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TAX TREATIES AND THEIR IMPACT ON RESIDENCY STATUS

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Introduction

Tax agreements are essential in defining whether people or organizations are considered residents for tax-related matters. These agreements between nations are designed to avoid taxing the same income twice and to clarify how income from different countries is taxed. For India, these agreements greatly influence the residential status of individuals, which directly affects their tax obligations. This blog post will examine how tax agreements and residency status are interconnected, with a particular emphasis on the Indian viewpoint[1].

Tie-Breaker Rules in Tax Treaties

Tax agreements often feature "tie-breaker" provisions designed to settle disputes over multiple citizenships. These provisions outline a series of criteria to identify which nation has the main authority to tax an individual's earnings. The most frequently used tie-breaker criteria are:

i. **Permanent Residence:** If a person has a fixed home in both nations, they are deemed a resident of the nation where their personal and financial ties are stronger (center of vital interests)[2].

ii. **Regular Residence:** If a person has a regular residence in both nations or neither, they are considered a resident of the nation where they have a fixed home.

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[1] Tax treaty, Wikipedia, https://en.wikipedia.org/wiki/Tax_treaty (last visited Apr. 28, 2024).

[2] *[Opinion] Residential Status and Tie-Breaker Clauses in International Tax Treaties*, (Apr. 18, 2024), https://www.taxmann.com/post/blog/opinion-residential-status-and-tie-breaker-clauses-in-international-tax-treaties.

iii. **Nationality:** If a person is a citizen of both nations or neither, the relevant authorities of the treaty countries must reach a consensus through mutual agreement.

iv. **Place of Effective Management:** For businesses, the location where the principal management and business decisions that are crucial for the operation of the business are made is identified as the place of effective management.

India has a broad array of tax agreements with numerous nations. The tax status of a taxpayer in India is established by the Income Tax Act, 1961 (the Act) along with the relevant tax agreement. Section 6 of the Act outlines the criteria for deciding whether an individual or entity is considered a resident.

For individuals, the Act differentiates between being a resident or non-resident by looking at the number of days they are in India during the tax year. If an individual fulfils the set criteria, they are regarded as an Indian tax resident.

However, when an individual is legally considered a resident in both India and another country according to their own local laws, the tie-breaker rules within the tax treaty are applied to figure out their true tax residency for treaty purposes. This is important because it decides which country has the main authority to tax the individual's earnings.

For entities, the primary criterion for determining their tax residency under the Act is the location where they are effectively managed (POEM). If an entity's POEM is in India, it is classified as a resident of India for tax filing. The idea of the POEM concept has been more clearly explained by the Central Board of Direct Taxes (CBDT) using different circulars and guidelines.

Effect on Tax Duties

The status of being a tax resident significantly influences the amount of taxes an individual owes. People who are tax residents usually have to pay taxes on their income from around the world, whereas those who are not residents are usually only taxed on the income they earn from within the country. Tax agreements usually help avoid the issue of being taxed twice by allowing people from one country to get a tax credit for the taxes they've already paid in another country.

Additionally, these agreements can affect how certain kinds of income are taxed, like interest, dividends, and royalties. A lot of agreements set lower tax rates for these kinds of income, giving a tax benefit to people living in the countries that have the agreement[3].

Practical Implications and Considerations

The relationship between tax agreements and the status of being a resident has various real-world consequences for those who pay taxes:

i. **Planning for Taxes:** People and businesses can arrange their situations to improve their status as residents and benefit from the perks of tax agreements, like lower tax rates or no taxes on some kinds of earnings.

ii. **Following the Rules:** It's important for those who pay taxes to understand the rules for being a resident under the law and the tax agreement to make sure they meet their tax duties in India and the other country involved in the agreement.

iii. **Solving Disputes:** Should there be disagreements about who is a resident, taxpayers can look for solutions through the mutual agreement procedure (MAP) in the tax agreement or the local ways to solve disputes in India[4].

Developments and Challenges in Complementary India

The Indian authorities have been diligently revising and amending its tax agreements to match the evolving economic environment and global tax norms. For instance, India has recently concluded an updated tax agreement with Mauritius, incorporating measures to curb treaty misuse and guarantee a smooth flow of information between the nations[5].

Nonetheless, the implementation of tax treaties in India faces its fair share of hurdles. The understanding of tie-breaker rules and the decision-making process for Permanent Establishment (POEM) have led to disagreements and legal actions. The Central Board of Direct Taxes (CBDT)

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[3] Tax treaty benefits for U.S. citizens and residents, (Feb. 8, 2018), https://thetaxadviser.com/newsletters/2018/feb/tax-treaty-benefits-us-citizens-residents.html.

[4] Tax Residency Certificate and Benefit of Tax Treaties in India: The Debate Reignited, SCC Blog (Jan. 16, 2024), https://www.scconline.com/blog/post/2024/01/16/tax-residency-certificate-and-benefit-of-tax-treaties-india/.

[5] Tax treaty, Wikipedia (Jan. 29, 2004), https://en.wikipedia.org/wiki/Tax_treaty.

has put forth directives to offer more clarity on the POEM concept, yet there remains a need for additional clarification and alignment with international best practices[6].

Conclusion

Tax agreements are essential in defining whether a person or a business is considered a resident for tax-related matters. The relationship between tax agreements and the concept of residency has major consequences for individuals and businesses, especially concerning their tax responsibilities and the access to treaty advantages. In the Indian scenario, individuals and businesses need to be aware of the Act's rules and the relevant tax agreement when deciding their residency and organizing their affairs accordingly.

As the worldwide economy progresses, the need to comprehend and manage the intricacies of tax agreements will grow further. Individuals and businesses are advised to consult with tax professionals to ensure they meet their tax duties and benefit from the treaty provisions. Meanwhile, governments are required to keep their tax agreements current and amend them as necessary to match the shifting economic environment and global tax norms.

[6] Taxguru In, Use of Tie Breaker in Residential Status of NRI's, (Apr. 25, 2020), https://taxguru.in/income-tax/tie-breaker-residential-status-nris.html.