Tax Hotline

September 19, 2008

GERMAN PARTNERSHIP FIRM ELIGIBLE FOR TREATY BENEFITS

In a recent decision of the Mumbai Bench of the Income Tax Appellate Tribunal (**"ITAT"**) in the case of *Asst. DIT v. M/s Chiron Bhering GmbH & Co.*[1], it was held that a German partnership firm would be entitled to benefits under the India-Germany Tax Treaty. The decision highlights certain important principles governing the scope of the expression 'resident' under Article 4 of the India-Germany Tax Treaty.

FACTS OF THE CURRENT CASE

The assessee (tax payer) is a limited partnership firm (Kommandit Gesellschaft) incorporated under the laws of Germany. It received Indian sourced income in the nature of royalties which was assessed to tax under section 9(1)(vi) read with section 44D of the Income Tax Act, 1961 (**"ITA"**). In accordance with section 115-A of the ITA, the royalty income was taxed at the rate of 20%[2].

The tax authorities denied the assessee the benefit of the lower withholding rate of 10% under the India-Germany Treaty on the grounds that the assessee could not be considered a resident of Germany. Reliance was placed on an OECD publication[3] indicating that under German laws, income tax would be charged at the level of the individual partners rather than at the level of the partnership. Accordingly, it was argued that the assessee was not 'liable to tax' in Germany and hence cannot qualify as a German resident for treaty eligibility purposes.

The ITAT was confronted with the question of whether the assessee was a resident of Germany and consequently entitled to the benefit of the lower withholding rate under the India-Germany Treaty.

ITAT DECISION

The ITAT observed that although income tax may be borne only at the level of the individual partner, under German laws, partnership firms are still assessed to trade tax.

Article 4 of the India-Germany Treaty defines 'resident' as any person who, under the laws of India or Germany, is liable to tax therein by reason of its domicile, residence, place of management or any criterion of a similar nature. A 'person' is defined to include an individual, a company and any other entity which is treated as a taxable unit under the taxation laws in force in the respective contracting States[4].

Further, By virtue of Article 2 of the India-Germany Treaty, the scope of the treaty extends to both income tax (Einkommensteuer) and trade tax (Gewerbesteuer) as may be levied under German laws.

The ITAT noted that the assessee was a limited partnership recognized by German law and hence could be considered a 'person'. It further noted that the assessee was registered for payment of trade tax and filed regular returns in this regard. Rejecting the department's argument that trade tax was a tax on turnover, the ITAT observed that under the German Trade Tax Act, the basis of the levy was income from business. Moreover, the German trade tax is specifically covered under the India-German Treaty. The assessee would therefore, qualify as a resident and is eligible for the lower withholding rate under the Treaty.

With respect to the comments in the OECD publication, the ITAT was of the view that as long as the provisions of the Treaty are unambiguous, no reference needs be made to external commentaries or foreign decisions[5]. The use of such external aids to interpretation is justified only when the scope of a treaty provision does not clearly emanate from the language used.

TAXATION OF HYBRID ENTITIES IN INDIA

The tax treatment of hybrid entities such as limited partnerships[6] and limited liability companies has always been a subject of controversy in India. This is especially since India does not recognize the concept of limited partnerships[6], and uncertainty prevails with respect to taxation of income earned by such hybrid entities. While this decision of the ITAT is in full conformity with the broad scope and intention behind the India-Germany Tax Treaty, complications may arise in situations where a pass through entity may not be liable to any of the taxes specifically enumerated in Article 2 of the treaty. Further complications may arise for partnerships established in other jurisdictions which specifically exclude partnerships from the definition of a 'person' (example, the United Kingdom), or which require partners to be subject to tax for the partnership to be eligible to claim treaty benefits (example, USA).

Other issues could arise in situations where certain countries treat partnerships as fiscally transparent, while others do not. In situations where partnerships are not treated as being a resident due to failure to satisfy the condition of being 'liable to tax', its partners should be entitled to the benefits of a tax treaty, However, this could be refuted by Indian tax authorities at the lower level, and hence such aspects would have to be thoroughly examined on a case by case basis.

- **Mahesh Kumar** & **Parul Jain**

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1. ITA No. 4633/Mum/2006.

2. This rate has now been changed to 10% (excluding surcharge and education cess)

3. The Application of the OECD Model Tax Convention to Partnerships.

4. Article 3(d), India-Germany Treaty.

5. It relied on the observations of the Supreme Court in CIT v. P.V.A.L. Kulandgaon Chetiar, (2004) 267 ITR 654 (SC).

6. India only has a concept of general partnerships, the introduction of a limited liability partnership regime is underway.

Source: Asst. DIT v. M/s Chiron Bhering GmbH & Co.

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