

Liable to Tax – Is it a step forward?

The Finance Bill 2021 (“FB2021”) ushered select proposals amending taxation of non-residents, one of which include introduction of a definition for the term ‘*Liable to tax*’ under S. 2(29A) of Income tax Act, 1961 (“ITA”) as below:

(29A) “liable to tax” , in relation to a person, means that there is a liability of tax on such person under any law for the time being in force in any country, and shall include a case where subsequent to imposition of tax liability, an exemption has been provided;

As may be observed, there are two limbs to the definition – (a) there is a liability of tax on a person (viz., the foreign resident) in his home country; and (b) after imposition of such tax, such home-country also has given an exemption.

FB2021 as well as its memorandum are silent on what tantamount to a ‘liability of tax’ and what does the words ‘subsequent to imposition of tax liability, an exemption has been provided’ signify.

The new definition appears to be an attempt of the lawmakers to consolidate, declutter and de-mystify issues surrounding taxability and claim of treaty benefits by a non-resident. The subsequent paras discuss the controversies that led to the lawmakers propose a specific definition in the tax law, and whether it can succeed in addressing all the controversies.

I. Genesis

The phrase ‘*liable to tax*’ has been used both under the ITA as well as in the International Laws such as the Double Tax Avoidance Agreements (DTAA), OECD Model Tax Convention on Income and on Capital, Version 2017 (‘OMTC’), etc.

While under the ITA, this term finds place in provisions of S. 6, S. 10(23FE), in the international law it finds place under the OMTC and DTAA following OMTC, in Article 4(viz., the provisions laying down the tests of ‘Resident’).

The term ‘*resident*’ under Article 4 is generally explained as a person who under the laws of that country is *liable to tax* by reason of his domicile, residence, place of effective management etc.

While Article 4 uses the phrase ‘*liable to tax*’, unfortunately both OMTC as well as DTAA are silent on how this phrase has to be interpreted. Article 3(2) of the OMTC as well as Explanation 4 to S. 90 of ITA provides that if any term is not defined in the treaty but defined under domestic law, it would derive its meaning from the domestic law definition.

Since the Indian Domestic Law, viz., the ITA did not contain any definition of the phrase ‘*liable to tax*’ thusfar under the law, this led to several controversies between the tax authorities and the non-resident taxpayers around the interpretation of these words.

These controversies largely revolved around issues such as:

- Whether ‘liable to tax’ means actual payment of tax?
- What is the scope of tax for the purpose of determining ‘liable to tax’?

- How should these words be reckoned in the context of Fiscally Transparent Entities ('FTEs')?

This has been elaborated in more detail below.

II. Nature of Key Controversies and whether the new definition can put these controversies to rest

1. *Whether 'Liable to Tax' means actual payment of tax?*

This controversy has largely emanated in the context of India-UAE DTAA, the reason being UAE doesn't subject all its resident to tax locally. A popular ruling in this context was the AAR ruling in the case of *Mohsinally Alimohammed Rafik, In re* [1995] 213 ITR 317 (AAR), where the AAR held that even if there is no tax in UAE, its resident can still avail the DTAA benefit as the constitution of that country doesn't debar its Government from introducing tax on its residents. So, if not today, these residents could still be liable to tax in UAE as when their Government introduces the specific tax law. Thus, this ruling interpreted 'Liable to Tax' to mean not necessarily the current tax, but also potential tax that their Government may introduce in future.

Unfortunately, the very same AAR in a subsequent ruling in case of *Cyril Eugene Pereira, In re* [1999] 239 ITR 650 (AAR) took a U-turn to hold that if the law doesn't impose tax on an individual, such individual cannot be said to be 'liable to tax' and therefore isn't eligible to DTAA benefits.

