<u>MLI – India's Endorsement</u>

As we all are aware the BEPS project which was launched by the G20 countries in 2008 concluded by the Group giving its detailed report by giving 15 Action Points in 2013. Indeed an achievement of sorts for the global countries to agree to this initiative and kudos to OECD for concluding this in such a short time.

The OECD in June 2017, developed the Multi-lateral instrument ie, MLI being an efficient mechanism to modify 3000 plus bi – lateral tax treaties entered by over 68 countries. We have a lot of countries who have signed up the MLI and this includes India. The signing of MLI by the developed and developing countries heralds a new era in the area of International taxation and would have significant repercussions on cross border operation of businesses.

Let us examine in detail the MLI position which India had adapted. Before we get into this the first question which arise is what is the legal position of on MLI which is an instrument modifying the existing bi – lateral treaties.?

The point worth noting here is that as per the Indian law ,Treaty is a piece of delegated legislation as provided under section 90 of the Income Tax Act, 1961.

The MLI sits as an instrument which modifies the Treaty and here the question is that does it stand on equal footing or is it one which is to be understood similar to a Protocol to a Treaty?

One has to wait and see how the Courts interpret the MLI and one to wait and watch?

The MLI specifies certain minimum standards to be adhered to by the Treaty Partners, the MLI would apply to a bi – lateral treaty if both the parties agree to be covered by the Articles sought to be modified and notify such Treaty. Such notification is referred to as Covered Tax Agreements(CTA)

<u>Article 3 – Fiscally Transparent Entities</u>

India's treaties with most countries do not contain a provision for giving Treaty relief to fiscally transparent entities. India has considered this in India – US Treaty and the amended India – UK Treaty specifically to partnerships and trusts. Here it would be pertinent to note the controversy which was decided in favour by the Income Tax Tribunal in case of Link Laters* and Bombay High court in Clifford Chance Case*, even though the Revenue has not accepted this position and challenged the same.

This is not a minimum standard but only an optional one.

India has reserved its right in entirety the application of this Article and had indicated that it will not apply this to any of its bi – lateral treaties.

- 9 ITR 217 (ITAT)
- 318 ITR 237 (Bom)

Article – 4 – Dual Resident Entities

This Article is intended to modify the tie- breaker rules of the Tax Treaty in respect of a persons other than individuals i.e., Companies, LLPs and other non – incorporates entities.

Here the modification provides that Competent Authorities shall determine by way of mutual agreement the residency having regard to the place of effective management.

Here it is interesting to point out that India has recently introduced detailed POEM test in its domestic laws.

India has not made any formal reservation against this Article, however there would be practical issues. The competent authorities would be unable to reach an agreement as the domestic POEM and the at guidelines are not totally in sync with the OECD commentaries on this subject.

Hence on this issue, there is likely to be a disagreement and Treaty benefit denied resulting in double taxation. So this can be a vexed issued for India's Treaty Partners unless India follows the International approach for its POEM.

Article – 5 – Methods for elimination of double taxation

This Article provides for three alternative steps to avoid double taxation. Option A and Option B exemption methods with specific reference to deductibility in a Contracting, State Option C is credit method.

India has reserved its right not to go with Article 5 as India in general has adapted credit methods as per Article 23B of the OECD Convention.

This being not a mandating minimum standard does not affect India's bi – lateral tax treaties

Article 6 – Preamble to a Bi – lateral Treaty

This is a minimum standard under the MLI and provides the Treaty partners to prevent Treaty abuse and modify the existing language to the Preamble to the Treaty by inserting prevention of Treaty abuse.

India interestingly has been silent on its position on Article 6. So, there could be a scenario, if a Treaty already has such a language then that does not require a change. However in all other Treaties the preamble language needs to be changed as it is a prescribed minimum standard. A point worth noting is the India – US Treaty and this does not have a similar language and given the fact that USA has not signed the MLI it would be interesting to see how this will be adapted!

Article – 7- Treaty Abuse

Article 7 of the MLI deals with Treaty abuse and uses three conditions and expects at least one of the conditions to be adapted as minimum standard

(i) a principal purpose test (PPT)
(ii) a PPT supplemented with a simplified limitation of benefits (SLOB)
(iii) Detailed limitation of benefits (LOB)

The PPT test has been prescribed as a default test and Parties can choose a supplementary SLOB or a LOB.

