



Multilateral Convention - impact on India vis-à-vis other treaty partners

Background

With 67 countries having signed the Multilateral Convention (MLI), the Organisation for Economic Co-operation and Development (OECD) would now contemplate to target some of the Base Erosion Profit Shifting (BEPS) strategies effectively. The measures adopted through the MLI attempt to prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of a Permanent Establishment (PE) and neutralise the effects of hybrid mismatch arrangements which are the action points dealt with by the MLI.

MLI modifies tax treaties that are Covered Tax Agreements (CTA). A CTA is an agreement for the avoidance of double taxation that is in force between parties to the MLI and for which both parties have made a notification that they wish to modify the agreement using the MLI.

There is no legal requirement to prepare consolidated texts of modified treaties. The MLI rather than amending the tax treaties like an amending protocol, modifies the tax treaties by sitting alongside¹.

The provisional MLI position of each signatory indicates the tax treaties it intends to cover, the options it has chosen and the reservations it has made. Signatories can amend their MLI positions until ratification. Even after ratification, parties can choose to opt in with respect to optional provisions or to withdraw reservations.

Given that signatories' positions can change significantly until ratification of the MLI, most signatories will not start to prepare consolidated versions immediately.

India has notified 93 countries² that would be covered by its provisional list of CTA in the MLI. Forty Three³ countries out of the 93 notified above, have not signed the MLI. Out of the balance 50 countries, 2⁴ countries have not included India in their CTA's. 48 countries⁵ out of the above have signed the MLI and have notified India meaning thereby that the tax treaties with these countries will be amended incorporating the relevant proposed amendments of the MLI.

Prominent amongst those who have not signed the MLI is the US which has already adopted some of the BEPS measures in its tax treaties with various countries. Some other countries have not signed the MLI e.g. include Malaysia, Thailand, etc. Mauritius has also not signed the MLI as of now, it however, has committed itself to sign the MLI by 30 June 2017.

² Albania, Armenia, Australia, Austria, Bangladesh, Belarus, Belgium, Bhutan, Botswana, Brazil, Bulgaria, Canada, China, Columbia, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Ethiopia, Fiji, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Indonesia, Ireland, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Korea, Kuwait, Kyrgyz Republic, Latvia, Libya, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mauritius, Mexico, Mongolia, Montenegro, Morocco, Mozambique, Myanmar, Namibia, Nepal, Netherlands, New Zealand, Norway, Oman, Philippines, Poland, Portugal, Qatar, Romania, Russia, Saudi Arabia, Serbia, Singapore, Czechoslovakia (Slovakia), Slovenia, South Africa, Spain, Sri Lanka, Sudan, Sweden, Swiss Confederation, Syria, Tajikistan, Tanzania, Thailand, Trinidad and Tobago, Turkey, Turkmenistan, Uganda, Ukraine, UAE, UK, Uruguay, USA, Uzbekistan, Vietnam, Zambia.

³ Some countries which have not signed the MLI are USA, Qatar, UAE, Malaysia, Philippines, Saudi Arabia, Brazil, Thailand, Kenya

⁴ Germany and China

⁵ Armenia, Australia, Austria, Belgium, Bulgaria, Canada, Columbia, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Fiji, Finland, France, Georgia, Greece, Hungary, Iceland, Indonesia, Ireland, Israel, Italy, Japan, Korea, Kuwait, Latvia, Lithuania, Luxembourg, Malta, Mexico, Netherlands, New Zealand, Poland, Portugal, Romania, Russia, Serbia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Swiss Confederation, Turkey, UK and Uruguay.

¹ However, for purposes of clarity, many governments may produce some form of consolidated text as guidance to aid readers.

Key amendments proposed to the MLI and its impact on India vis-à-vis various other countries

Prevention of treaty abuse

MLI provides options for implementing the minimum standard to combat treaty abuse outlined in the final report for Action 6 of the BEPS Action Plan.

Article 6 of the MLI provides treaty preamble language that would address the first leg of the minimum standard outlined in the final report for Action 6 of the BEPS Action Plan and Article 7 of the MLI offers options for addressing the second leg of the minimum standard.

