THE MULTILATERAL INSTRUMENT AND ITS APPLICABILITY IN INDIA

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INTRODUCTION

The O.E.C.D. initiated the Base Erosion and Profit Shifting ("B.E.P.S.") Project in 2013 with a view to curtail tax avoidance. The B.E.P.S. Project seeks to nullify tax planning strategies that exploit gaps and mismatches in tax rules in order to artificially shift profits to low-tax or no-tax locations with inadequate economic substance or activity. It is estimated that B.E.P.S. strategies cost countries $100-240 billion in lost revenue, annually. Under the B.E.P.S. Project, over 90 countries and jurisdictions are collaborating to implement the recommended 15 B.E.P.S. measures.

One of the most significant outcomes of the B.E.P.S. Project is the signing of the multilateral instrument ("M.L.I.") in 2017. The M.L.I. seeks to address B.E.P.S. concerns in thousands of bilateral tax treaties through one common treaty. While the M.L.I. does not replace bilateral tax treaties, it acts as an extended text to be read along with the covered bilateral tax treaties for implementing specific B.E.P.S. measures. In order to be considered a "covered tax treaty" under the M.L.I., each partner jurisdiction to a tax treaty must notify the treaty and then agree on the specific provisions of the M.L.I. that will apply.

India has been at the forefront of implementing B.E.P.S. measures and submitted a ratified M.L.I. with the O.E.C.D. on June 25, 2019. The date of entry into force of the M.L.I. has been notified by India as of October 1, 2019. Accordingly, India's covered tax treaties will need to be read with the M.L.I. from April 1, 2020. India has notified tax treaties with 93 jurisdictions (including the U.S.) under the M.L.I. India has not notified the tax treaty with China under the M.L.I. since the treaty was recently amended bilaterally to incorporate B.E.P.S. measures.

As of January 10, 2020, 23 Indian bilateral tax treaties are treated as covered. These are the following:

Austria	Australia	Belgium	Finland	France
Georgia	Ireland	Israel	Japan	Lithuania
Luxembourg	Malta	Netherlands	New Zealand	Poland
Russia	Serbia	Singapore	Slovak Republic	Slovenia
Sweden	U.K.	U.A.E.		

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IMPACT OF THE M.L.I. ON INDIAN STRUCTURES OF U.S.-BASED BUSINESSES

The U.S. is not a signatory to the M.L.I. However, many U.S.-based businesses have in the past used either Mauritius, Singapore, or the Netherlands to route investments into India or for rendering managerial, technical, or consultancy services to Indian entities, due to the beneficial tax treatment in India's treaties with these countries. Benefits include the following:

- Exemption on capital gains arising on disposal of shares of Indian companies in certain situations
- Exemption from withholding tax or lower withholding tax on service payments
- Relaxed conditions for constituting a Service Permanent Establishment in India

Given that India's tax treaties with Singapore and the Netherlands will be covered by the M.L.I. from April 1, 2020, onwards, this development would be of keen interest for U.S.-based businesses that have routed their Indian interests through these countries.

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Importantly, while Mauritius has signed the M.L.I., it has yet to notify the tax treaty with India under the M.L.I. Accordingly, the India-Mauritius Tax Treaty will not be currently impacted by the M.L.I. However, the treaty is expected to be bilaterally amended along the lines of the B.E.P.S. measures, especially the minimum standards required under the M.L.I. India's position on each of the articles of the M.L.I. and its generic impact is discussed below.

INDIA'S RELEVANT POSITIONS ON THE M.L.I.

Article	In Brief	India's Position & the Impact
Article 3: **Transparent Entities**	A fiscally transparent entity will be granted tax treaty benefits only to the extent the income is considered to be that of a resident of the jurisdiction for taxation purposes and taxed at the level of its members.	India has not adopted this article, and accordingly, this article will not impact or modify any of India's tax treaties. Interestingly, Indian tax authorities have, in the past, denied complete tax treaty benefits to fiscally transparent entities on the grounds that they themselves are not tax residents of their jurisdiction. Although courts have overruled this view in a number of instances, the tax authorities continue to deny tax treaty benefits to fiscally transparent entities. Accordingly, the position remains unsettled.

Article	In Brief	India's Position & the Impact
Article 4: **Dual Resident Entities**	This article deals with cases where a non-individual is dual tax resident. In such a case, the final tax residency will be decided by mutual agreement between competent authorities of the jurisdictions involved. To arrive at a conclusion, the authorities will consider factors such as the place of effective management ("P.O.E.M.") of the entity, its place of incorporation or constitution, and any other relevant factors. In absence of such agreement, a dual tax resident will be denied tax treaty benefits altogether, unless otherwise agreed between the authorities.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Under Indian tax law, companies are tax resident in India if they are incorporated in India or have their P.O.E.M. in India. If a company incorporated outside India is held to be resident in India under the P.O.E.M. rule, this article will mandate mutual agreement to be reached between Indian tax authorities and authorities of the other jurisdiction. In absence of such agreement, the tax treaty benefits are likely to be denied.
Article 5: **Application of Methods for Elimination of Double Taxation**	Three options are provided for eliminating double taxation under domestic tax law: • Option A: Exemption method (the foreign income is not taxed at all in the jurisdiction of residence) • Option B: Exemption method (for all income other than dividends that are deductible in the jurisdiction of source) • Option C: Credit method (the foreign income is taxed in the jurisdiction of residence with an appropriate tax credit for foreign taxes)	India has adopted Option C (*i.e.*, the credit method). Most of India's tax treaties already provide for the credit method. Only four of the India's tax treaties (*i.e.*, with Bulgaria, Egypt, Greece, and the Slovak Republic) provide for the exemption method. Since these tax treaties are not commonly used in India-related structures, this article is not expected to have major impact.