India has taken a position to apply PPT with SLOB across all its notified Treaties. Interestingly India has just now introduced a detailed GAAR in its domestic legislation and one needs to see the inter-play it would have with Treaty law.

On a prima facie analysis a PPT test can get triggered even if tax benefit is one of the consideration to the transaction, whereas a GAAR requires tax benefit to be the main benefit. Further GAAR has an Approving panel, however PPT test would be decided by Competent Authorities would apply if one has a disagreement with the decision.

Another interesting point worth considering from an India perspective is with respect to Dividends, Interest, Royalties and Fees for Technical services. As per all the Treaties India has entered into India being the source country has the right to levy a withholding tax where the recipient is the beneficial owner and here the PPT has little or no role to play.

So there is a possibility that when one is dealing with Article 10,11 and 12 of the relevant bi-lateral Treaties, the question of PPT may not arise as irrespective of whether the transaction is to claim a benefit, the source country ie: India is protected by way of withholding tax !

So one needs to see how this would play as a PPT does not provides for procedural safe guards whereas GAAR has an Approving panel and one would need to see whether an assesee can invoke domestic law over Treaty ,taking recourse to section 90(2) of the Act?

<u>Article – 8 - Dividend Transfers</u>

Article 8 seeks to modify the provision of the Treaty to provide for minimum shareholding period for the beneficial owner to get reduced rate of tax withheld by the source country.

India has made a reservation against this Article as India had moved away from the classical system of levy of withholding tax on dividends and instead levied a dividend distribution tax on the distributing company.

This will have an impact on the Treaty partners

<u>Article 9 – Capital gains on alienation of shares or interest in entities deriving value principally from Immovable property</u>

This Article now provides for a source country to tax the gains in two parts;

Part A – where the existing Treaty provides a right to tax such gains if the value threshold is met anytime during the year preceding the alienation and the alienation interest are that of interest in unincorporated entities such as partnerships or trusts.

Part B – In a situation where the Treaty does not provide to a provision to apply to such a right to tax gains derived from alienation of shares in entities deriving value principally from immovable property then the Contracting State shall notify, termed as Choice Notification.

India has chosen to adopt both Part A and B that confer taxing rights to India. However the point to note is that the other Treaty partner also needs to adopt similar position, for this to apply.

Article – 10 - Anti-abuse rule for PE's in third jurisdictions

This one happens in situations where through structuring of transactions, the assets are transferred from the PE (source country) to a third country with a favourable tax regime so that effectively Nil or low tax is payable on such attributable Income. This is termed as Triangular cases.

The MLI provides in Article 10 to avoid such misuse, by providing that if the tax payable on the attributable income in the third State is less than 60% of the tax that would have been payable in the Country of Residence of the PE, then the Treaty relief would not apply. This is termed as the 60% test.

India has made no reservation to this Article. However if the other Treaty partner were to notify this position then same shall be applied by India.

Article – 11 - Tax Agreements to restrict a party 's right to tax its own Residents

The MLI under this Article provides that CTA shall not affect the taxation of a Contracting State of its residents. This is intended to address the concern that the provisions in a CTA that are to tax non – residents, should not be a limiting factor to tax its residents.

India has made no reservations to this Article.

Article – 12 - Artificial Avoidance of PE

This provision in the MLI is based on the BEPS report dealing with artificial avoidance of PE's through commissionaire arrangements. The Article provides that similar arrangements shall be deemed to be a PE. Also it clarifies that if a person acting a behalf does in the ordinary course of business in an independent capacity, then he shall be considered as independent, unless he acts exclusively, or almost exclusively on behalf of the other enterprise, then he would constitute a PE.

This is not a minimum standard and parties can reserve the right to apply it to their Tax treaties.

India's position has been similar and several of its existing treaties have similar clauses. So, India has reserved its right for this reservation and accordingly notifies that this will apply to all its Treaties.

However the interesting point is that India's most Treaty partners have not notified this and hence applicability of this is questionable as both parties need to notify.