With respect to the first leg, signatories to the MLI are only permitted to opt out to the extent a CTA already contains language satisfying the minimum standard. With respect to the second leg, option 1—the PPT alone—is the default unless the signatory elects one of the other options. Signatories may elect to opt out of the PPT with respect to CTAs that already contain a PPT, or across the board if they elect to satisfy the minimum standard by adopting a detailed LOB (to be negotiated) and domestic anti-conduit rules.

All countries opted for the PPT to address treaty abuse either by accepting the default rule, or opting out on the basis of an existing PPT. In addition, 12 signatories including India have chosen to supplement the provisions of the PPT with a simplified LOB test, the remaining 11 being Argentina, Armenia, Bulgaria, Chile, Colombia, Indonesia, Mexico, Russia, Senegal, Slovak Republic and Uruguay.

Tax treaty benefits would be available only to 'qualified person' which includes:

- Individual
- Contracting jurisdiction/political subdivision/ local authority, etc.
- Listed entity
- NGO/regulated retirement benefit entity
- Entity in which at least 50 per cent shares held by above persons who are residents of the State, on at least half of the days in 12 month period

The tax treaty benefits to be available to non-qualified persons engaged in 'active conduct of business' if income derived from other state emanates from/is incidental to that business. The following activities or any combination thereof will not be considered as falling under '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)

The countries where simplified LOB vis-à-vis India may become applicable are Bulgaria, Colombia, Indonesia, Mexico, Russia and the Slovak Republic. The countries that already have a simplified LOB in the tax treaty with India are Albania, Armenia, Iceland, Mexico, Sri Lanka, Tajikistan, Tanzania, Uruguay and U.S.A. Further, while India has opted out of the detailed LOB, none of the tax treaty partners of India have opted have for detailed LOB.

Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property

India has opted to adopt both the provisions relating to taxability of capital gains in the source state which provides that the gains would be taxable if value threshold is met at any time during 365 days preceding alienation (including alienation of interest in a trust/partnership). However, its applicability to India's tax treaties will depend on whether its treaty partners have also chosen to adopt these provisions.

Currently, there are 71 tax treaties with India which already contain the said provision, including Cyprus; France; Netherlands; Australia. Similarly, the provisions would get added in the balance tax treaties which India has with the remaining countries.

The aforesaid provision would not apply in case of some countries e.g. Canada, Singapore, and UK which have made reservations on the applicability of the provisions.

Dividend Transfer Transactions

India has opted for the provision relating to the minimum shareholding to be met throughout 365 days for beneficial dividend tax rate. However, its applicability to India's treaties will depend on whether its treaty partners have also chosen to adopt these provisions.

India has reserved the applicability of this provision in the case of Portugal as there already exists a higher threshold of 2 years. India has further notified 21 countries where the restriction of the holding period has not been prescribed some of them being Canada; Denmark; Qatar; Italy; Singapore; U.S.A.

Some of the countries which have made reservation on applicability are Canada, Denmark and Singapore where resultant minimum shareholding period will not apply.

Artificial avoidance of PE status through commissionaire arrangements and similar strategies

- Market support arrangements

Key changes proposed by the MLI consist of the following:

- the scope of PE expanded to include agent playing principal role, leading to routine conclusion of contracts, without material modification;
- agent acting exclusively or almost exclusively on behalf of one or more closely related enterprises not to be considered independent.

India has adopted the MLI changes and the key countries that stand impacted are Japan, Netherlands, Indonesia and France, whereas the key countries that do not stand impacted due to this amendment are UK, Singapore, Cyprus and Canada.

- *Specific activity exemptions where the activity is of a “preparatory or auxiliary” character*

Key changes proposed by MLI consist of the following:

- Activities carried out by the foreign company need to be tested on individual, as well as collective basis for meeting ‘Preparatory and auxiliary test’ - Option A6;
- PE to be formed by disregarding fragmentation of cohesive business operations whether within entity; or within the group.

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. The key countries that stand impacted by virtue of this amendment would be Japan, Netherlands, Indonesia and Russia. The key countries that would remain unaffected by virtue of this amendment would be UK, Singapore, Cyprus, France, etc.

- *Artificial splitting-up of contracts*

The provisions of MLI requires aggregation of time spent (in excess of 30 days in the aggregate) at a building site or construction or installation project by the enterprise and connected activities carried out (during periods that exceed 30 days) by closely related enterprises at the same building site or construction or installation project during different periods of time. Many jurisdictions opted out of the rule relating to splitting up contracts, but some⁷ elected to adopt the rule (although some only with respect to activities other than natural resource exploration and exploitation).

