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THE MULTILATERAL INSTRUMENT AND ITS IMPACT ON INDIA'S BILATERAL TAX TREATIES

3 July 2017

With an object to address aggressive tax strategies by multinational enterprises (MNE), the Organisation for Economic Cooperation and Development (OECD) had undertaken the landmark Base Erosion and Profit Shifting (BEPS) Project. Under BEPS Project, the OECD had identified 15 (fifteen) Action Points (BEPS Action Plan) to address tax planning strategies which exploit gaps and mismatches in tax rules and result in the shifting of profits by MNEs to no/low tax jurisdictions. Previously, the OECD had issued recommendations and reports for each of the actions points. It was realised that it would take years to amend more than 3000 bilateral tax treaties so as to give effect to the recommendations in the BEPS Action Plan. As part of Action Point 15 [Development of the Multilateral Instrument (MLI) to implement tax treaty related BEPS measures], it was decided to draft a MLI. It was envisaged that countries would sign and notify the treaties they want to be governed by the MLI and the extent thereof by expressing reservations on the provisions of the MLI. Pursuant to this, the OECD had released the text of the MLI in November 2016.

The first joint signing ceremony of the MLI was held on 7 June 2017, whereby 68 contracting states (including India) signed the MLI. This historic event marks a key milestone in the implementation of the BEPS Project. As part of the signing ceremony, each contracting state was required to provide its provisional list of reservations (to opt out of certain provisions except for the minimum standards) and position on MLI provisions. India has complied with this requirement. The MLI is to be read along with the bilateral tax treaties while interpreting the provisions of the latter. These tax treaties would then constitute 'covered tax agreements' (Covered Tax Treaties) which would be covered by the provisions of MLI. Currently, 1103 bilateral tax treaties would be modified by the MLI. However, with other contracting states expected to sign the MLI, the number of Covered Tax Treaties would increase on a continuous basis.

The MLI does not function in the same manner as an amending protocol does with respect to existing tax treaties. Instead, the MLI is to be applied alongside existing bilateral tax treaties, modifying their application in order to implement the BEPS measures. To provide flexibility for jurisdictions to implement the MLI provisions, contracting states have the right to opt-out of a provision by way of reservation and signatories are required to inform the Secretary-General of the OECD (Depository) about the options chosen or the reservations made by way of notifications.

The MLI contains provisions in respect of dual resident entities, transparent entities, prevention of treaty abuse and dispute resolution. This update summarises some of the important provisions of the MLI and assesses the impact of the reservations and positions expressed by India on its existing network of tax treaties. The analysis of MLI's impact on bilateral tax treaties has been bifurcated into two categories: (i) impact on the provisions of the Covered Tax Treaties notified by India and; (ii) impact on the provisions of the Covered Tax Treaties that have not been notified. At the outset, it is important to note that the tax treaties, which are not Covered Tax Treaties, would not be impacted by the provisions of the MLI.

MLI- When does it come into force

The MLI would need to be ratified by the signatories and at the time of such ratification, each signatory would need to re-submit its list of the reservations and position. The MLI would come into force 3 (three) months after at least 5 (five) signatories have submitted the instrument for ratification, acceptance or approval to the Depository. However, with respect to each of the Covered Tax Treaties, the provisions of the MLI would come into force after both the contracting states to that particular Covered Tax Treaty have ratified the MLI.

Key provisions and their impact on India's bilateral tax treaties

A. Article 3- Transparent Entities

- *MLI Provision*

  The MLI provides that income derived by or through a transparent entity shall be considered income of a resident only to the extent that income of such entity is treated for the purposes of taxation, as income of a resident of that contracting state. The MLI provides liberty to contracting states not to apply this provision entirely, to Covered Tax Treaties.

- *Impact on Covered Tax Treaties*

  India has expressed its reservation on this Article and has not adopted this Article in its entirety. Consequently, the eligibility of fiscally transparent entities to claim benefit under India's tax treaties would continue to be as per the provisions of the particular tax treaty in this regard. It is interesting to note that the India-UK and India-US tax treaties are already aligned with the MLI provision, and allow partnerships to claim treaty benefit to the extent the income is taxed in its hands or in the hands of its partners as residents of the UK or US, respectively.

