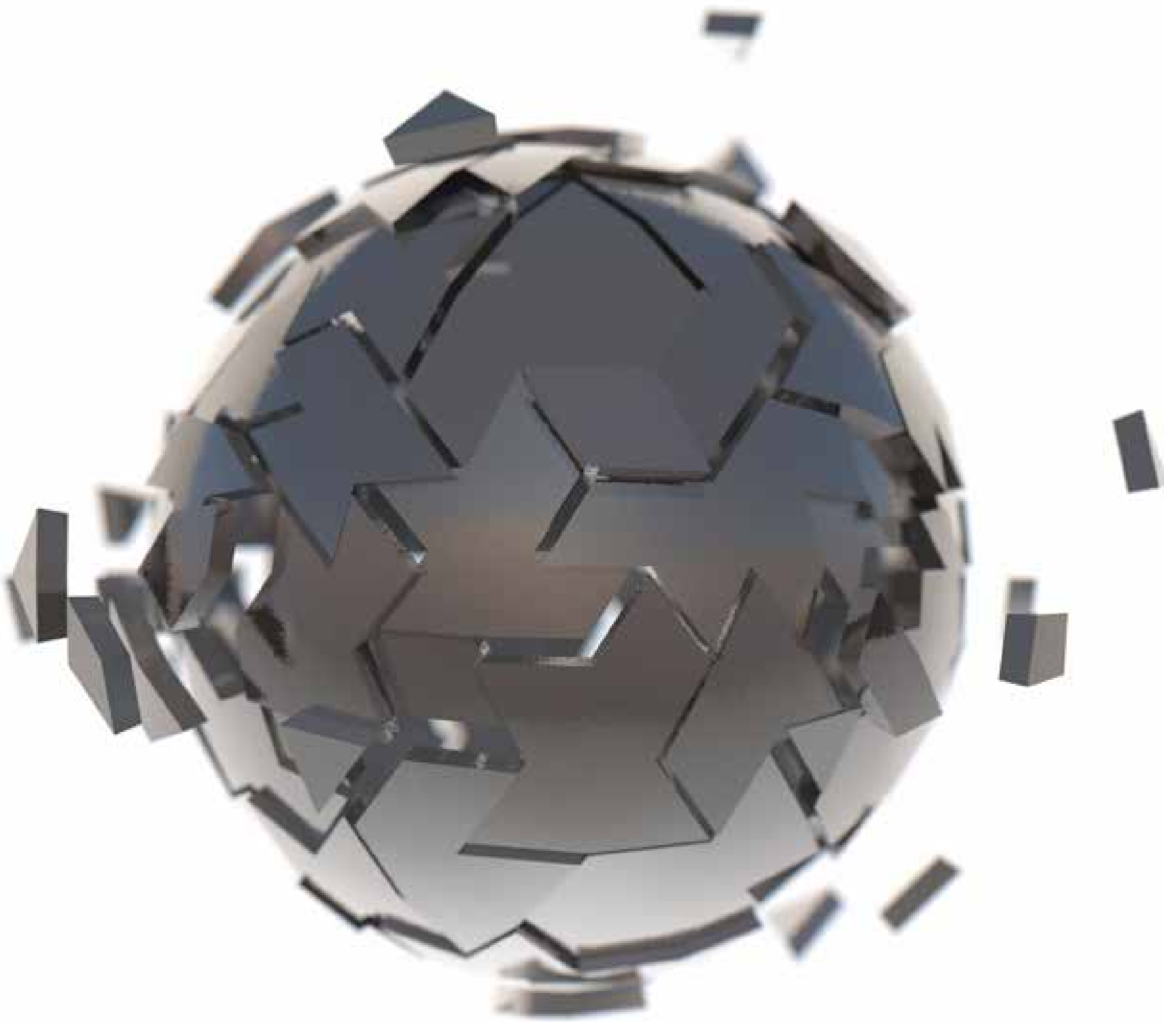

Multilateral Instrument

Analysis and India perspective

September 2017

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Introduction

On 24 November 2016, the Organisation for Economic Co-operation and Development [OECD] released the widely-anticipated text of the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting [Multilateral Instrument / MLI]. An explanatory statement that accompanied the release provides clarification of the approach taken and how each article is intended to affect treaties covered by the MLI.

