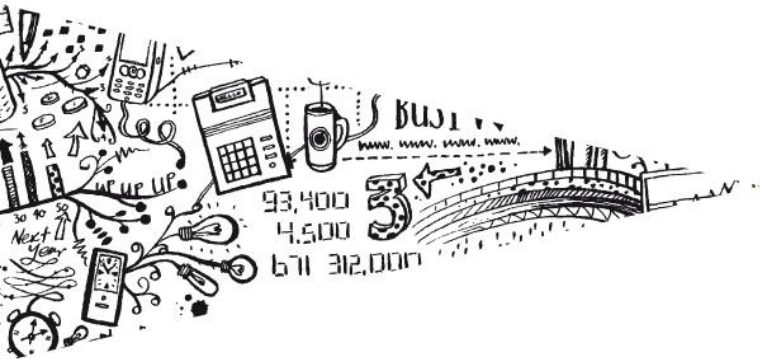


4 January 2012

EY Tax Alert

Amendments to India tax treaty with Australia



Executive summary

This Tax Alert summarizes the key changes amendments to the existing double taxation avoidance agreements (DTAAs) entered into between India and Australia. The 1991 DTAA between India and Australia (Australia DTAA) has been amended vide a Protocol signed on 16 December 2011, but it is yet to come into force (Australia Protocol)^[1].

The Australia Protocol restricts the scope of source country taxation by introducing or enhancing thresholds for creation of a permanent establishment (PE) in certain circumstances and by removing the 'force of attraction rule' in taxation of business profits. The Australia Protocol also introduces an article on non-discrimination in the DTAA, which seeks to prevent discrimination in tax treatment on a reciprocal basis in circumstances described in the Australia Protocol. The Australia Protocol has updated and enhanced the provisions relating to exchange of information and assistance in the collection of taxes.

^[1]The text of the Australia Protocol has been sourced from the Australian Treasury website - <http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=2286>.

Our Tax Alert, 'Amendments to India tax treaty with Switzerland' dated 4 January 2012, provided only a summary of the details of the Australia Protocol, as is available on the Indian Government's Press Information Bureau website.

Key amendments to the Australia DTAA

Introducing/enhancing time thresholds in the PE definition in Article 5

The notion of PE contained in Article 5 is a key concept used for allocation of taxing rights when an enterprise of one country derives business profits from another country. The existence of a PE of a foreign enterprise (FE) in a country determines whether or not the business profits of the FE can be taxed in that country.

Higher time threshold for Services PE

- ▶ A clause on furnishing of services for creation of a PE is not present in the OECD Model Convention (OECD MC). It, however, finds place as Article 5(3)(b) in the United Nations MC (UN MC) and in a number of DTAAs signed by India. Under the existing Australia DTAA, an FE is deemed to have a 'Services PE' in the Source State if the FE furnishes services, including managerial services, for a period(s) aggregating to more than 90 days within any 12 month period. If the services are furnished to an associated enterprise (AE), then a single day is sufficient to create a Services PE.
- ▶ The Australia Protocol raises the threshold for creation of a Services PE by increasing the time period(s) to 183 days in any 12 month period. This time threshold will also apply in the case of services furnished to an AE. Furthermore, services are broadly defined to include consultancy services (without providing for any

exception), furnished by employees or other personnel engaged by the FE 'for such purpose'. It also provides for aggregation of time threshold in respect of the same or connected projects.

Exploration/exploitation of natural resources and use of substantial equipment

- ▶ An FE will be deemed to have a PE if it carries on activities in respect of exploration for or exploitation of natural resources situated in the Source State or if, contractually, substantial equipment is used in the Source State.
- ▶ The Australia Protocol amends this PE definition to provide that carrying on activities, including operation of substantial equipment, for a period exceeding 90 days in any 12 month period creates a PE. Also, operation of substantial equipment in the Source State for more than 183 days in any 12 month period creates a PE.

Removing the 'force of attraction' rule in Article 7 - business profits

- ▶ Under the existing Australia DTAA, an FE would be taxed on its business profits earned in the Source State to the extent that the profits are attributable to the PE. It also has a force of attraction rule that extends taxation rights in the Source State to profits earned through the sale of same or similar goods or by undertaking same or similar business activities as those carried out through that PE.
- ▶ The Australia Protocol amends Article 7 by eliminating the force of attraction rule, thus, aligning it with Article 7(1) of the 2008 OECD MC.

Non-discrimination article introduced (Article 24A)

While the non-discrimination article introduced by the Australia Protocol is largely similar to that present in Article 24 of the OECD MC/UN MC, it contains some deviations and incorporates a provision that allows the contracting states to disregard the provision in case of tax abuse.

