

## Multilateral Instruments – The Road Ahead for Bilateral Tax Treaty Network



*The Base Erosion Profit Shifting (BEPS) project had the following goal: on account of developments in the global economy, revising the international tax framework to ensure that profits are taxed where the economic activities are carried out & the value is created. The Organisation for Economic Co-operation and Development (OECD) Committee at the request of G20 Leaders, in 2015, delivered 15 action plans (BEPS Action Plans) to address BEPS strategies in a comprehensive manner, to eradicate the double non-taxation and address the gaps and mismatches in tax rules resulting in artificial shifting of profits. Implementation of the final BEPS Package required changes to model tax conventions, as well as to the bilateral tax treaties based on those model conventions. The process to renegotiate each of the bilateral tax treaty negotiated between the countries would have been burdensome and time-consuming, leading to varied inconsistencies across treaties and thereby limiting the effectiveness of multilateral efforts. To circumvent this situation, Action 15 of BEPS Action Plan recognised the Multilateral Instrument (MLI) as a measure to effectively tackle base erosion. This article aims to highlight the important MLI provisions and India's position in respect thereof. Read on to know more...*



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### Evolution of the Multilateral Instrument

The report on Action 15 Report of BEPS concluded that a multilateral instrument, providing an innovative approach to enable countries to swiftly modify their bilateral tax treaties, is desirable and feasible, and that negotiations for such an instrument should be convened quickly. The



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# International Taxation

MLI seeks to implement measures developed in the course of the work on BEPS and provides measures for prevention of treaty abuse, improving dispute resolution and preventing the artificial avoidance of the Permanent Establishment (PE) status, etc.

An Ad hoc Group of more than 100 countries and jurisdictions from G20, OECD, BEPS associates and other interested countries was formed which worked on an equal footing for the finalisation of the text of the MLI, starting May 2015. The text of the MLI and the accompanying Explanatory Statement was adopted by the Ad hoc Group in November 2016 and was opened for signature in December 2016. On June 7, 2017, the signing ceremony was concluded in Paris with 68 jurisdictions signing the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting”, also referred to as the Multilateral Instrument (MLI) for the modification of potentially 1100<sup>1</sup> bilateral tax treaties.

## Modus Operandi of the MLI

The MLI operates to modify the tax treaties between countries who have signed it and ratified it in accordance with domestic law. Notably, it does not amend /or replace the existing tax treaties in entirety, but, will apply alongside the existing tax treaties to supplement their application in line with the BEPS Action Plans. The MLI shall come into force only when both the parties to a bilateral tax treaty have notified for modification of the agreement using MLI, such bilateral treaties to be referred as ‘Covered Tax Agreements’ (CTA). India, so far, has notified the provisional list of its tax treaties with 93 countries as CTA’s.

MLI will enter into force on the first day of the month after expiry of three months after the deposit of the fifth instrument of ratification, acceptance or approval. For the taxes levied (with the exception of taxes withheld at source), MLI will take effect six months after the said MLI has entered into force.

The provisions of MLI may vary depending upon the options that a signatory has chosen and the reservations it has made. In case where a provision reflects a minimum BEPS standard, opting out of the BEPS minimum standard provision is

possible only where a Party’s CTA already meets that minimum standard. Where one party has reserved its right for provisions of MLI to not to apply to a CTA, the relevant provisions shall not apply irrespective of whether the other party makes a reservation on the same or not. The parties can choose to opt in with respect to optional provisions or to withdraw reservations even after the ratification of MLI.

MLI intends to apply to the maximum possible number of agreements. However, in a situation where a bilateral tax treaty has been recently renegotiated<sup>2</sup>, to implement the outcomes of the BEPS Package or where the countries have consciously agreed to renegotiate it through the bilateral means with the intent of implementing those outcomes in the renegotiated agreement, the same may not be covered as a CTA by the respective jurisdictions.

With the above backdrop, this article aims to highlight the important MLI provisions and India’s position in respect thereof in the ensuing paragraphs.

## Article 7 - Prevention of treaty abuse (Minimum Standard)

The MLI provides options for implementing the minimum standard to combat treaty abuse outlined in Action 6 of the Final BEPS Package viz. ‘Preventing the Granting of Treaty Benefits in Inappropriate Circumstances’. The minimum standard operates as a preliminary amendment to the Preamble of CTA (Article 6) thereby stating *elimination of double taxation without creating opportunities for non-taxation/reduced taxation through tax evasion or avoidance* as the purpose of the tax treaty. As a minimum standard, Action 6 of the BEPS Report requires the countries to implement at least one of the following three

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<sup>1</sup> OECD, Information Brochure on Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting

<sup>2</sup> One such example being the India-Mauritius tax treaty amended in May 2016

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**Articles 12 to 15 of the MLI provide for implementing the recommendations outlined in the final report of Action 7 (Artificial Avoidance of PEs) of the BEPS Package. Action 7 is not a minimum standard. Accordingly, signatories to the MLI are free to opt out or selectively adopt the provisions relating to PEs in Articles 12 to 15 of the MLI.**

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alternatives to address the situation of treaty abuse:

- (i) Principal purpose test (PPT Rule); or
- (ii) PPT Rules supplemented with a simplified or detailed Limitation on Benefits (LOB) Rule; or
- (iii) Detailed LOB, supplemented by a mechanism to deal with conduit arrangements not already dealt with in the tax treaty.