B. Article 4- Dual Resident Entities

- *MLI Provision*

  The OECD Model Convention provides that a person (other than an individual) who is resident in both the contracting states shall be deemed to be a resident of the state in which its place of effective management (POEM) is situated. As against this, the MLI provides that the residency of a dual resident entity shall be determined by a Mutual Agreement Procedure (MAP) between the contracting states having regard to its POEM, place of incorporation or constitution and any other relevant factors.

- *Impact on Covered Tax Treaties*

    - *Provisions notified by both contracting states*- Currently India's bilateral tax treaties contain a tie breaker test to determine residency of a dual resident entity. India has notified the provisions of all of its 93 Covered Tax Treaties. Consequently, when the respective contracting states of these 93 Covered Tax Treaties also notify the provisions on the test to determine residency for a dual resident entity, the provisions of the said Covered Tax Treaties would be replaced by the MLI provision. This is unless the particular treaty partner of a Covered Tax Treaty expresses its reservations on Article 4 of the MLI.

    - *Provisions not notified by other contracting states*- Where India's treaty partners to the Covered Tax Treaties do not notify the provisions on tests to determine residency for dual resident entities, the MLI provisions would apply to such Covered Tax Treaties only to the extent that provisions of such tax treaty are incompatible with the MLI provision.

C. <u>Article 5 – Methods for elimination of double taxation</u>

- *MLI Provision*

  Article 5 of the MLI refers to 3 (three) options for preventing double non-taxation situations arising due to the residence state providing relief under the exemption method for income not taxed in the source state.

- *Impact on Covered Tax Treaties*

  India has expressed its reservation on Article 5 and has decided not to apply the said Article 5 to any of its Covered Tax Treaties. Given that India's tax treaties apply the credit method for providing relief from double taxation, the situation contemplated under Article 5 may not be relevant in the Indian context.

D. <u>Article 6 and Article 7- Prevention of Treaty Abuse</u>

- *MLI Provision*

  Article 6 of the MLI provides a mandatory requirement amendment to the preamble of the Covered Tax Treaties, by including language reflecting the intent of the contracting states to avoid double non-taxation and treaty shopping.

  Article 7 of the MLI provides for a principal purpose test (PPT) as a mandatory requirement. The benefit under a Covered Tax Treaty (in respect of income or capital) would not be available if obtaining that benefit was one of the principal purposes of any arrangement, or transaction. This is unless it is established that granting that benefit in the circumstances would be in accordance with the object and purpose of the relevant provision of the Covered Tax Treaty. The MLI also provides liberty to apply the simplified Limitation of Benefits (LOB) clause. By virtue of the simplified LOB, an entity would be able to claim relief in respect of an income, only if it is a 'qualified person' or if it is engaged in 'active business' and the income derived by such entity from India would need to be incidental to or emanate from its business.

Also, (i) operating as a holding company; (ii) providing overall supervision or administration of group companies; (iii) providing group financing; or (iv) making or managing investments (unless it is a bank or insurance company or registered securities dealer in the ordinary course of its business), do not qualify as 'active business' for the purpose of the MLI.

➢ *Impact on Covered Tax Treaties*

- *Provisions notified by both contracting states*-The PPT and modification to the preamble of Covered Tax Treaties would be applicable as a minimum standard, unless the other contracting states notify the adoption of a detailed LOB or other permissible measure to meet the minimum standard.

  India has adopted a simplified LOB clause under Article 7 of the MLI and if the other contracting state does the same, the simplified LOB would be added to the Covered Tax Treaties.

- *Provisions not notified by both contracting states*- Where the other contracting state does not choose a simplified LOB, the simplified LOB would supersede the provisions of the Covered Tax Treaties to the extent that such provisions are incompatible with the MLI. This is unless the other contracting state reserves not to apply the simplified LOB to its Covered Tax Treaties.

E. <u>Article 8- Dividend Transfer Transactions</u>

➢ *MLI Provision*

Article 8 of the MLI stipulates the conditions under which a person of one contracting state (holding shares beneficially) can avail an exemption or limited rate of tax on dividends paid by a company resident of another contracting state. Article 8 requires the shares to be held by the beneficial owner for a period of 365 days in order to claim an exemption or lower withholding tax rate on dividend income. Contracting states can reserve the application of this Article in its entirety or reserve the holding period contained in any Covered Tax Treaties, which is more or less than a period of 365 days.

➢ *Impact on Covered Tax Treaties*

- *Provisions notified by both contracting states*- India has notified 21 of its Covered Tax Treaties which contain provisions dealing with taxation of dividend income. If the other contracting states also notify these provisions, the provisions of the Covered Tax Treaties would be replaced by Article 8 of the MLI.

