Key highlights of the revised tax treaty between India and South Korea

Background
The Government of India and the Government of Republic of Korea entered into a double taxation avoidance agreement (the current tax treaty). On 18 May 2015, both the governments have signed the revised double taxation avoidance agreement (the revised tax treaty). Key changes introduced in the revised tax treaty are summarised as follows:

Entry into force
The provisions of the revised tax treaty shall have effect in India, in respect of income derived in any fiscal year beginning on or after the first day of April next following the calendar year in which the revised tax treaty enters into force. Both the countries shall notify each other in writing, through diplomatic channels, of the completion of the procedures required by the respective laws for the entry into force of this revised tax treaty. However, the revised tax treaty shall enter into force on the date of the later of the above-referred notifications. Further the current tax treaty shall cease to have effect from the dates on which the revised tax treaty becomes effective.

Assuming the Republic of Korea as well as India notifies each other in writing, through diplomatic channels, the revised tax treaty on or before 31 December 2016, then the same will be effective in India from 1 April 2017 i.e. financial year 2017-18.

Resident
A resident shall also include that state and any political subdivision or local authority thereof. The resident, however, does not include any person who is liable to tax in that state in respect only of income from sources in that state.

Permanent Establishment
The term ‘Permanent Establishment’ (PE) shall especially include a sales outlet, a warehouse in relation to a person providing storage facilities for others, and a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on.

A PE shall encompass a building site or construction, installation or assembly project or supervisory activities in connection therewith, only if such site, project or activities last more than 183 days, instead of earlier threshold of nine months.

Also, a PE shall encompass the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or connected project) within the country for a period or periods aggregating more than 183 days within any 12-month period.

An enterprise shall be deemed to have a PE in the other contracting state in respect of any activities, which a person, other than an agent of an independent status, undertakes for the enterprise, if such a person:

1 South Korea’s official name is ‘Republic of Korea’
2 Notification No. GSR 111(E), dated 26 September 1986
• Has no authority to conclude contracts in the name of the enterprise, but habitually maintains in the other state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, or

• Habitually secures orders in the other state, wholly or almost wholly for the enterprise itself.

An insurance enterprise of a contracting state shall, except in regard to reinsurance, be deemed to have a PE in the other contracting state if it collects premiums in other state or insures risks situated therein through a person other than an independent agent.

When the activities of such an agent are devoted almost wholly on behalf of an enterprise of the other contracting state, and conditions are imposed between that enterprise and the agent in their commercial and financial relations, which differ from those that would have been made between independent enterprises; he will not be considered an agent of an independent status.

**Business profits**

Insofar as it has been customary in a contracting state to determine the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in the relevant paragraph of the tax treaty shall preclude that contracting state from determining the profits to be taxed by such an apportionment as may be customary. However, the method of apportionment adopted shall be such that the result shall be in accordance with the principles contained in this Article.

**Dividends**

If the beneficial owner of the dividends is a resident of the other contracting state, the tax charged shall not exceed 15 per cent of the gross amount of the dividends. The tax rate of 20 per cent and the other conditions to claim 15 per cent tax rate present in the current tax treaty have been deleted.

**Interest**

The tax charged on the gross amount of the interest has been reduced from 15 to 10 per cent. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

**Royalties and Fees for Technical Services**

The tax charged on the gross amount of royalties or Fees for Technical Services (FTS) has been reduced from 15 to 10 per cent, if the beneficial owner of royalties or FTS is a resident of the other contracting state.

**Capital gains**

Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a contracting state may be taxed in that state. As per the protocol to the revised tax treaty, such shares means the shares deriving more than 50 per cent of their value directly or indirectly from immovable property.

Gains derived by a resident of a contracting state from the alienation of shares of a company resident of the other contracting state, may be taxed in that other state if, the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least 5 per cent of the capital of that company. Earlier, such gains were taxed only in the state of a resident.

**Associated enterprises**

In the revised tax treaty, paragraph 2 in Article 9 has now been specifically introduced to allow one country to give some compensatory or corresponding adjustment if there is a double taxation.

The Indian tax authorities contend that, since the provisions similar to newly introduced Article 9(2) are absent in Indian tax treaties, India shall not entertain any Bilateral Advance Pricing Agreements (APAs) or Mutual Agreement Procedures (MAPs) on transfer pricing issues with respect to transactions involving such country. This has now been resolved with the introduction of paragraph 2 of Article 9 in the revised tax treaty which now makes Bilateral APAs and MAPs on transfer pricing issues between India and the Republic of Korea possible.
Independent personal services
As per the revised tax treaty, the income derived by an individual who is a resident of a contracting state from performance of independent activities may also be taxed in the other contracting state, if his/her stay in the other contracting state is for periods amounting to or exceeding in the aggregate 183 days in any 12-month period. In such a case only so much of the income as is derived from his/her activities performed in that other state may be taxed in that other state.

Dependent personal services
The threshold period of 183 days has to be determined within any 12-month period commencing or ending in the fiscal year concerned.

Shipping and air transport
Under the current tax treaty, there were separate Articles on Shipping and Air Transport. However, under the revised tax treaty both the Articles are combined. The revised tax treaty shall not apply to profits derived from the participation in a pool, a joint business or an international operating agency.

