period of 12 months, preceding this investment being done in India.

Concept of residence

The article of residence under this agreement must be clearly explained. Concept of residence can be classified in two parts:

Individual

An individual is liable to pay tax by having his domicile, place of incorporation, residence etc. but excludes those who are liable to pay tax in respect only of income from other sources in that state. After applying this principle, one can conclude a person to be resident of one of the contracting state and provisions of treaty shall apply accordingly.

Legal Entities/Corporations

For legal entities or corporations, the test for residency is based upon its place of incorporation or place of effective management.

Conclusion

Double Tax Avoidance Agreement is a treaty which indeed helps in removing ambiguity of paying tax twice and at same time ensures that there is no tax evasion by exchange of information among both the countries. But the most important thing to be kept in mind is to prevent misuse of the agreement, by not adopting methods such as treaty shopping.