

Dilution of 'Source' Rule under India-Australia Tax Treaty

India and Australia recently signed¹ a protocol to the existing tax treaty (originally signed way back in 1991) which brings about major changes in the allocation of taxing rights and obligations between the two jurisdictions. The impact of the protocol is twofold:

- (1) The protocol limits source based taxation by restricting scope and tax implications of the permanent establishment ('PE') concept; and
- (2) It introduces measures to promote exchange of information and deal more effectively with the menace of black money.

The latter is in furtherance of State efforts to effectively deal with tax evasion. However, more significant are the changes impacting 'source' rule as discussed below.

Limitation of 'Source' Rule

The Protocol enhances the threshold period for constitution of PE making it more difficult for the 'source' state to tax profits of non resident as profits attributable to PE.

PE Threshold

Treaty Rule	Before Protocol	After Protocol
Service PE ² - Provision of services to Third Party	90 days	183 days
Service PE - Provision of services to Associated Enterprises	No threshold specified	183 days
Deemed PE resulting from 'operation of substantial equipment'	No threshold specified	183 days
Deemed PE resulting from 'exploitation/ exploration of natural resources'	No threshold specified	90 days

¹ Protocol was signed on December 16, 2011. Signing does not imply coming into force. The Protocol shall come into force only after it has been notified by both countries.

² Service PE clause is found only in UN MC and not in the OECD MC.

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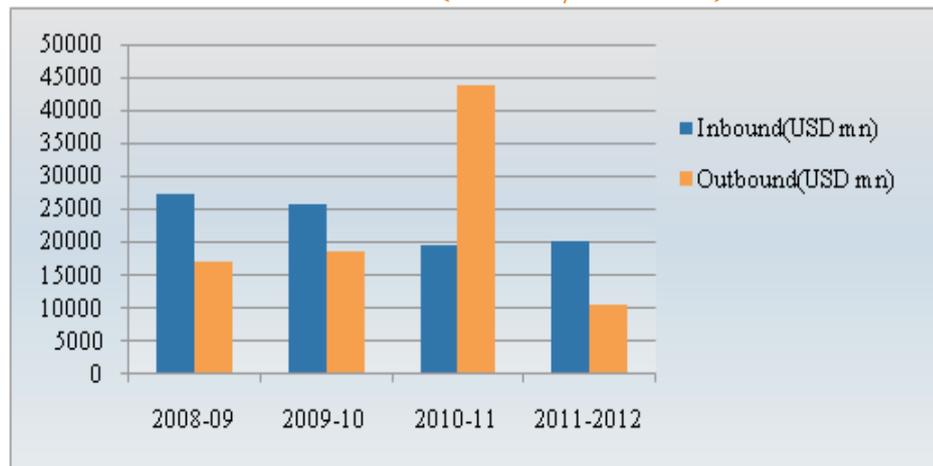
Deletion of Force of Attraction Rule

The 'Force of Attraction' Rule found in a number of Indian treaties is a feature peculiar to the UN Model Convention. A clear departure from arm's length principle, the rule taxes in the source state not only profits attributable to PE but also profits from sale of goods/ economic activity of same or similar kind as those effected or undertaken through the PE. The deletion of 'Force of Attraction' rule in the Indo-Australia tax treaty is perceived to be a path breaking amendment running counter to India's historical and aggressive stand on 'source' based taxation.

The Bigger Picture

Permanent establishment ('PE') is the trigger point for taxation of a non resident doing business 'in' (as against 'with') the source country. The width and latitude of PE has been a matter of debate between developed and developing countries each seeking to garner a greater share of taxable profits. Historically, as the forerunners of globalization, developed countries have favoured residence based taxation and endorsed the OECD Model. For developing countries - which are invariably the destination for outbound investment - the UN Model with its emphasis on 'source' based taxation has been the logical choice. The end result of treaty negotiation is the outcome of a long drawn process impacted by multifarious interests (social and political as much as economic) lying anywhere between the opposing ends of the spectrum.

Investment Trend (Inbound/ Outbound)



Source: - Reserve Bank of India Bulletin (November 2011)

The Protocol to India-Australia treaty is a fine example of changing dynamics impacting treaty negotiation. More than just a bargaining position, the curtailment of PE definition and the concomitant surrender of 'source' based taxation may well be the reflection of changing economic scenario (in India), wherein outbound investment has not only kept pace but exceeded inbound investment. Also, with India being granted 'observer' status at OECD, India-OECD interaction has seen a quantum jump over the last few years. Considered in this light, the Protocol and the radical step closer to OECD MC should not come as a surprise even to those knowing Indian Authorities as aggressive proponents of 'source' rule.

The bigger question is whether the Protocol is merely an isolated development or an indicator of a policy shift. Recently, the Swiss Protocol (notified on December 27, 2011) also witnessed similar amendments [such as amendment to Article 7(1)] aligning it with OECD MC. The Indian Government has significantly expanded the FT&TR (Foreign Tax and Tax Research) division dealing with international taxation and treaty negotiation. It is reported that 70 treaties are being re-negotiated. Going by the trend and India's growing closeness with OECD, one surely cannot rule out the possibility of similar protocols (diluting the 'source' rule) in respect of other treaties. Winds of change could well be blowing across the treaty landscape!

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