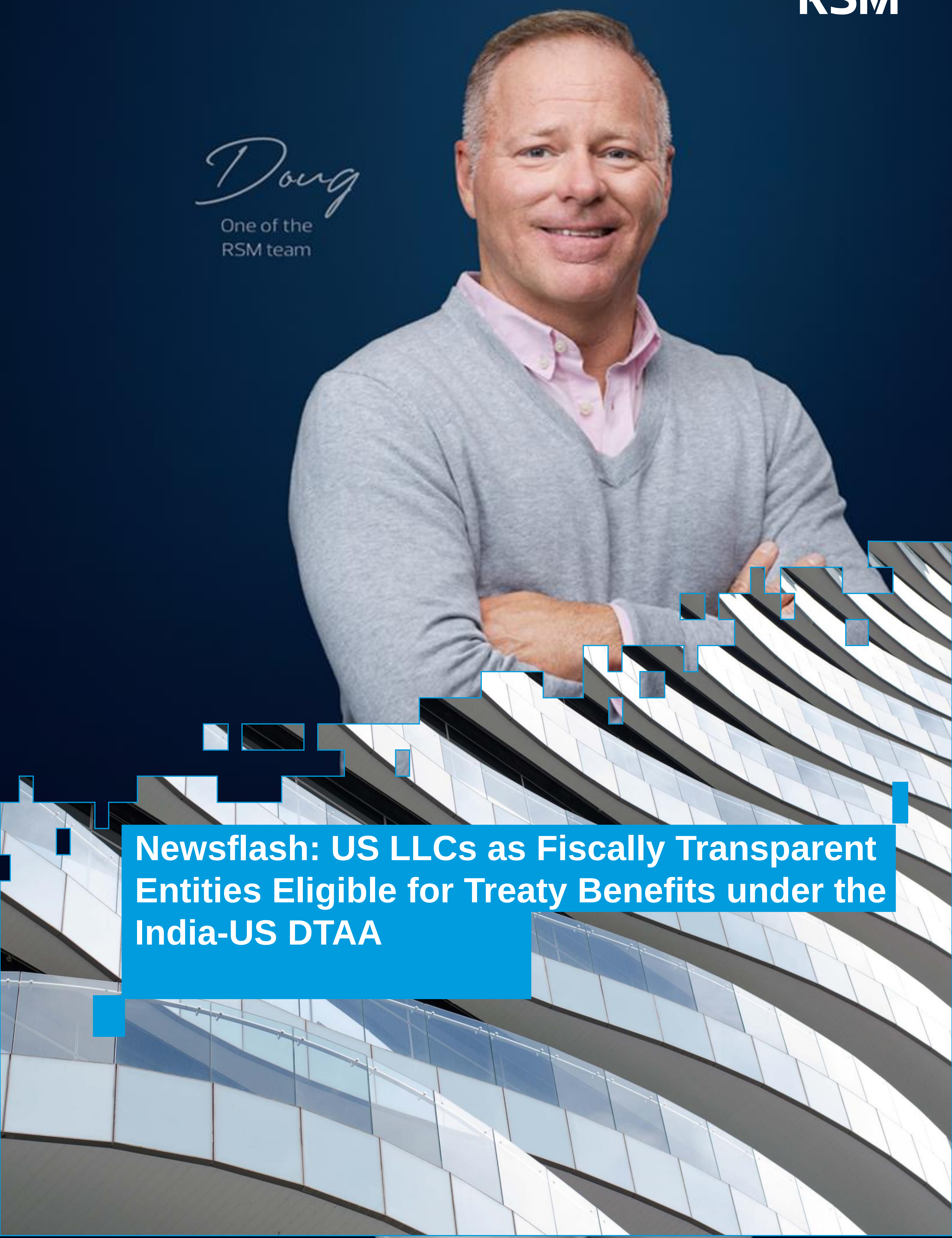

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Newsflash: US LLCs as Fiscally Transparent Entities Eligible for Treaty Benefits under the India-US DTAA

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US LLCs as Fiscally Transparent Entities Eligible for Treaty Benefits Under the India-US DTAA

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1.0 Background

With the expansion of global markets, cross-border activities have grown, posing challenges such as double taxation of income across jurisdictions. To address this, nations have implemented Double Taxation Avoidance Agreements (DTAAs) to eliminate double taxation and curb practices like tax evasion and treaty shopping, ensuring fairness in international taxation.