PPT operates as a default test unless the signatory elects for the application of the other options. Signatories may elect to opt out of the PPT with respect to CTAs that already contain a PPT, or if they elect to satisfy the minimum standard by adopting a detailed LOB (to be negotiated) and domestic anti-conduit rules. India has opted to supplement the provisions of the PPT with a simplified LOB test.

The simplified LOB provides that tax treaty benefits would be available only to 'qualified person' which includes: (i) Individual; (ii) Contracting jurisdiction/political subdivision/ local authority, etc.; (iii) Listed entity; (iv) NGO/regulated retirement benefit entity; (v) Entity in which at least 50 per cent shares are held by above persons who are residents of the State, on at least half of the days in a 12 month period.

The tax treaty benefits shall be available to non-qualified persons engaged in 'active conduct of business' if income derived from other state emanates from/or is incidental to that business. The following activities or any combination thereof shall not be included within the purview of the term 'active conduct of business':

- Operating as Holding Company
- Providing overall supervision/administration of group companies
- Providing group financing (including cash pooling)
- Making/managing investments (except banks/ insurance companies/registered security dealer).

Notably, General Anti-Avoidance Rule (GAAR) gets triggered only if the 'main purpose' of the arrangement is to obtain a tax benefit. On the other hand, the PPT Rule stipulates that no benefit under the CTA shall be granted if obtaining the benefit was 'one of the principal purpose' of the arrangement. Thus, the PPT provisions are apparently wider and more onerous than GAAR. Further, it may be pertinent to note that availability of the tax treaty benefit demonstrating that 'principal purpose' is not to obtain a tax benefit will be highly subjective. Thus, it would be necessary that the domestic tax regulators provide a framework within which such subjective powers may be exercised by the tax authorities.

### ***Artificial Avoidance of Permanent Establishment (PE)***

Articles 12 to 15 of the MLI provide for implementing the recommendations outlined in the final report of Action 7 (Artificial Avoidance of PEs) of the BEPS Package. Action 7 is not a minimum standard. Accordingly, signatories to the MLI are free to opt out or selectively adopt the provisions relating to PEs in Articles 12 to 15 of the MLI.