- ▶ The PE non-discrimination clause states that taxation on a PE shall not be less favourably levied than the taxation levied on enterprises of the Source State carrying on the same activities. However, it also states that this provision shall not be construed as obliging a contracting state to grant individuals who are residents of the other contracting state any personal allowances, reliefs and reductions for taxation purposes, on account of civil status or family responsibilities which it grants to its own residents. The OECD/UN MC does not restrict it to individuals but extends it to all residents.
- ▶ Another exception is provided for levy of taxes of a PE at a rate higher when compared with that imposed on profits of a similar company in the Source State. This is not regarded as discrimination. The determination of profits of a PE, in accordance with Article 7(3) of the Australia DTAA that provides for allowance of deductions in accordance with and subject to the limitations of the law relating to tax of the Source State, is also not regarded as being in conflict with the PE non-discrimination clause.

- ▶ The newly inserted provision also incorporates a clause that states that the non-discrimination article will not apply to any provision of the domestic laws of India or Australia which is designed to prevent avoidance/evasion of taxes, including measures to address thin capitalization or to ensure that taxes can be effectively collected or recovered. This article also does not apply in respect of tax incentives to eligible taxpayers for expenditure on R&D, subject to certain conditions and as agreed to between the two countries through Exchange of Notes.

Articles on Exchange of information and collection of taxes

- ▶ Article 26 (Exchange of information) has been amended and Article 26A (Assistance in the collection of taxes) has been introduced which is largely similar to that present in Article 26 and Article 27, respectively, of the 2010 OECD MC.

Comments

The Australia Protocol brings about some significant changes to the Australia DTAA. The limiting of the Source State taxation by raising the PE thresholds and by removing the 'force of attraction rule' in the taxation of business profits is likely to reduce tax barriers to international trade and commerce between the two states. With the objective of promoting international cooperation to prevent fiscal evasion, the Australia Protocol introduces a more effective provision for exchange of information on a wider range of taxes. It also provides for the exchange of banking

information, as well as information without domestic interest.

It may be noted that the Australia Protocol, amending the Australia DTAA, will come into force only after both countries have notified each other in writing. The notification in this regard is not yet available. Upon notification, the Australia Protocol shall be effective in India in respect of income arising in any fiscal year on or after 1 April following the date on which the Australia Protocol enters into force.

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near. C.N Vidhyalaya
Ambawadi,
Ahmedabad - 380 015
Tel: +91 79 6608 3800
Fax: +91 79 6608 3900

Bengaluru

12th & 13th floor
"U B City" Canberra Block
No.24, Vittal Mallya Road
Bengaluru - 560 001
Tel: +91 80 4027 5000
+91 80 6727 5000
Fax: +91 80 2210 6000 (12th floor)
Fax: +91 80 2224 0695 (13th floor)

Chandigarh

1st Floor
SCO: 166-167
Sector 9-C, Madhya Marg
Chandigarh - 160 009
Tel: +91 172 671 7800
Fax: +91 172 671 7888

Chennai

Tidel Park,
6th & 7th Floor
A Block (Module 601,701-702)
No.4, Rajiv Gandhi Salai
Taramani
Chennai - 600 113
Tel: +91 44 6654 8100
Fax: +91 44 2254 0120

Hyderabad

Oval Office
18, iLabs Centre,
HITECH City, Madhapur,
Hyderabad - 500 081
Tel: +91 40 6736 2000
Fax: +91 40 6736 2200

Kochi

9th Floor "ABAD Nucleus"
NH-49, Maradu PO,
Kochi - 682 304
Tel: +91 484 304 4000
Fax: +91 484 270 5393

Kolkata

22, Camac Street
3rd Floor, Block C"
Kolkata - 700 016
Tel: +91 33 6615 3400
Fax: +91 33 2281 7750

Mumbai

6th Floor Express Towers
Nariman Point
Mumbai - 400 021
Tel: +91 22 6192 0000
Fax: +91 22 6192 2000

14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (west)
Mumbai - 400 028
Tel: +91 22 6192 0000
Fax: +91 22 6192 1000

5th Floor Block B-2,
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: +91 22 6192 0000
Fax: +91 22 6192 3000

NCR

Golf View Corporate
Tower - B
Near DLF Golf Course,
Sector 42
Gurgaon - 122 002
Tel: +91 124 464 4000
Fax: +91 124 464 4050

6th floor, HT House

18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: +91 11 4363 3000
Fax: +91 11 4363 3200

4th & 5th Floor, Plot No 2B,

Tower 2, Sector 126,
Noida - 201 304
Gautam Budh Nagar, U.P. India
Tel: +91 120 671 7000
Fax: +91 120 671 7171

Pune

C-401, 4th floor
Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: +91 20 6603 6000
Fax: +91 20 6601 5900

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