A key condition of DTAAs, outlined in Article 1, is that treaty benefits are typically limited to residents of one or both contracting states. This residency requirement ensures proper application of treaty provisions.

The Honorable Delhi High Court addressed a critical question of residency in ***General Motors Company USA vs. ACIT, Circle International Taxation (ITA No. 2359/Del/2022).*** The case examined the applicability of the India-USA Double Taxation Avoidance Agreement (DTAA) to a Limited Liability Company (LLC) incorporated in the United States.

The General Motors Company, a single-member LLC, claimed the status of a resident of the USA to avail of reduced tax rates under the DTAA. Specifically, the company sought to tax its income at 15% instead of the standard 25% rate applicable under Indian law. The core legal question pertained as to whether the LLC could be considered "liable to tax" under Article 4 of the DTAA and thereby qualify as a "resident."

2.0 Facts of the Case

The assessee, General Motors Company USA, is a Limited Liability Company (LLC) incorporated in the state of Delaware, USA and operates as a fiscally transparent entity under US tax laws, meaning its income is taxed not at the entity level but in the hands of its members. The said company derived income from Indian entities in the form of fees for included services and claimed the reduced tax rate of 15% under Article 12 of the India-USA DTAA, which governs taxation on fees for technical services.

During the assessment for the years 2014-15 and 2015-16, the Assessing Officer (AO) contested this claim. The AO argued that under Article 4 of the DTAA, only a "person" who is "liable to tax" in the resident state qualifies as a resident. The AO asserted that the LLC's income is not directly taxed in the USA but rather attributed to its member, making it fiscally transparent and ineligible for treaty benefits. Consequently, the AO taxed the income at 25% as per domestic tax laws, denying the DTAA rate.

The Dispute Resolution Panel (DRP) upheld the AO's view, asserting that the fiscally transparent nature of the LLC disqualified it from being treated as a "resident" under the DTAA. This decision prompted the assessee to appeal to the Income Tax Appellate Tribunal (ITAT).

3.0 Assesssee’s Contention

The assessee argued that it was a resident of the USA, as defined under Article 4 of the Indo-US Double Taxation Avoidance Agreement (DTAA). This residency status was crucial for applying the benefits of the treaty. Further, it contended that it was entitled to tax its income from fees at the preferential rate of 15%, as specified in the India-USA DTAA, rather than the higher rate of 25% imposed by the Assessing Officer.

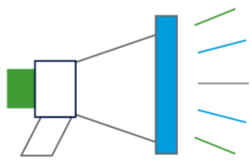
The assessee emphasized that an LLC, while being considered a fiscally transparent entity under US tax law, still qualifies as a separate legal entity. It argued that its incorporation and recognition as a distinct entity allowed it to be treated as a 'person' under Indian tax law. The LLC pointed out that under US federal income tax law, even though it is disregarded as separate from its owner for tax purposes, it still incurs tax liabilities at the owner level.

Therefore, it maintained that it was subject to taxation in its resident state (USA). Also, the assessee contended that the tax authorities erred in not extending the benefits of the Indo-US DTAA to it. It argued that its status as a resident should have been recognized, allowing it to benefit from the lower tax rate. The LLC likely referenced relevant legal precedents and interpretations of tax treaties to support its claim for residency and eligibility for treaty benefits.

4.0 Revenue’s Contention

The AO asserted that the LLC is a fiscally transparent entity under US tax law, meaning its income is not subject to tax at the entity level in the USA. Thus, it does not qualify as a "resident" under Article 4 of the Indo-US DTAA. The AO argued that only entities that are "liable to tax" in their country according to local laws can be considered residents for the purpose of the DTAA. Since the LLC's income is not taxed in its own hands in the USA, it does not meet this criterion.