- *Provisions not notified by both contracting states*- Where the other contracting state does not notify the provisions of the respective Covered Tax Treaties, the minimum holding period contained under Article 8 would not apply. India has reserved the holding period contained in India-Portugal tax treaty, where the holding period is 24 months to avail the benefit in respect of dividend income contained in that tax treaty.

F. Article 9- Capital gains from transfer of share deriving value from immovable property

- *MLI Provision*

  Article 9 of the MLI provides for levy of capital gains tax arising from alienation of shares or comparable interest in entities such as partnership or trust; that derive more than a certain percent of their value (Value Threshold) from immovable property, in the state where the immovable property is situated.

  Article 9 provides for 2 (two) alternatives: (a) Option 1, which specifies that where the Value Threshold is met at any time during the 365 days preceding the transfer, the capital gains from the sale of shares or comparable interests shall be taxable in the country where immovable property owned by the entity is situated. Contracting states can bilaterally negotiate the Value Threshold in their tax treaties; and (b) Option 2, which is similar to Option 1 also fixes a Value Threshold of more than 50% for the trigger of source taxation in Article 9.

- *Impact on Covered Tax Treaties*

  - *Provisions notified by both contracting states*- India has chosen to apply Option 2, and the look back period of 365 days triggers the source taxation of the transfer of shares or comparable interest where such shares or comparable interest derive more than 50% of their value form immovable property situated in India. While India has notified 61 of its Covered Tax Treaties which contain provisions dealing with source taxation of transfer of shares which derive their value from immovable property. In the event that the other contracting states also chose Option 2, the provisions of the Covered Tax Treaties would be replaced by para 4 of Article 9 of the MLI.

  - *Provisions not notified by both contracting states*- Where the other contracting state does not notify the provisions of the respective Covered Tax Treaties, the provisions of Article 9 would apply to the extent the provisions of the Covered Tax Treaties are incompatible with the MLI.

G. Article 10- Anti-abuse rule for permanent establishment situated in a third jurisdiction

- *MLI Provision*

  Article 10 of the MLI provides that where:

  (i) an enterprise of a contracting state (Residence State) to a Covered Tax Treaty derives income from another contracting state (Source State) and the Residence State treats such income as attributable to a PE of the enterprise situated in third jurisdiction (PE State) and;

  (ii) the profits attributable to that PE are exempt from tax in the Residence State,

  then the benefits of the Covered Tax Treaties shall not apply to any item of income on which tax in the PE State is less than 60% of the tax that would have been payable if that PE was situated in the Residence State. The MLI provides that such income would remain taxable as per the domestic law of the Source State. The MLI also provides that any income derived from the Source State in connection with / or incidental to active business carried out through the PE shall not be subject to tax in Source State.

➢ *Impact on Covered Tax Treaties*

India has neither expressed any reservation nor has it notified any provisions of its Covered Tax Treaties. Consequently, the MLI provisions in this respect would supersede the Covered Tax Treaties and would apply to the extent that the provisions of the latter are incompatible with Article 10 of the former.

H. <u>Article 11- Application of Tax Agreements to restrict a Party's right to tax its own residents</u>

➢ *MLI Provision*

Article 11 provides a saving clause to clarify that Covered Tax Treaties shall not affect the right of taxation of a contracting state to tax its own residents, save for certain benefits granted, under the provisions of the Covered Tax Treaties.

➢ *Impact on Covered Tax Treaties*

India has neither expressed any reservation nor has it notified any of its Covered Tax Treaties, which contain such a provision. Consequently, the MLI provisions in this respect would supersede the Covered Tax Treaties and would apply to the extent that the provisions of the Covered Tax Treaties are incompatible with Article 10 of the MLI.

I. <u>Article 12- Artificial Avoidance of PE through commissionaire arrangement and similar strategies</u>

➢ *MLI Provision*

Article 12 provides changes to be made to the Covered Tax Treaties to address the artificial avoidance of PE status through commissionaire arrangements and similar strategies. The MLI provides for a broader dependent agency PE rule. In addition to it applicability to persons having the authority to conclude contracts, the agency PE rule now extends to persons who habitually play the principal role in the routine conclusion of contracts, without material modifications by the enterprise. The activities described would however not create a PE, if carried on by certain independent agents. Under the MLI provisions, a person cannot be considered an independent agent if he acts exclusively or almost exclusively on behalf of a person closely related to such enterprise (CRE). Article 12 gives an option to countries to opt out of this Article in its entirety.

