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# Impact of the MLI on Indian Tax Treaties

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To date, 71 countries have signed the Multilateral Instrument ("MLI"), including India. Clearly, there is a long way to go to achieve the objective of MLI. However, this is a great beginning. The MLI has far reaching implications for the existing network of bilateral tax treaties. This article analyzes the key provisions under the MLI and its impact on India's existing network of bilateral tax treaties.

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## Mechanics of the MLI

The text of the MLI was released in November 2016. The first joint signing ceremony of the MLI was held on June 7, 2017 ("signing") and as of October 26, 2017, 72 countries (including India) have signed the MLI. At the time of signing, each contracting state was required to notify the treaties they want to be governed by the MLI and the extent thereof by expressing provisional list of reservations and positions on the provisions of the MLI. It is vital to note that a particular Double Taxation Avoidance Agreement ("DTAA") could only be impacted by the MLI if both the countries notify the DTAA between them to be a covered DTAA, under their list of covered DTAAs under the MLI.

After the signing, each state is required to provide its final list of reservations and positions at the time of ratification of the instrument, once at least five signatories have ratified the MLI, and the MLI would come into force. As regards the MLI between two signatories, the MLI provisions would come into effect only after both the signatories have ratified the instrument.

The MLI does not function in the same manner as an amending protocol does with respect to existing DTAAs. Instead, the MLI is to be applied alongside the existing bilateral DTAAs, modifying their application in order to implement the BEPS Action Points. 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 certain mandatory provisions (such as a principal purpose test, amendment to the preamble to avoid double non-taxation, mutual agreement procedure) as /.well as certain optional provisions. While the signatories cannot express a


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reservation on the mandatory provisions, the optional provisions offer leeway to the signatories to exclude a particular covered DTAA, or to apply the provisions to the particular covered DTAA differently than its DTAAs with other countries by expressing reservations.

Each MLI article contains a paragraph which establishes the relation of that article with the covered DTAAs, i.e. whether the provision modifies, amends or replaces the DTAA provision. Where such paragraph provides that the article would "apply in place of or in absence of a provision" the MLI provision would apply to the extent the DTAA provision is incompatible with the MLI provision (even though one of the states has not notified the provisions of its covered DTAA). However, for any other relationship with the DTAA (where such paragraph does not use the above words to describe relationship with DTAAs), for the MLI provision to apply and replace the provision of a particular covered DTAA, it would be necessary that both the parties to that DTAA notify their provisions of that DTAA. In the event that one of the signatories fails to notify the provisions of that DTAA, such MLI provision would not apply to the relevant DTAA.

## Key MLI Provisions and its Impact on India's Bilateral Tax Treaties

### Article 3—Transparent Entities

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 taxed as income of the resident of that contracting state. The MLI provides liberty to contracting states not to apply this provision entirely, to covered DTAAs.

India has expressed its reservation on this article and has not adopted it in its entirety. Consequently, the eligibility of fiscally transparent entities to claim benefit under India's DTAA would continue to be as per the provisions of the particular DTAA in this regard.

The reservation stems from India's disagreement to OECD commentary which provides that where transparent entity is denied DTAA benefit, such benefit should be allowed in the hands of its partners who are taxed in the state of residence. It is worth noting that India's DTAA with the U.S. and U.K. are in line with the MLI provision and allow a fiscally transparent entity such as partnership or trust to claim benefit under DTAA to the extent that such income is taxed in the hands of residents of that state (such as partners), and the position agreed under the respective DTAA as regards the fiscally transparent entity's claim to DTAA benefits remains unchanged under India's DTAAs.

It would appear that India would reserve the right to grant this benefit in DTAAs through bilateral negotiations.

### Article 4—Dual Resident Entities

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 Place of Effective Management ("POEM"), place of incorporation or constitution and any other relevant factors.

India would like this to apply to all of its 93 covered DTAAs and hence has notified it accordingly. Consequently, when the respective contracting states of these 93 covered DTAAs also notify the provisions on the test to determine residency for a dual resident entity, the provisions of those covered DTAAs would be replaced by the MLI provision, unless there is reservation by the other contracting states.

As India and the U.K. both have notified Article 4(3) of India–U.K. DTAA, the text of Article 4(3) in India–U.K. DTAA would be replaced by MLI provision upon ratification of the instrument.

Where a notification mismatch exists (i.e. contracting state does not notify provision of India's DTAA with that state dealing with dual resident entities) the MLI provision would apply to the extent of incompatibility, unless the other contracting state has reservation on Article 4 in its entirety.

### Article 6 and Article 7—Prevention of Treaty Abuse

Article 6 of the MLI requires a mandatory amendment to the preamble of the covered DTAAs, by including language reflecting the intent of the contracting states to avoid double non-taxation and treaty shopping.

Further, Article 7 of the MLI provides principal purpose test ("PPT") as a mandatory requirement, as per which the benefit under a covered DTAA (in respect of income or capital) would not be available if obtaining the treaty benefit was one of the principal purposes of any arrangement, or transaction. This would be triggered 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 DTAA.