Based on these conclusions, the AO proposed taxing the LLC's income at a higher rate of 25% under Indian tax law, rather than the preferential rate of 15% claimed by the LLC under the DTAA. The AO relied on the OECD commentary regarding tax residency, which indicates that if a country treats an entity as fiscally transparent and taxes its owners instead, that entity cannot be considered a resident for tax purposes.



5.0 Observations and Ruling of the Delhi Tribunal

The ruling of Delhi Bench of the Income-tax Appellate Tribunal (ITAT) addressed the eligibility of a Limited Liability Company (LLC) incorporated in the USA for benefits under the India-US Double Taxation Avoidance Agreement (DTAA).

4.1 Status of LLC Under US Tax Law:

A Limited Liability Company (LLC) is recognized under US federal tax law as a business entity that may elect to be treated as a partnership, corporation, or a disregarded entity for tax purposes. An LLC with one member is disregarded as separate from its owner for income tax purposes, and the income is reported on the owner’s tax return.

4.2 Residency Certification and Treaty Provisions:

Residency certification (Form 6166) confirms that the LLC is a branch, division, or business unit of a US corporation resident for US tax purposes. The India-US Double Tax Avoidance Agreement (DTAA) recognizes an LLC as a ‘person’ under Article 4, by virtue of incorporation and it’s recognition as a separate existence from its Members qualifies as a ‘person’.

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4.3 'Liable to Tax':

The Tribunal observed that where a LLC is disregarded as separate from its tax owner for US federal income tax purposes, the tax owner of the LLC pays tax on the tax owner's share of the taxable income attributed from the LLC. This further supports the legal situation of a LLC being liable to tax, *i.e.,* the LLC is essentially 'liable to tax' but the income is attributed to it's tax owner and such tax is imposed and paid by its respective tax owner, like US consolidated group rules where all affiliated US corporations file a single US federal income tax return.

Thus, the LLC is deemed 'liable to tax' under US law as its income is subject to tax, whether paid directly by the LLC or through its owner.

4.4 Treaty Interpretation and Precedents:

Paragraph 1(b) of Article 4 of the DTAA acknowledges partnerships as residents if their income is subject to tax in the US, either in the hands of the partnership or the partners. The rationale in ***Linklaters LLP v. ITO [2010] 40 SOT 51/[2011] 9 ITR(T) 217*** supports the interpretation that fiscally transparent entities qualify for treaty benefits if their income is subject to tax in the resident state.

Thus, the Tribunal held that while the mechanisms of taxation may differ across jurisdictions, the critical consideration is whether the income for which treaty protection is sought is subject to tax in the treaty partner country. It was further determined that even if a partnership firm is not taxed directly on its profits but instead through its partners, as long as the entirety of the firm's income is taxed in the country of residence, the benefits of the treaty cannot be denied.

Based on the above observations, the Tribunal held that the lower tax authorities erred by not recognizing the LLC as a 'person' and by failing to appreciate that the 'liable to tax' condition was met under US law. Thus, relying on the ***General Electric Pension Trust, In re [2006] 150 Taxman 545/280 ITR 425 (AAR),*** it held that exclusion clause in the DTAA applies only to income not subject to tax in the US, indicating that a fiscally transparent partnership is included as 'liable to tax' at the outset

6.0 Way forward

This ruling sets a precedent regarding the treatment of LLCs as Resident under India USA DTAA and also lays guidance for similar fiscally transparent entities under other tax treaties. It provides clarity on how such entities can claim residency and treaty benefits, which may influence future cases involving similar pass through structures. The decision offers guidance to US LLCs on their tax positions when dealing with income sourced from India, potentially leading to more favourable tax treatment as per the treaty and thereby shall have reduced withholding taxes implications on payments received from Indian entities.

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This Newsflash summarizes on a Delhi Tribunal’s ruling stating that US LLCs as Fiscally Transparent Entities are eligible for Treaty Benefits Under the India-US DTAA. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said judgement and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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