Finally, the Hon'ble Supreme Court in its celebrated decision of *Union of India vs. Azadi Bachao Andolan* (2003) 263 ITR 706 (SC), held as below:

"We are inclined to agree with the submission of the appellants that, merely because exemption has been granted in respect of taxability of a particular source of income, it cannot be postulated that the entity is not 'liable to tax' as contended by the respondents. ... In our view, the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the DTAC, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax."
(emphasis supplied)

The way the Apex Court has interpreted the term, it looks like – if a country tax-exempted a particular source of income under its domestic tax law, it cannot be interpreted that such resident is not 'liable to tax' as at all. The Apex Court overruled Cyril Eugene Pareira's ruling that a 'liability to tax' is same as payment of tax.

The decision of the Apex Court in Azadi Bachao's case was rendered in context to India-Mauritius DTAA. However, the underlying principle of the distinction between liable to pay and actual payment, emanating from the decision, should be applied to other DTAA's as well. However, the same was not the case. Even after the decision of the Apex Court in Azadi Bachao (supra) litigation in this regard kept on growing. Reference can be drawn to the cases of:

- *Emmerich Jaegar v. CIT*, (2005) 274 ITR 125 (Guj) in context of Indi-Austria DTAA
- *Abdul Razak A. Meman, In re* (2005) 276 ITR 306 (AAR) in context of India-UAE DTAA
- *Emirates Shipping Line, FZE v. ADIT*, (2012) 349 ITR 493 (Del) in context of India-UAE DTAA

- General Electric Pension Trust, In re (2006)280 ITR 425 (AAR) in context of India-USA DTAA
- BP Singapore Pte Ltd v. ITO, (2018) 168 ITD 325 (Rajkot) in the context of India-Singapore DTAA

The principles laid down by Hon'ble Supreme Court in Azadi Bachao's case (supra) when compared with the wordings of the proposed new definition of '*liable to tax*' under FB2021 seem to indicate that the lawmakers have tried to respect the Apex Court's principles while framing the new definition. We believe that this may effectively mean that if the home country has introduced tax laws and under such laws, a source of income of a taxpayer is tax exempt in the home country, then such an exemption wouldn't mean that such taxpayer is not '*liable to tax*'. Consequently, he would still be eligible to the DTAA benefits.

However, what still remains unclear is – what happens if a country doesn't have taxation on certain class of persons. Would such person still be said to be '*liable to tax*' and eligible to avail DTAA benefits? Such situations still remain open to controversies, and to avoid that it would be prudent that the lawmakers clarifies this aspect while enacting the final law.

2. *What is the scope of tax for the purpose of determining 'liable to tax'?*

The next controversy revolves around what is the scope of the word 'Tax' contained in the phrase '*liable to tax*' for the purpose of claiming DTAA benefit. The Bombay High Court in the case of DIT vs. Chiron Bearing GmbH & Co. (TS-12-HC-2013(Bom)) had held in the context of India-German DTAA that since Article 2 of that DTAA dealing with 'Covered Taxes' even included a Trade Tax within its scope, any person who is subjected to Trade Tax in Germany should be held as '*liable to tax*' in Germany, and therefore, eligible to DTAA benefits. Under German Domestic Law, any person, irrespective of its domicile, residence, place of management or otherwise (*viz., even if it is a non-resident under its income tax law*), is liable to Trade Tax if it carries any operations in Germany. Hence, such interpretation was heavily criticized by subject matter experts, as it could be subject to mis-use.

The Question arises how should the word 'tax' in the proposed new definition of '*liable to tax*' be interpreted?

Incidentally, the ITA also defines the word 'tax' under S. 2(43), which effectively only covers Income tax applicable within the boundaries of India. A question arises whether S. 2(43) can be applied for interpreting the scope of proposed new definition under S. 2(49A). In other words, would the tax referred in S. 2(49) be interpreted to mean Indian Income tax only. A rational interpretation would be 'no' - the scope of word 'tax' in the proposed new definition of '*liable to tax*' cannot merely mean Indian Income tax. The basis for this being – the new definition under S. 2(49A) refers to *liability of tax of a person in his home country (and not India), and such home country wouldn't levy Indian Income tax, but may have its own taxes*. Hence, applying S. 2(43) in S. 2(49A) would only lead to absurd results. It may therefore be advisable that a suitable explanation be inserted by the lawmakers in the proposed S. 2(49A) before its enactment to the effect that the word 'tax' means *any tax as may be defined in the applicable DTAA*.