➢ *Impact on Covered Tax Treaties*

- *Provisions notified by both contracting states*- India has not expressed any reservation and has notified all of its Covered Tax Treaties, which contain provision(s) dealing with agency PE. When the other contracting states also notify the Covered

Tax treaties, the provisions of the Covered Tax Treaties would be replaced by Article 12 of the MLI.

- *Provisions not notified by both contracting states*- Where the other contracting state does not notify the provisions of the respective Covered Tax Treaties, the MLI provisions contained in Article 12 would not apply to the Covered Tax Treaties.

J. <u>Article 13- Artificial Avoidance of PE through specific activity exemption</u>

➢ *MLI Provision*

Article 13 deals with specific activity exemptions to PE and provides 2 (two) options to achieve this. Option A provides that listed activities would qualify for specific activity exemption only if such activity qualifies as preparatory or auxiliary in character. On the other hand, Option B allows contracting states to retain the automatic exemption to listed activities, irrespective of the same being preparatory or auxiliary based on the premise that these specifically listed activities are intrinsically preparatory or auxiliary. Furthermore, irrespective of the options, Article 13 also provides for an anti-fragmentation rule which denies specific activity exemption where the activities carried out by the enterprise along with its CREs, at the same or another place, exceed the preparatory or auxiliary character.

➢ *Impact on Covered Tax Treaties*

- *Provisions notified by both contracting states*- India has chosen Option A and has accordingly notified all of its Covered Tax Treaties which contain provisions dealing with preparatory and auxiliary activity exemption. When the other contracting state chooses Option A and also notifies the Covered Tax Treaties, the relevant provisions of the Covered Tax Treaties would be replaced by Option A of Article 13 of the MLI. Where the other contracting state chooses Option B, then due to incompatibility, the MLI provisions in Article 13 would not apply.

- *Provisions not notified by both contracting states*- Where the other contracting state does not notify the provisions of the respective Covered Tax Treaties, the MLI provisions contained in Article 13 would not apply to the Covered Tax Treaties. Note that, India has not notified any provisions in respect of the anti-fragmentation rule, hence it would not be relevant for India's Covered Tax Treaties.

K. <u>Article 14- Splitting of contract</u>

➢ *MLI Provision*

Article 14 of the MLI provides for determining time thresholds in a tax treaty for construction/installation/supervisory or any PE provision have been exceeded under a Covered Tax Treaty. The Article provides for an aggregation of time spent on connected activities by CREs in the same project to determine the threshold. This provision is optional and does not apply where either of the contracting states have made a reservation on the application of this Article.

- *Impact on Covered Tax Treaties*

  Provisions not notified by both contracting states- India has not expressed any reservation nor has it notified any of its Covered Tax Treaties. In the event that the other contracting state notifies or does not notify the Covered Tax Treaties, the provisions of Article 14 of the MLI would apply to the extent the provisions of the Covered Tax Treaties are incompatible with Article 14. This is of course unless the other contracting state expresses its reservation on Article 14.

L. <u>Article 15- Definition of CRE</u>

- *MLI Provision*

  Article 15 of the MLI provides the definition of CRE for the purposes of Article 12-14 of the MLI. For this purpose, a CRE in relation to an enterprise covers a person who has control over the other enterprise or both are under control of same persons or enterprise. This provision also deems a person as a CRE if such person possesses directly or indirectly more than 50% of the: (i) beneficial interest; or (ii) aggregate vote and value of shares of an enterprise.

- *Impact on Covered Tax Treaties*

  India has not expressed any reservation; the definition would apply to the Covered Tax Treaties unless a treaty partner to the Covered Tax Treaties expresses a reservation on Article 12 - Article 14 of the MLI.

M. <u>Article 16- MAP</u>

- *MLI Provision*

  Article 16 of the MLI introduces the minimum standards for improving dispute resolution. Article 16 requires contracting states to allow taxpayers to present a MAP case to the competent authorities (CA) of either of the states and not only to the CA of the state of residence. Furthermore, the Article 16 requires that MAP access should be allowed in a case where the MAP application is presented within 3 (three) years of the first notification of the action resulting in taxation not in accordance with a tax treaty.