The MLI is designed to swiftly implement the tax treaty related measures arising from the G20/ OECD BEPS project. It includes a number of minimum standards that jurisdictions signing up to the MLI are required to implement. The MLI supports all previously agreed BEPS approaches by allowing jurisdictions to select from alternative options by filing reservations. The MLI inter alia includes articles on permanent establishment [PE], treaty abuse, dispute resolution and hybrid mismatches.

The MLI provides significant flexibility to signatories. For example, a country can decide which tax treaties will be covered by the MLI and which will be outside its purview. Moreover, each country can also opt out of a provision of the MLI (entirely or partly), provided it is not a minimum standard. Even in respect of certain minimum standards, the MLI has offered options.

Pursuant to the Cabinet's approval, India's Finance Minister participated in the signing of the MLI at Paris on 7 June 2017. At the signing of the MLI, India has given a provisional list of expected reservations and notifications. India has notified 93 double tax avoidance treaties [tax treaties] indicating the intention of applying the selected MLI provisions to all these tax treaties. Presently, the MLI has been signed by 71 jurisdictions including Australia, Canada, China, Cyprus, France, Germany, Hong Kong, Japan, Luxembourg, Netherlands, Singapore and the United Kingdom. Interestingly, the United States has not signed the MLI.

Various notifications / reservations made by India and other countries are discussed in the subsequent paragraphs[1]. Generally speaking, a provision of the MLI would get adopted in the Indian tax treaty only when matching action happens i.e. acceptance by both the parties to a MLI provision results in adoption of the same provision in the tax treaty. In absence of such matching, other than in the case of a minimum standard, the existing provisions of the tax treaties may generally continue.

[1] Provisional Notifications of few countries other than India are analysed

Part I -Scope and Interpretation of Terms

Article 1 – Scope of the Convention

Article 1 provides the scope of the MLI. It modifies all the Covered Tax Agreements [CTA] (i.e. notified tax treaties).

Article 2 – Interpretation of the terms

Article 2 defines the following terms:

- **Covered Tax Agreement** – It refers to an existing tax treaty with respect to which each party to the tax treaty has made a notification for application of the MLI.
- **Party** – It means a state or a jurisdiction for which the MLI is in force or a jurisdiction which has signed the MLI and for which the MLI is in force.
- **Contracting Jurisdiction** – It means a party to a CTA.
- **Signatory** – It means a state or jurisdiction which has signed the MLI, but for which the MLI is not yet in force.

In respect of terms not defined in the MLI, the meaning as per the CTA should be adopted.

India perspective

India has notified 93 tax treaties as CTAs to be covered by the MLI. It is pertinent to note that Mauritius, Germany and China have not notified their tax treaties with India as CTAs.

Part II – Hybrid Mismatches

Part II is an outcome of BEPS Action 2 – Neutralising the effect of hybrid mismatch arrangements. While the majority of recommendations arising on hybrid mismatches were changes to domestic law, optional changes to the tax treaty treatment of transparent entities, the use of competent authority tie-breaking procedures to determine the residence of otherwise dual resident entities, and the application of the exemption and credit methods of double tax relief are included.

Article 3 - Transparent entities

Article 3 is based on the new Article 1(2) of the OCED model convention and addresses income earned through transparent entities. It inter alia provides that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either contracting jurisdiction, shall be considered to be income of a resident of the jurisdiction. However, this shall be only to the extent that the income is treated for purposes of taxation by that contracting jurisdiction as the income of a resident.

India perspective

As per the provisional reservation, India has opted not to adopt this provision in its tax treaties.

Article 4 - Dual resident entities

Article 4 is based on Article 4(3) of the OECD model convention and provides that the issue of dual residency for non-individuals is to be addressed by mutual agreement between competent authorities. In absence of such agreement the tax treaty benefit may be denied. The factors to be considered by the competent authorities include place of effective management [PoEM], the place of incorporation or constitution and any other relevant factors.

India perspective

As per the provisional notification, India would adopt this Article, while some other countries (Canada, Cyprus, France, Luxembourg, Singapore) have opted not to adopt this Article in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.

Article 5 - Application of methods for elimination of double taxation

Article 5 addresses the situations arising from the exemption method followed by countries to avoid double taxation and situations where income paid on an instrument is deductible in the source country, but not subject to tax in the hands of the recipient as per the tax laws of the country of residence. It gives three options in which parties may address the aforesaid issue.

India perspective

As per the provisional reservation, India has opted not to adopt this Article in its tax treaties.

