

Tax Hotline

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INDIAN TRIBUNAL UPHOLDS ELIGIBILITY OF LLC INCORPORATED IN USA TO CLAIM BENEFIT UNDER INDIA-US TAX TREATY

- The Delhi ITAT recently allowed an appeal holding that an LLC is a tax resident of US under Article 4 of the India-USA Treaty by virtue of incorporation.
- The LLC being a resident under Article 4 of the India-USA Treaty by virtue of incorporation and its recognition as a separate existence from its members qualifies as a 'person'.
- An LLC with a single owner is disregarded as separate from its owner unless the LLC elects to be treated as a corporation for US federal income tax purposes. The ability of the LLC to elect its tax classification under US federal supports the legal situation or aspect of the LLC being liable to tax.

Eligibility of fiscally transparent entities ("FTE") to claim benefit under tax treaty has been an issue of litigation in India. Type of entities which are typically considered as FTEs are trusts, partnerships, foundations, limited liability corporation ("LLC") etc. Setting up FTEs such as partnerships and trusts is popular across the world considering the tax efficiency which they offer. FTEs allow income to 'pass through' them i.e. income is taxed at one level and there is no taxation at the entity level. This, however, creates a doubt on whether such entities can claim benefits under tax treaties. Typically, tax authorities contend that such entities do not fall under the definition of 'person' under tax treaties and that they are not a 'resident' in its state of incorporation/location as they are not 'liable to tax'.

The core of the debate lies in the different principles applied by various states with respect to characterization of entity, i.e., whether an entity is taxed as 'taxable unit' or 'fiscally transparent'. While the wording of the tax treaties and treatment given under the domestic law provide an answer to some extent, confusion arises when two contracting states (i.e., resident state and source state) adopt conflicting approaches leading to double taxation or double non-taxation. Certain countries (like Singapore, China, Netherlands etc.) consider partnerships as FTE whereas some countries (like India, Mexico, Hungary etc.) consider partnership as a taxable unit.

Over the years, jurisprudence has developed on whether FTEs can claim benefits under Indian tax treaties. The Supreme Court of India in the landmark *Azadi Bachao Andolan* case (2003 263 ITR 706 SC) laid down the principle that liability to taxation is a legal situation and payment of tax is a fiscal fact. Essentially, the Supreme Court held that actual payment of tax is not necessarily needed in order to be 'liable to tax'. In context of partnerships, the Tribunal in case of *Linklaters LLP (40 SOT 51 Mum 2010)* held that considering that one of the fundamental objectives of tax treaties is to provide relief to economic double taxation, even when a partnership firm is taxable in respect of its profits, not in its own hand but in the hands of the partners, as long as the entire income of the partnership firm is taxed in the residence country, treaty benefits cannot be declined. In context of trusts, the Authority for Advance Ruling in case of *General Pension Electric Trust ([2005] 280 ITR 425)* denied tax treaty benefit to the foreign trust considering that the trust was not subject to tax on account of an exemption under the US tax law.

While Indian Courts have examined whether a foreign trust, a foreign partnership will be entitled to obtain benefit under tax treaty, the recent case (*General Motors Company USA vs ACIT (ITA Nos. 2359 & 2360)*) is the first case wherein the Indian Tribunal has upheld the ability of an LLC to claim benefit under tax treaty. The taxpayer, an LLC incorporated in USA, claimed benefit of the lower tax rate under Article 12 of the India-US Tax Treaty and offered its income to tax at the rate of 15% instead of 25% (i.e. the tax rate under section 115A of the Income-tax Act, 1961 during the relevant assessment year). The Tribunal ruling underscores the importance of domestic law to determine the classification and manner of taxation of a foreign entity. The Tribunal examined the Publication 3402 of the Department of the Treasury, IRS of the Government of USA on taxation of LLC. The Tribunal noted that in case of one member LLCs, the LLC is classified as an entity disregarded as separate from its owner and its income, deductions, gains, losses and credits are reported on the owner's income tax return. The Tribunal held that the ability of the LLC to elect its tax classification under US federal income tax law supports the aspect of the LLC being liable to tax. Considering the fact that the LLC held a valid TRC, the Tribunal held that it qualified as a body corporate as it fulfilled all requirements of a 'body corporate' in the form of legal recognition of a separate existence of the entity from its member and a perpetual existence distinct from its members. Therefore, the Tribunal held that the LLC qualified as a 'person' under Article 4 of the US Tax Treaty and was eligible to claim benefits under the US Tax Treaty. The decision of Tribunal is welcome as it reinforces the well settled principle that matters relating to status of an entity will be based on the law of the state of incorporation i.e. *lex domicilii*.

While the decision of the Tribunal is welcome, there may be continued litigation on taxation of FTEs, absent specific clarification by Indian tax authorities. Entities adopting for a pass-through regime in host jurisdictions should evaluate classification under the laws of incorporation and determine eligibility to claim tax treaty benefits accordingly.

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(We thank Avani Maheshwari for her valuable contributions and insightful inputs to this hotline).

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