#### **o Article 12 - Artificial avoidance of PE status through Commissionaire and other similar arrangements**

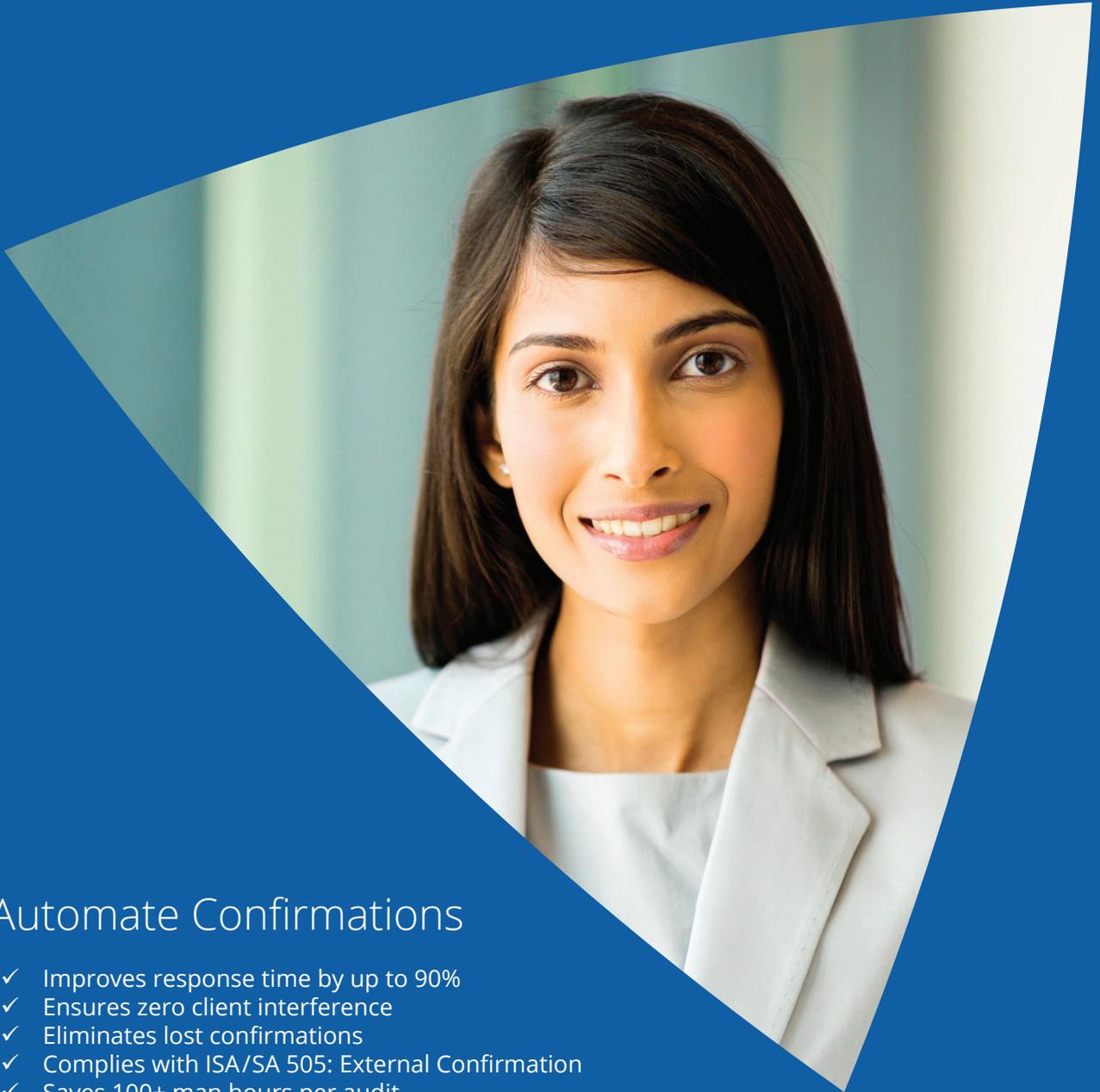
The OECD Model Convention, 2014 provides that a PE is deemed to be established in the contracting jurisdiction, if the independent agent habitually concludes the contracts in the name of the enterprise of other contracting jurisdiction. In many cases, 'commissionaire arrangements' and other similar strategies were put in place primarily with an intent to evade the taxable base of the state where sales took place.

In order to address such issues, Article 12 of the MLI provides that a PE shall be deemed to be established where a person acting on behalf of an enterprise, who habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

- (i) in the name of the enterprise; or
- (ii) for transfer of ownership or the right to use property belonging to the enterprise; or
- (iii) for providing services by the enterprise.



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Article 12 also covers contracts for the transfer or use of property of the principal, or for the provision of services by the principal.

Article 12(1) provides that para 1 shall not apply to a person acting in an independent capacity and in ordinary course of business. However, an agent shall not be considered independent if that agent works exclusively or almost exclusively on behalf of one or more closely related enterprises. India amongst many other countries has chosen to include this provision.

## o Article 13 - Artificial avoidance of PE status through specific activity exemptions

The current OECD model convention specifically identifies certain activities in the nature of preparatory or auxiliary character that may be carried on at a location without creating a PE. Following the recommendations in the Final Report on Action 7, to address concerns about the use of these exemptions to “artificially” avoid a PE, Article 13 of the MLI provides several options for modifications to the availability of these exemptions. It provides the signatories to the MLI a choice between two options:

- Option A provides in order to qualify for specific activity exemption:-
  - (i) all activities currently included in the treaty;
  - (ii) any other activity not already mentioned in the treaty; and
  - (iii) any combination of activities in (i) and (ii),
 must be of a *preparatory or auxiliary* character. Thus, in view of the provisions as entailed in Option A, the activities of a company in another jurisdiction need to be tested on individual as well as collective basis for meeting preparatory and auxiliary test.

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**Mutual Agreement Procedures (MAPs) are designed to provide taxpayers with a mechanism for resolution of tax disputes under a treaty. Article 16 seeks to improve the efficiency of these rules by applicability of the provision in place of or in absence of the existing provision under a bilateral treaty.**

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- Option B, which was included as an alternative to Option A provides a leeway in respect of activities already existing in the treaties which is not specifically required to be of preparatory or auxiliary nature. However, all activities not already mentioned in the existing tax treaties shall be subject to an overall condition of preparatory or auxiliary character.

India has opted for Option A i.e. in addition to falling under specific activities listed in exclusions under PE Article, it will additionally be necessary to prove that these activities are of a preparatory and auxiliary character.