The key countries that stand impacted by virtue of this proposed amendment are France, Netherlands, Indonesia, New Zealand, etc. whereas the key countries that are not impacted by this amendment are UK, Singapore, Japan, Germany, etc.

⁶ Around one-third of the signatories elected option A including Argentina, Australia, Austria, Germany, India, Indonesia, Italy, Japan, Mexico, the Netherlands, New Zealand, South Africa and Spain.

⁷ including Argentina, Australia, France, India, Indonesia, Ireland, the Netherlands and New Zealand.

Dispute Resolution

It is provided for expressing reservation on presentation of the case to either of the competent authorities whereas India has opted for the option for the cases to be presented by the taxpayer only in the country of its residence.

With regard to time limit for presenting the case for Mutual Agreement Procedure (MAP), India has agreed with the prescribed time limit of three years except for a shorter time limit with certain countries e.g. Canada.

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 key countries that are now aligned on account of this reservation are France, Belgium, Swiss Confederation, etc. whereas the key countries that are not impacted are Germany, China, etc.

Arbitration

The MLI includes optional provisions for mandatory binding arbitration (MBA) providing flexibility to countries to bilaterally agree on the mode of application of the MBA, including the form of arbitration. The MLI provides for ‘final offer’ arbitration (also known as ‘baseball arbitration’) as the default type of arbitration process.

However, countries may make a reservation on the “final offer” type of arbitration proceedings and opt for the “independent opinion” process instead.

Whereas India has opted out of the arbitration process, 25⁸ of the 7 June signatories have signed up for the arbitration provisions in the MLI. This will lead to the introduction of arbitration to over 150 existing tax treaties. Most of the countries opting in for arbitration have opted for the default option of final offer arbitration. While arbitration was fairly widely adopted, the carve-outs are in many cases quite broad and not always very clearly drafted, with the result that it’s not clear how many disputes will be in scope.

Further action on implementation of the MLI and the Entry into force

The MLI will enter into force three months after the deposit of the fifth instrument of ratification, acceptance or approval. Six months after the MLI has entered into force, it will take effect for taxes levied (with the exception of taxes withheld at source).

⁸ Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, the Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the United Kingdom

It is expected that the OECD would launch a public online matching tool. The tool will be based on a database containing all relevant data from the MLI positions, facilitating the analysis of information. Further, the matching tool could also simulate the likely matching outcome, while noting that the final matching process is one of legal interpretation of the formal documents. The tool will be expanded and refined over the next couple of years, to include detailed information on the timing of the modifications made by the MLI. The first parts of the tool will be made available as soon as possible, when all data will be carefully processed and analysed by the signatories and the OECD Secretariat. It is expected that a beta version of the tool will be available by October 2017.

Our comments

Considering the number of jurisdictions that have already signed the MLI or that have expressed their intention to sign the MLI, one can expect modification of a significant and growing number of tax treaties. Signatories include developed and developing jurisdictions, including financial centres and treaty-shopping hubs. Considering that the treaty abuse was one of the most important concerns in the BEPS agenda, and now that the MLI covers a large number of treaties and with key countries included, the OECD contemplates that treaty-shopping structures will come to an end as the anti-abuse provisions are introduced in the treaty networks of treaty-shopping hubs. From an Indian context, with the introduction of PPT, one would also have to evaluate its impact on the existing grandfathering provisions to the recently amended bilateral tax treaties of India with Mauritius, Singapore and Cyprus.

As far as adopting the minimum standards is concerned, in spite of a significant number of countries having initially chosen only to adopt the minimum standards i.e. treaty abuse and mutual agreement procedures, one will have to adopt a wait and watch approach to conclude if that indeed will be their final position, and it will be important to monitor that, as positions can change any time until ratification. Even after ratification, parties can choose to opt in with respect to optional provisions or to withdraw reservations.

The MLI requires signatories to notify all changes to their MLI positions to the Depositary in order for those changes to become effective. The Depositary will record and publish all future changes made to MLI positions.

With the OECD being the Depositary for the MLI and as the OECD would also be launching a public online matching tool, which will be based on a database containing all relevant data from the MLI positions, facilitating the analysis of information, it would play a key role in facilitating the transitory process of amending the few thousand tax treaties and set the road for peer review process.



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