The MLI also provides liberty to apply the simplified Limitation of Benefits ("LOB") clause. Through the simplified LOB, an entity can 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 should be incidental to or emanate from its business.

The following businesses do not qualify as "active business" for the purposes of the MLI:

(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).

The PPT and modification to the preamble of covered DTAAs 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. Thus, all the covered DTAAs of the signatories would include a PPT and benefit of a covered DTAA would not be available if a structure is mainly driven by tax benefit. This should go a long way in reducing BEPS.

Interestingly, India has adopted a simplified LOB clause under Article 7 of the MLI and if the other contracting state also does the same, the simplified LOB would be added to the covered DTAAs, where it does

not adopt simplified LOB but has not expressed reservation on the same, simplified LOB would apply to the extent of incompatibility. Perhaps, inclusion of the recently amended India–Mauritius DTAA was to enact a stricter LOB contained in the simplified LOB, however as Mauritius has not notified the India–Mauritius DTAA as covered DTAA, the India–Mauritius DTAA would not be impacted by the MLI.

It is important to note that although India–Singapore DTAA also contains a LOB clause, the simplified LOB under the MLI being a stricter LOB, would apply to the India–Singapore DTAA, as Singapore has not expressed any reservation on the simplified LOB.

### Article 8—Dividend Transfer Transactions

Article 8 of the MLI stipulates the conditions under which a person of one contracting state (holding shares beneficially) can avail an exemption or lower 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 to claim an exemption or lower withholding tax rate on dividend income.

As such, under the current tax regime in India for taxation of dividends, this article is less relevant. India imposes a dividend distribution tax in the hands of Indian companies distributing dividends. Dividends are then exempt in the hands of the shareholder.

However, this article would be relevant for inbound investments in India from an intermediary jurisdiction, which seeks to benefit from lower withholding tax on dividends under applicable DTAA between the intermediary and the parent company, as the shares in the intermediary company would need to be held beneficially for 365 days to claim the lower rate under the DTAA. There are also discussions that the Indian tax regime for dividends may also undergo change.

### Article 9—Capital Gains from Transfer of Share Deriving Value from Immovable Property

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. India has opted the threshold to be 50 percent and a look back period of one year for the application of this article.

This article would be relevant in respect of transfer of shares of companies engaged in the development and promotion of real estate. Upon the MLI coming into force, India would be able to tax capital gains realised from transfer of share or interest in an entity which derives more than certain portion of its value from immovable property in India.

It is interesting to note that both India and Netherlands have notified Article 13(4) of their DTAA, and hence Article 9(1) of the MLI would apply to the India–Netherlands DTAA. Therefore, relief from capital gains tax in India otherwise available to a Netherlands resident, under Article 13(4) of the India–Netherlands DTAA (where the shares derived their principal value from immovable property in India) would be modified to the extent of provisions of Article 9(1) of the MLI, once the MLI comes into force as regards the India–Netherlands DTAA.

In respect of treatment of capital gains on transfer of investments made before April 1, 2017, the position under India's DTAA with Singapore, Mauritius and Cyprus, remains unaltered.

### Articles 12, 13 14—Artificial Avoidance of Permanent Establishment ("PE")

Article 12 of the MLI provides a wider rule for determination of dependent agency PE. In addition to persons having the authority to conclude contracts being treated as dependent agent, as per this rule, now persons who habitually play the principal role in the routine conclusion of contracts, without material modifications by the enterprise would also constitute PE of the foreign enterprise. India has not expressed any reservation and has notified all of its covered DTAAs, hence, once the MLI comes into force, this wider definition of dependent agent PE would apply in case of India's covered DTAAs when the MLI is notified by the other contracting states. Where there is a mismatch of notification, this provision of the MLI would not apply.

As regards the fixed place PE, Article 13 deals with specific activity exemptions to PE and provides 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. India has chosen option A, thus its covered DTAA would deny specific activity exemption from PE in the event that the other contracting states in India's covered DTAA also chose option A, failing which this MLI provision would not apply.

Article 14 of the MLI provides for determining time thresholds in a DTAA for construction/installation/supervisory or any PE provision have been exceeded under a covered DTAA. The article provides for an aggregation of time spent on connected activities by "closely related enterprises" 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.

## Conclusion

The MLI marks a key milestone in the implementation of the Action Plans of the BEPS project. The success of the MLI would also depend on the number of countries that will sign and notify 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 within a period of three years.

With the PPT being implemented as a minimum standard and strategies for avoidance of PE being tackled by Articles 12 to 14 of the MLI, the international tax regime and the interaction of the various


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DTAAs across the globe will undergo a massive change and would go a long way towards reducing BEPS.

With the general anti avoidance rule ("GAAR") in force in India, one would need to carefully structure investments and transactions to be in compliance with the GAAR and the proposed MLI provisions in the DTAAs between India and state of residence, if both India and state of residence notify their DTAA to be a DTAA covered under the MLI.

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