Article	In Brief	India's Position & the Impact
Article 6: **Purpose of a Covered Tax Agreement**	This is a minimum standard that requires clarifying the intention of the tax treaty through modification, or insertion, of the preamble of the tax treaty. The preamble will clarify that the intention of the jurisdictions is to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including cases of treaty shopping for indirect benefits for residents of third jurisdictions.	The standard preamble provided in the M.L.I. and adopted by India, being a minimum standard, will apply to all Indian tax treaties notified and covered under the M.L.I. Indian courts have, in the past, relied on the preamble text while interpreting tax treaty provisions. This is a very important update and is expected to influence the interpretation of tax treaty provisions while adjudicating tax treaty benefits in India.
Article 7: **Prevention of Treaty Abuse**	This is one of the most anticipated and important articles of the M.L.I. The article requires insertion of the following one or more tests in the tax treaty for preventing tax treaty abuse: • Principal Purpose Test ("P.P.T.") – minimum standard • Simplified Limitation of Benefits ("S.L.O.B.") clause – optional and in support of the P.P.T. • Detailed Limitation of Benefits ("D.L.O.B.") clause – to be bilaterally agreed in line with B.E.P.S. measures and can replace the P.P.T.	India has adopted both the P.P.T. and S.L.O.B. with an option to bilaterally agree to a D.L.O.B., as required. The P.P.T. being a minimum standard, it will apply to all Indian tax treaties notified and covered under the M.L.I. However, an S.L.O.B. will apply only in cases where it has also been adopted by the other jurisdiction. Most of India's key tax treaty partners have not opted for an S.L.O.B. Singapore and the Netherlands have both applied only the P.P.T. and not the S.L.O.B. clause, and hence, their tax treaties with India will be modified only to the extent of the P.P.T. The applicability of the P.P.T. is one of the most significant updates arising from the M.L.I. in the context of India's tax treaties. In fact, the P.P.T. could result in increased litigation with the tax authorities if not implemented carefully and in spirit. A detailed discussion on the possible impact of the P.P.T. is provided in the next section for better understanding.

Article	In Brief	India's Position & the Impact
Article 8: **Dividend Transfer Transactions**	Many tax treaties provide for exemptions or concessional withholding tax rates on dividends for certain shareholders, which are different than the withholding tax rates otherwise applicable under the tax treaty. Article 8 requires meeting additional criteria of shareholding of minimum 365 days to avail the exemption or concessional withholding tax rate.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Currently, India does not impose any withholding tax on dividend payments by Indian companies, since these companies pay a dividend distribution tax ("D.D.T.") and the dividend is exempt from tax in hands of the nonresident shareholder. However, the Finance Bill, 2020, has proposed to abolish the D.D.T. with effect from April 1, 2020. Resultantly, the dividend would be taxable in the hands of the nonresident shareholder. With the proposed abolishment of the D.D.T. regime, the impact of this article on withholding tax on dividend payments must be considered going forward, as applicable.
Article 9: **Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property**	This article expands the taxing rights of the jurisdiction of source if the capital gain is essentially derived from immovable property in that jurisdiction held through a company, partnership, trust, or others.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. India will now have the right to tax • capital gains arising from the alienation of shares or comparable interests (such as interests in a partnership or trust), • if at any time during the 365 days preceding the alienation, • these shares or comparable interests derived more than 50% of their value directly or indirectly from immovable property situated in India.

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Article 10: **Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions**	This article denies tax exemptions to P.E.'s situated in a third state and not engaged in active business if the tax rate in the third state is less than 60% of the tax rate in the country of residence of the taxpayer.	India is silent on this article in the ratified M.L.I. In absence of any reservation, it will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. However, Indian tax treaties generally permit the taxation of an overseas P.E. of an Indian tax resident. A requisite foreign tax credit is provided against the Indian tax payable on profits of such P.E. Hence, this article is not expected to have much impact on Indian structures in usual circumstances.
Article 11: **Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents**	This article seeks to clarify that a jurisdiction continues to have a right to tax its own residents unless the tax treaty specifically provides for other treatment.	India is silent on this article in the ratified M.L.I. In absence of any reservation, the same will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. However, since India follows the credit method under most of its tax treaties, this article is not expected to have a material impact on Indian structures.
Article 12: **Artificial Avoidance of P.E. Status Through Commissionnaire Arrangements and Similar Strategies**	This article tackles cases that would otherwise not be covered in the definition of P.E. (especially Agency P.E.) under existing tax treaties. The article brings the following activities under the P.E. definition: A person • habitually concluding contracts or • habitually playing a principal role in the conclusion of contracts on behalf of another entity.	India has adopted this article. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. India has also amended its tax law to include such cases within its own concept of taxable presence, akin to a P.E. (*i.e.*, "Business Connection"). This amendment may result in Indian tax authorities adopting an aggressive approach to establish a foreign company's P.E. status in India.