  Under the MLI, CAs of both the states need to endeavour to resolve a case under MAP if they are not able to arrive at a satisfactory solution unilaterally. Also, the MAP agreements are to be implemented notwithstanding any time limits under domestic laws.

- *Impact on Covered Tax Treaties*

  (i) Bilateral recourse to MAP

  India has reserved its right for not adopting the modified provisions on the basis that it would meet the minimum standard by allowing MAP access in the resident state and by implementing a bilateral notification process. Thus, each of the Covered Tax Treaties would have a bilateral notification process to allow MAP recourse not only to Indian residents but also residents of other contracting states who are partners of Covered Tax Treaties.

(ii) Time period of three years to invoke MAP

India has notified tax treaties which provide a lower limitation period of (a) 2 (two) years and; (b) those that have minimum period of 3 (three) years for presenting a MAP case. Thus, the notified tax treaties with Belgium, Canada, Italy and UAE would now provide a minimum time limit of 3 (three) years for MAP access.

(iii) Bilateral MAP when unilateral MAP fails

India has notified its tax treaties which require a provision enabling bilateral MAP with the CAs of both the contracting states when unilateral MAP does not resolve the dispute.

N. Article 17- Secondary Adjustments

➢ *MLI Provision*

As a minimum standard under dispute resolution, the contracting states are to provide MAP access in transfer pricing (TP) cases. Also, as a complementing best practice, the MLI suggests that contracting states include a provision to provide that where a TP adjustment is made in one of the contracting states, the other contracting state shall provide corresponding adjustment. The MLI provides that a contracting state may opt out of this provision to the extent the Covered Tax Treaties already contain such a provision.

➢ *Impact on Covered Tax Treaties*

India has reserved its right to apply this article and has notified its Covered Tax Treaties that contain the enabling provision for secondary adjustment. For Covered Tax Treaties that do not contain such provision, the provisions of Article 17 would apply to the extent the provisions of the Covered Tax Treaties are incompatible with the former.

O. Article 35- Entry into force

➢ *MLI Provision*

The MLI provisions will generally have effect on a tax treaty at different times with respect to taxes withheld at source, and all other taxes levied in a contracting state:

(i) In relation to provisions relating to withholding taxes, the date of entry into effect is the first day of the next calendar year after notification of internal procedures for ratification of the MLI, by both the contracting states. The MLI provides an option to use the term "taxable year" in place of "calendar year";

(ii) With respect to all other taxes levied by a contracting state, the MLI shall come into effect for taxable periods beginning on or after, the expiration of 6 (six) calendar months from the latest date of the MLI entering into force for each of the contracting states to a tax treaty; and

(iii) MAP provisions of the MLI will enter into force for cases presented to the CA on or after, the latest date on which the MLI enters into force for each of the contracting states to the tax treaty.

- *Impact on Covered Tax Treaties*

  India has chosen to substitute "calendar year" with "taxable period". Further, in respect of the date of "entry into effect" of the MLI provisions, India has expressed its reservation. India's position is that the MLI is to be applied 30 days after the OECD receives the latest notification by each of the contracting states, affirming the completion their respective internal procedures with respect to the tax treaties. Thus, for withholding taxes, the MLI provisions would come into effect from the beginning of the financial year which falls 30 days after the date of notification of completion of internal procedures by both the contracting states to a Covered Tax Treaty. With respect to other taxes, MLI provisions would come into effect from the financial year which falls 7 (seven) months from the date of notification of compliance with internal procedures, by both the contracting states to a Covered Tax Treaty.

Comment

The MLI marks a key milestone in the implementation of the BEPS Project. The success of the MLI would also depend on the number of countries that will sign it. However, the OECD needs to be applauded for avoiding the need to undertake the magnanimous task of modification of more than 3000 tax treaties. It is also worth noting that the OECD has done this phenomenal work in a period of 3 (three) years.

The signatories include UK, Canada, Australia, Belgium, Finland, France, Cyprus, and Singapore, the Netherlands, Luxembourg, Japan, South Africa and Ireland. Thus, India's recently revised / amended treaties with Cyprus and Singapore would also be impacted by the MLI. Also, Mauritius is expected to sign the MLI soon and hence, the India-Mauritius Tax Treaty would also be impacted by the MLI. With the PPT being implemented as a minimum standard and strategies for avoidance of PE being tackled by Article 12 to 14 of the MLI, the network of the bilateral tax treaties will undergo a vital change and go a long way towards reducing BEPS.

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