Part III – Treaty Abuse

Part III is an outcome of BEPS Action 6 – "Preventing the granting of treaty benefit in inappropriate circumstances" and seeks to prevent tax treaty shopping and other tax treaty abuse strategies depriving countries of tax revenues. An option is given to support the different approaches permitted under the minimum standard; principal purpose test [PPT], detailed limitation on benefits [LOB] rule supplemented by a mechanism to deal with conduit arrangements, or simplified or detailed LOB rules supplemented with a PPT. A multitude of outcomes can arise where the approaches differ and asymmetric results are possible if both countries approve.

Article 6 - Purpose of a Covered Tax Agreement

Article 6 primarily seeks to insert a statement in the preamble of the tax treaties to the effect that the purpose of the treaty is not to create opportunities for double non-taxation or reduced taxation through tax avoidance or evasion including treaty shopping.

This being a minimum standard requirement, is mandatory and needs to be incorporated in the tax treaties either by replacing the existing preamble with the suggested text or adding such language if not already included in the tax treaties.

India perspective

This is a minimum standard and accordingly, the preamble of Indian tax treaties will be modified or replaced.

Article 7 - Prevention of treaty abuse

Article 7 seeks to insert a general anti-abuse provision / LOB provision in the tax treaties. The minimum standard for avoiding treaty abuse can be implemented by adopting either of the following:

- Only PPT (conceptually similar to India's general anti-avoidance rule)
- PPT plus either simplified or detailed LOB provision
- Detailed LOB supplemented by a mechanism that would deal with conduit arrangements not already dealt with in the tax treaties

Article 7 includes the PPT and simplified LOB.

India perspective

As per the provisional notification, India would adopt PPT and simplified LOB in its tax treaties. Most countries (Canada, Cyprus, Luxembourg, France, Japan, Netherlands, Singapore, UK) have adopted only PPT. In other words, generally countries have not adopted simplified LOB. Consequentially, simplified LOB may not be included in Indian tax treaties if the other jurisdictions do not agree for inclusion of simplified LOB.

Article 8 - Dividend transfer transactions

Article 8 addresses the abuse of beneficial tax treatment (say 5% rate) given under the tax treaties for dividend income in case of minimum 25% shareholding in the company distributing dividend. It requires a minimum holding of 365 days to avail the beneficial rate provided in the tax treaties.

India perspective

Certain tax treaties signed by India (e.g. Bangladesh, Belarus, Canada, etc.) offer beneficial tax rate on dividend income if the shareholder owns certain stake in the company. As per the provisional notification, India would adopt Article 8 in all the tax treaties with the exception of Portugal (which already contains a two year threshold). Countries such as Canada, Cyprus, Japan, Luxembourg, Singapore, UK have opted not to adopt this Article. This Article can get adopted in Indian treaties, subject to matching.

Article 9 - Capital gains from alienation of shares or interests of entities deriving their value principally from immovable property

Article 9 addresses misuse of provisions based on Article 13(4) of the OECD Model, which gives taxing rights to a source country (i.e. the country where the immovable property is situated) to tax gains on alienation of shares of a company if the shares derive more than 50% of their value directly or indirectly from immovable property situated in the source country.

It provides that the source country will get taxing right if the value threshold is met any time during the period of 365 days preceding the date of transfer. It also extends this provisions to interest in partnership or trusts.

India perspective

As per the provisional notification, India would adopt this Article in its tax treaties. Certain countries (Canada, Cyprus, Luxembourg, Singapore, UK) have opted not to adopt this Article, while certain countries (e.g. France, Japan, Netherlands) would adopt the Article. This Article can get adopted in Indian treaties, subject to matching.

Article 10 - Anti-abuse rule for permanent establishment in third jurisdictions

Article 10 addresses abuse of tax treaties in triangular situations.

India perspective

As per the provisional statement, India has not made any reservation as regards adoption of this Article and hence it would get adopted in its tax treaties, subject to matching. However, certain countries (e.g. Canada, Cyprus, France, Luxembourg, Singapore, etc.) have opted not to adopt this Article.

Article 11 - Application of tax agreements to restrict a party's right to tax its own residents

Article 11 seeks to avoid an argument, according to which, the tax treaty impairs rights of a country to tax its own residents. In other words, it provides for a saving clause which preserves the right of a Contracting Jurisdiction to tax its own residents subject to certain exceptions. Additionally, Article 11 also ensures that certain benefits granted to tax residents are not impacted.