As per the current tax treaty, profits derived from the operation of ships in international traffic may be taxed in the other contracting state but the tax charged shall not exceed 50 per cent of the corresponding domestic tax. However, as per the revised tax treaty, such profits shall be taxable only in the contracting state of the resident.

Profits from the operation of ships or aircraft in international traffic shall include profits derived from:

- the rental of a ship or aircraft on a bare boat charter basis; and
- the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods and merchandise, where such rental or such use, maintenance or rental, is incidental to the operation of ships or aircraft in international traffic.

Interest on investments directly connected with the operation of aircraft and ships in international traffic shall be regarded as profits derived from the operation of such aircraft and ships if they are integral to the carrying on of such business.

Directors’ fees
As per the revised tax treaty, the salaries and other similar remuneration paid to an official in a top-level managerial position shall not be covered under the ‘Directors’ fees’.

Other income
The provisions of Article 7 or Article 14, as the case may be, shall apply to income, if:

- It is other than income from immovable property as per Article 6(2),
- If the recipient of such income, being a resident of a contracting state, carries on business in the other contracting state through a PE situated therein, or performs in that other state independent personal services from a fixed base situated therein, and
- The right or property, in respect of which the income is paid, is effectively connected with such PE or fixed base.

Elimination of double taxation
The current tax treaty provided that any amount which would have been payable as tax for any year, but for an exemption or reduction of tax granted for that year, shall be treated as ‘tax payable’. Consequently, foreign tax credit was available under the tax sparing method as an incentive for the promotion of economic development of the respective country. However, this clause has been deleted in the revised tax treaty.

Limitation of benefits
The revised tax treaty introduces ‘limitation of benefit’ Article. It provides that the revised tax treaty shall not restrict the application of the laws or regulations of a contracting state, which are designed to prevent the avoidance or evasion of taxes, whether or not described as such. The benefit under the revised tax treaty shall not be available, if its affairs were arranged in such a manner that the main purpose or one of the main purposes was to avoid taxes to which this revised tax treaty applies.
In respect of Articles 10 (Dividends), 11 (Interest), 12 (Royalties and FTS), 13 (Capital gains) and 22 (other income), a resident of a contracting state shall not be entitled to benefits otherwise accorded to residents of a contracting state by the revised tax treaty, if:

- The resident is controlled directly or indirectly by one or more persons that are not residents of that contracting state; or

- The main purpose or one of the main purposes of any person concerned with the creation or assignment of a share, a debt-claim, or a right in respect of which the income is paid, is to take advantage of these Articles by means of that creation or assignment.

**Non-discrimination**

As per the protocol to the revised tax treaty, in the case of India, this Article shall not be construed as preventing India from charging the profits of a PE, which a company of Korea has in India at a rate of tax which is higher than that imposed on the profits of a similar company of India, nor as being in conflict with the provisions of Article 7(3)

In the case of Korea, where a company which is a resident of India has a PE in Korea, the profits of the PE may be subjected to an additional tax in Korea in accordance with its law, but such tax shall not exceed 15 per cent of the amount of such profits after deducting therefrom income tax and other taxes on income imposed thereon in Korea.

**Exchange of information**

If information is requested by a contracting state in accordance with this Article, the other contracting state shall use its information gathering measures to obtain the requested information, even though that other state may not need such information for its own tax purposes. A contracting state shall not decline to supply information, solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

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*Paragraph 3 of Article 7 of the revised tax treaty states that in determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the state in which the PE is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the tax laws of that state.*

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**Assistance in the collection of taxes**

The revised tax treaty has introduced a new Article dealing with ‘Assistance in the collection of taxes’ in line with the current international standards. This Article will help the tax authorities of India and Korea to collect outstanding tax debts on a wider range of taxes.

**Our comments**

The revised tax treaty has amended the PE related Article in line with various tax treaties signed by India. India has already opened the insurance sector and allowed insurance activities of foreign companies; hence, the scope of the PE has been correspondingly enlarged to cover such activities. The reduction of tax rates on dividend and interest is a welcome change and is expected to increase the investment in respective countries. The revised tax treaty has brought within its tax net certain gains arising from the sale of shares, and therefore, an investor needs to carefully take into account these changes while investing/divesting such shares. The introduction of an Article on ‘Limitation of Benefits’ is continuing a trend of introducing such article in almost all tax treaties India has entered into in past several years. Further, the profits derived from shipping business through international traffic shall now be taxed in the state of residence.

On the transfer pricing front, the Indian tax authorities contend that, since the provisions similar to newly introduced Article 9(2) are absent in the Indian tax treaties, India shall not entertain any bilateral Advance Pricing Agreements (APAs) or Mutual Agreement Procedures (MAPs) on transfer pricing issues with respect to transactions involving such country. Till now, in the absence of Article 9(2), bilateral APAs and MAPs on transfer pricing issues between Indian and South Korean companies was not possible. This has now been resolved with the introduction of paragraph 2 of Article 9 in the revised tax treaty which now makes bilateral APAs and MAPs on transfer pricing issues between India and South Korea possible. This much needed amendment now paves the way for India-South Korea bilateral APAs and MAPs on transfer pricing issues and could possibly result in several taxpayers who are currently facing the issue of double taxation to opt for the bilateral APA/MAP route.