Article – 13 - Artificial Avoidance of PE Status through activity exemptions

The MLI in Article 13 provides for curbing specific activity based exemptions to avoid PE in the source country by curbing activities which were hitherto considered as preparatory and auxiliary in nature.

Here the Article provides that Parties may have two options;

(i) Option A – this replaces existing Treaty provisions so as not to change the negotiated list of activities but consider within this list/activities that is done from the fixed place of business which shall fall within its ambit as preparatory or auxiliary in nature.

(ii) Option B on the other hand, does not relate to activities from the fixed place of business but provides a carve out. In that sense option B gives more flexibility to Treaty partners.

India has taken a position to go by option A and India tax treaties will be modified from its existing provision with respect to specific activity exemption. This can have a conflicting effect from other Treaty partners if they choose for reservation under Option B !

Article – 14 - Splitting up of contracts.

The MLI in Article 14 provides a mechanism in cases to avoid a PE in construction or installation projects, the contracts were split so that the PE does not last longer and are well within the threshold period of 6 months or 9 months depending on the respective bi- lateral Treaty.

In order to prevent abuse of this exemption Article ie; provides that in a related enterprises, the activities connected with construction / installation shall be considered based and functions and aggregated to determine the threshold for the existence of a PE.

However this is not a minimum standard and parties can reserve their right to adopt it or not.

India in this situation has remained silent; so neither expressed any reservation nor has adopted this language of splitting of contracts in its Tax treaties. However if the other party has accepted this Article then India would be compelled to adopt this in its Treaties.

Article 15- Definition of Closely related persons.

Article 15 of the MLI to be consistent that parties adopt similar definition for closely related persons, provides that for the purpose of Article 12,13, and 14 of the MLI, closely related persons shall be one if they directly or indirectly control more than 50% of the aggregate notify power or value of the company's share.

India has expressed no reservation in respect of this Article. However if the Treaty Partners had adopted this definition, then India shall be compelled to adopt the same.

Article 16 – Mutual Agreement Procedure

Article 16 of the MLI as part of dispute reservation provides for MAP as a minimum standard to be adopted by the parties. However parties can express reservation if their existing Treaties have a MAP procedure and same has been notified in the CTA.

India has made a reservation against Article 16(1) on the basis that its present Tax treaties meet the minimum standard as required under the BEPS dispute resolution partners. However India has not made any additional reservations.

Article 17 – Corresponding Adjustments

Article 17 of the MLI provides for making corresponding adjustment on respect of transfer pricing disputes to relieve double taxation.

This is not a minimum standard and parties have the flexibility to adopt this or not.

India in some of its treaties have this provision of correlative adjustment and has notified the same. Hitherto India had taken a position that in the absence of correlative adjustment in Article 9(2) in the Treaty, it cannot enter into bi-lateral APA's in respect of Transfer pricing disputes. However very recently the CBDT had changed its position and had held that its is open to correlative adjustment in a APA if the other Treaty partner is accepting such a position.

<u>Article – 18 to 26 - Arbitration</u>

The MLI provides for best practices for dispute resolution and provides for a detailed mandatory binding arbitration in respect of disputes where the Competent Authorities are unable to reach an agreement. However this is an optional one and applies only if a Country notifies the same to be part of its CTA.

India has opted to stay away from this whole arbitration powers. India's position seems to stem from the fact that the agreement to a mandatory binding arbitration shall dilute its sovereign powers, being to levy and collect of tax .

However this position seem to be misplaced as constitutional experts opine that as soon as we agree to enter into a Tax Convention as per delegated powers under section 90 of the Act, the sovereign powers to that extent has been diluted for larger economic good. Now mentioning that this shall dilute the sovereign powers in their opinion is a flowed one.

<u>CONCLUSION</u>

The whole BEPS project even though initiated by the G20 Countries; India has been one of the most enthusiastic parties having adopted almost all of the recommendations. India again has been probably the first among the developing countries to sign the MLI. India to improve its ranking in the global index of ease of doing business, needs to watch the international development closely and see that corrective actions are taken immediately. India's position should vastly improve if India were to accept mandatory arbitration, and one needs to wait and see how it would unfold.

So far it seems to be good going for India.