3. *How should the words 'liable to tax' be reckoned in the context of FTEs?*

Another controversy relating to 'liable to tax' has been around the ability of FTEs to claim DTAA benefits. As may be appreciated, a FTE doesn't have any effective tax liability as they are merely tax passthroughs. In other words, their tax liability effectively rollover to its partner or member.

A FTE, thus, is never liable to tax and therefore, the question is whether a FTE can be said to be 'liable to tax' and therefore, eligible to claim DTAA benefits?

In this context, reference is drawn to the following:

(a) Article 4(1)(b) of India-US DTAA: *"in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries."*

(b) Article 4(1)(b) of India UK DTAA is also similarly worded, thereby expressly providing that even if a partner is subject to tax/liable to tax, the partnership would be considered as a resident.

Since most of the DTAA's do not contain express language as given in India-US/India-UK DTAA, interpretation of words 'liable to tax'/Resident status for FTEs have always been controversial. While the DTAA benefits have been denied in cases like Schellenberg Wittmer, In re, (2012) 210 Taxman 319 (AAR), the same has been allowed in:

- i. Linklaters LLP v. ITO, (2010) (40 SOT 51) (Mum)
- ii. DDIT v. A.P. Moller, [TS-555-ITAT-2013(Mum)]
- iii. ITO v. Linklaters & Paines, (2014) 65 SOT 266 (Mum)
- iv. P & O Nedlloyd Ltd. & Ors. V. ADIT, (2014) 369 ITR 282 (Cal)
- v. Maersk Line U.K. Ltd. v. DIT, (2016) 68 taxmann.com 173 (Cal)

If one were to analyse the wordings of the proposed new definition, it states *"in relation to a person". This effectively means there is a liability of tax on such person.* This means the tax has to be on FTEs itself, and not on the partners/member, to be considered as a resident, and to avail the DTAA benefits. The proposed amendment seems to be phrased in such a manner that on a literal reading, unless the treaty provides otherwise, FTEs would not be eligible to claim DTAA benefits. This view, also seems to be inline with India's position on Article 3 of MLI wherein India has expressed its reservation to apply 'Article 3 – Transparent Entities' to its existing DTAA's. To avoid any controversy on this count, a specific clarification in the proposed new definition under S. 2(49A) by the lawmakers would be solicited.

III. In nutshell

While it's a good intent on the part of the Government/lawmakers to bring clarity in law, there are several elements of past controversies which still remain unaddressed while proposing a new definition under S. 2(49A). Also, any action unilaterally taken in the domestic law, if having an impact of increasing taxes on the non-residents under already-prevailing DTAA's isn't good for our country, which is on a goodwill drive to excite non-resident investors. Hence, it may be worth for the Government to first resolve any DTAA-related interpretational issue by bringing an amendment in the DTAA through

bilateral negotiations. Having done that, it may then look to also amend its domestic law (viz., ITA) by introducing the proposed new definition. Even while doing that, the lawmakers have to be careful that a complete clarity is provided in the law that addresses all past controversies, while making these amendments.

Lastly, the new definition of 'Liable to tax' is proposed to be retroactively introduced effective AY21-22 (viz., FY20-21). Any retroactive amendments that could result in additional taxes only put hardship on the taxpayers. This has side-effects – (1) it dishonours the Government averment given upon coming to power - to both its citizens as well as the international fraternity - that it would not indulge in such acts; and (2) it adversely effects country's image in the global market. Hence, even if in worst case, Government is inclined to add this new definition, it should be only with prospective effect (viz., FY21-22 and onwards).

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