India perspective

As per the provisional statement, India has not made any reservation on adoption of this Article and hence it would get adopted its tax treaties subject to matching. However, certain countries (e.g. Canada, Cyprus, Singapore, etc.) have opted not to adopt this provision.

Part IV – Permanent establishment

Part IV is an outcome of BEPS Action 7 - "Preventing the Artificial Avoidance of Permanent Establishment Status" and recommends amendment to Article 5 of the tax treaty on PE. The threshold at which a PE (taxable presence) arises is lowered through (i) broadening the scope of dependent agent PEs (preventing the use of commissionaire arrangements and other matters); (ii) narrowing exemptions for fixed place of business PEs by requiring activities to be 'preparatory and auxiliary' in character and/or by introducing an anti - fragmentation rule; and (iii) countering avoidance where long - duration construction contracts are split into a series of shorter contracts

Article 12 - Artificial avoidance of PE through Commissionaire and similar arrangements

Article 12 seeks to amend Article 5 of the tax treaties, which defines the term PE, on the following aspects:

- Scope of agency PE to counter the commissionaire arrangement entered into by foreign enterprise in order to avoid PE in the source state;
- Creation of agency PE when the agent habitually plays principle role leading to conclusion of contracts with routine approval of the principal;
- Agent will not be considered to be an independent agent if he acts exclusively or almost exclusively on behalf of a closely related enterprise.

India perspective

As per the provisional notifications, India would adopt this Article in its tax treaties. However, certain countries (Canada, Cyprus, Luxembourg, Singapore, UK, etc.), have opted not to adopt this Article, while certain countries (e.g. France, Japan, Netherlands) would adopt the Article. This Article can get adopted in Indian treaties, subject to matching.

Article 13 - Artificial avoidance of PE status through specific activity exemption

The primary objective of Article 13 is to ensure that the benefit of Article 5(4) [i.e. certain activities do not result in PE even when carried out through fixed place] is allowed only when the activities, carried on either individually or collectively, are preparatory or auxiliary in nature. It also contains an anti-fragmentation provision to prevent breaking of activities in order to benefit from the preparatory or auxiliary exemption.

India perspective

As per the provisional notifications, while India would adopt this provision, certain countries (e.g. Canada, Cyprus, France, Luxembourg, Singapore, etc.), have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.

Article 14 - Splitting-up of contracts

Article 14 addresses avoidance of PE by splitting the contracts between related enterprises to circumvent the threshold of creation of PE.

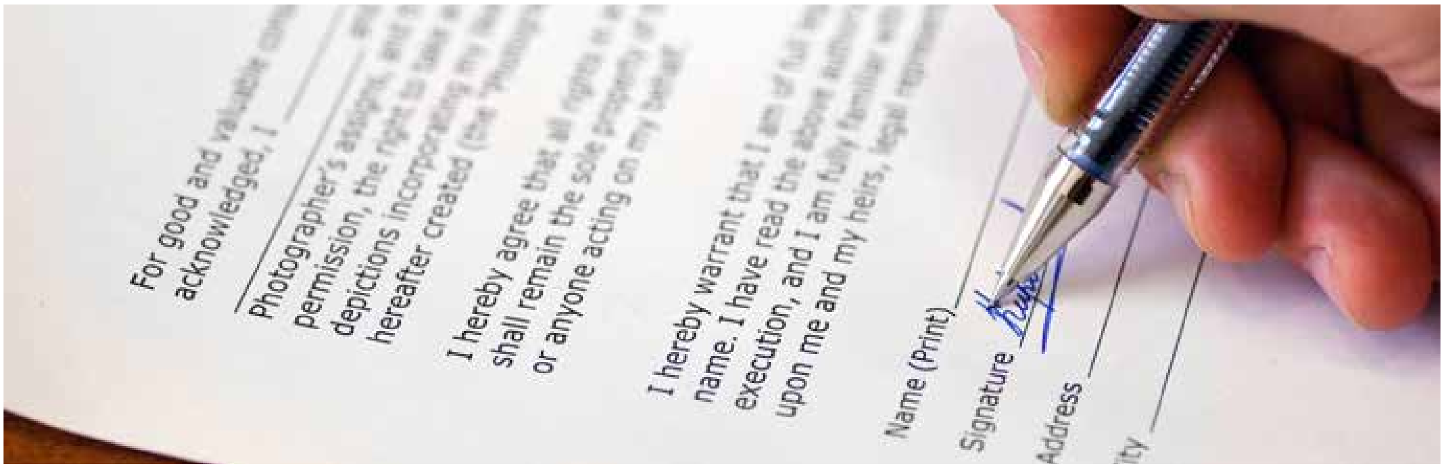
India perspective

As per the provisional statement, India has not made any reservation against adoption of this Article, while certain countries (e.g. Canada, Cyprus, Japan, Luxembourg, Singapore, UK, etc.) have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.