Article 13 also provides an anti-fragmentation provision. The provision operates to cause the specific activity exemptions not to apply when an enterprise or a closely related enterprise carries on business activities in one or more places in the same State, and either (1) one or more such places constitute a PE for one of the related enterprises, or (2) the overall activity resulting from the combination of the activities in such places is not of a preparatory or auxiliary character. India has opted to elect the anti-fragmentation provision.

## o Article 14 - Splitting-up of Contracts

Article 14 of the MLI aims to prevent artificial avoidance of a PE through splitting up of contracts. It provides that for the purpose of determining the threshold for constitution of PE, the time spent:

- at a building site or construction or installation project by the enterprise; and
- connected activities carried out by closely related enterprises at the same building site or construction or installation project during different periods of time

shall be aggregated and in case if the aggregate period exceeds 30 days, PE shall be deemed to be constituted. India has chosen to adopt the provision relating to splitting up of contracts.

## *Improving dispute resolution (Minimum Standard)*

### o Article 16 - Mutual Agreement Procedure

Mutual Agreement Procedures (MAPs) are designed to provide taxpayers with a mechanism for resolution of tax disputes under a treaty.

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# International Taxation

Article 16 seeks to improve the efficiency of these rules by applicability of the provision in place of or in absence of the existing provision under a bilateral treaty. It allows taxpayers to present a case to Competent Authority (CA) of either treaty jurisdiction regardless of the remedy provided under the domestic law.

It also requires the taxpayers with a time limit of at least 3 years to request MAP assistance to endeavour to resolve the case by mutual agreement and any difficulties arising from the interpretation of the treaty. However, if an existing bilateral treaty allows a taxpayer to approach CA even after the expiry of specified time period of 3 years, such provision shall remain unchanged.

## o Article 17 - Corresponding adjustment

Article 17 provides for corresponding adjustments in cases of transfer pricing disputes. This Article requires a tax authority to make a downward adjustment in one jurisdiction where an upward adjustment has been made in the other treaty jurisdiction which reflects the true allocation of profits in accordance with arm's length principles.

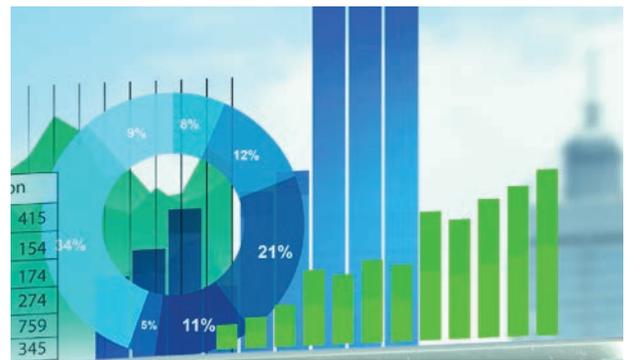
India has reserved its right for the applicability of the provisions relating to corresponding adjustments not to apply to its CTA that already contain such a provision.

## The Way forward

The bilateral nature of the tax treaties are retained in MLI since the amendment is to be made through a bilateral declaration. The MLI itself would not make any amendments. Treaty will stand modified only when both the countries have exercised the same option. If either of the countries chooses not to opt for a particular option, the treaty will continue as is. The OECD will play a vital role as a Depository for the MLI. The MLI requires Signatories to notify all changes to their MLI positions to the Depository for those changes to become effective.

In line with the OECD's earlier announcement to launch the public online matching tool, it has released the preliminary version of the tool. The tool is based on a database containing all relevant data from the MLI positions, facilitating the analysis of information. Further, the matching tool will also simulate the likely matching outcome, while noting

**The Courts in India have generally been seen as a stabilising force for tax disputes. It now needs to be seen as to the manner in which the MLI provisions will be applied by the revenue authorities in actual practice. Implementation of changes on account of MLI is likely to add to the tax disputes, thus, leading to the complexity of doing business and it may take some time before stability is established for the benefit of all stakeholders.**



that the final matching process is one of legal interpretation of the formal documents. It would be interesting to see in times to come as to how MLI will enable the treaty jurisdictions to alter treaty related BEPS recommendations into their existing networks of bilateral tax treaties while saving them from multiple bilateral negotiations and re-negotiations to implement these changes.

It may be noted that BEPS project provide a lot more rights to the source country to tax different streams of income. This can be seen as a positive development for most developing countries as the tax collected can be used for their own growth and economic development. Indian tax authorities have, at times, taken a highly tax centric approach which may have helped them in increasing the tax base and higher collection of taxes at the cost of reducing the treaty benefits. The Courts in India have generally been seen as a stabilising force for tax disputes. It now needs to be seen as to the manner in which the MLI provisions will be applied by the revenue authorities in actual practice. Implementation of changes on account of MLI is likely to add to the tax disputes, thus, leading to the complexity of doing business and it may take some time before stability is established for the benefit of all stakeholders. ■