Article 15 - Person closely related to an enterprise

Article 15 defined the term "person closely related", which is relevant in the context of Articles 12, 13 and 14.

Part V – Improving Dispute Resolution



Part V is an outcome of BEPS Action 14 – "Making Dispute Resolution Mechanisms More Effective". It inter alia provides for inclusion of Articles 25(1) to 25(3) of the OECD model convention on mutual agreement procedures [MAP] in all the tax treaties. If a tax treaty related case qualifies to be considered under the MAP, upon the request of a taxpayer, the competent authorities should endeavour to agree between themselves how tax treaties should apply, and implement any agreement.

Article 16 - Mutual agreement procedure

Some of the salient features of Article 16 are:

- The tax payer can approach competent authority of either of the contracting jurisdiction (under the existing provision of Article 25 of the OECD model convention the tax payer can only approach the competent authority of the country of which he is resident / national)
- The tax payer needs to present his case to the competent authority within three years of the first notification of the action resulting in taxation, not in accordance with the provisions of the tax treaty (Article 25 of the OECD model convention contains similar provision)
- The agreement reached among competent authorities shall be implemented irrespective of the time limits in the domestic laws (Article 25 of the OECD model convention contains similar provision).

India perspective

As per the provisional reservation, India has opted not to adopt a provision according to which the tax payer can approach competent authority of either of the contracting jurisdiction. However, as this is a minimum standard, India has opted for bilateral notification or consultation process.

Article 17 - Corresponding adjustment

Article 17 is based on Article 9(2) of the OECD model convention and requires compensatory or corresponding adjustment if there is double taxation arising out of transfer pricing adjustments.

India perspective

As per the provisional statement, India would adopt this provision except where such provision already exists in the tax treaty. Certain other countries with whom India has tax treaties that do not contain Article 9(2) of the OECD model convention (e.g. Belgium, France, Sweden) would also adopt this Article. This Article can get adopted in Indian treaties, subject to matching. Adoption of this Article in the tax treaties would facilitate settlement of transfer pricing disputes through MAP and bilateral APA negotiations.

Part VI – Arbitration

Part VI is also an outcome of BEPS Action 14 – "Making Dispute Resolution Mechanisms More Effective", where one of the recommendations is binding arbitration provisions.

Articles 18 to 26 – Arbitration

Articles 18 to 26 deal with mandatory arbitration and issues such as appointment of arbitrators, confidentiality of arbitration proceedings, and resolution of a case prior to the conclusion of arbitration, type of arbitration process, etc.

India perspective

As per the provisional notification, India has opted not to adopt mandatory arbitration provisions.

Part VII – Final Provisions

Articles 27 to 39 – Final Provisions

Part VII deals with procedural provisions such as signature, ratification, reservations, notifications, date of entry into force, date of effect, etc. to make the MLI provisions operational.

India has currently notified 93 existing tax treaties and also given provisional list of reservations and notifications. Once MLI is ratified and comes into effect, it would be binding on India. The Indian tax treaties need to be read and interpreted along with the provisions of MLI. However, at the time of submission of final documents to the depository (i.e. OECD), India will have the option of making changes to what has been provisionally notified.

Ratification of the MLI does not impair India's powers to enter into new tax treaties and sign protocols to existing tax treaties. Even after ratification, it would be possible for India to make new notifications. Further, after ratification, India can also opt in with respect to optional provisions or withdraw reservations made earlier or replace an earlier reservation with a more limited version.

India can also completely withdraw from MLI by making appropriate notification. The date from which the MLI provisions would become effective with respect to Indian tax treaties will depend on (i) the date on which MLI enters into force for India and for the treaty partner countries (ii) the date of entry into effect of the MLI, which in turn could depend on the choices made by India and the treaty partner countries.

It is likely that the first modifications to covered tax treaties will become effective in the course of 2019.

Conclusion

The MLI is a big step in the BEPS implementation process. The provisional list of reservations and notifications made by India and by other countries, has provided insights on how Indian tax treaties will shape up in the BEPS world. It needs to be seen if India makes any further changes in the provisional list of reservations and notifications.