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Article 13: **Artificial Avoidance of P.E. Status Through the Specific Activity Exemptions**	This article provides two options for determining a P.E. in cases where a P.E. is currently not constituted due to specific exemptions provided under the tax treaty: • Option A: The exempted activities stated in the tax treaty will not result in a P.E. only if they are, singularly or in combination, of a preparatory or auxiliary character. (This is a stricter provision to satisfy.) • Option B: Exempted activities will continue to not result in a P.E., irrespective of whether they are of auxiliary or preparatory character. (This is a more lenient provision to satisfy.)	India has adopted Option A. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Foreign entities taking a position of not having a P.E. in India on the grounds that the activities are specifically exempt or are preparatory or auxiliary in nature should re-analyze their positions in light of the impact of the M.L.I. on the relevant Indian tax treaty.
Article 14: **Splitting-up of Contracts**	This article seeks to tackle cases where contracts for building or construction sites or installation projects are artificially split amongst group entities to avoid P.E. status due to each entity's presence in the other jurisdiction not exceeding the threshold of days provided for constitution of P.E. under the tax treaty.	India is silent on this article in the ratified M.L.I. In absence of any reservation, it will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article. Foreign entities having similar structures should re-analyze the position of not having a P.E. in India, in light of the M.L.I.
Article 15: **Definition of a Person Closely Related to an Enterprise**	This article defines who is a person "closely related" to an enterprise, a term used in Articles 12, 13, and 14.	India is silent on this article in the ratified M.L.I., and hence, it will apply where Articles 12, 13, and/or 14 are applicable.
Article 16: **Mutual Agreement Procedure ("M.A.P.")**	This article describes how M.A.P. procedure or practices can be implemented.	India has opted for a bilateral notification or consultation process. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article.

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Article 17: **Corresponding Adjustments**	This article deals with double taxation of profits due to Transfer Pricing adjustments. It recommends that competent authorities in the other jurisdiction should provide corresponding adjustments arising on account of transfer pricing.	India has accepted the application of this article but has reserved the right not to apply it to tax treaties that already contain a similar provision. It will apply to all Indian tax treaties notified and covered under the M.L.I. and where the other jurisdiction has similarly adopted this article.
Articles 18 to 26: **Mandatory Arbitration**	This article provides for mandatory binding arbitration where agreement cannot be reached under M.A.P.	India has not adopted this article, and accordingly, this article will not impact or modify any of India's tax treaties.
Article 35: **Entry into Effect**	A specific provision of the article refers to the term "calendar year" for application of M.L.I.	India has substituted "calendar year" with the term "taxable period."

IMPACT OF THE P.P.T. ON TAX TREATIES NOTIFIED AND COVERED UNDER THE M.L.I.

The main impact of the M.L.I. on all covered Indian tax treaties will be the amendment or insertion of the preamble under Article 6 of the M.L.I. and, at the minimum, insertion of the P.P.T. under Article 7 of the M.L.I. For instance, both articles will apply to India's tax treaties with Singapore and the Netherlands. The P.P.T. in particular needs careful attention as it broadly states that:

A benefit under a tax treaty shall not be granted an item of income or capital if having regard to all relevant facts and circumstances it is reasonable to conclude that obtaining tax benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless granting that benefit in the circumstances would be in accordance with the object and purpose of the relevant provisions of the tax treaty.

Accordingly, the P.P.T. is a discretionary and subjective test for denying tax treaty benefits where obtaining the tax benefit under the tax treaty is one of the principal purposes (if not the main purpose) of the arrangement or transaction.

INTERPLAY BETWEEN THE P.P.T. AND G.A.A.R.

As the P.P.T. is an anti-abuse provision, its interplay with the General Anti-Avoidance Rule ("G.A.A.R."), introduced in India's tax law from April 1, 2017, makes for an interesting situation. Both the P.P.T. and G.A.A.R. permit the tax authorities to deny

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tax treaty benefits. However, at present, the manners in which they can be invoked have stark differences, as explained below:

- G.A.A.R. can be invoked only if the main purpose of an arrangement is to obtain a tax benefit. However, the P.P.T. can be invoked even if one of the principle purposes of the arrangement is to obtain a tax benefit under the tax treaty.
- G.A.A.R. can be invoked only if the tax benefit amounts to I.N.R. 30 million or more in a financial year with respect to the parties in the arrangement. The P.P.T. does not prescribe any such threshold.
- G.A.A.R. grandfathers investment structures before April 1, 2017. The P.P.T. does not provide for any such grandfathering.
- G.A.A.R. requires the income-tax officer to obtain their senior's approval and also consult the Approving Panel ("A.P.")[1] before invoking G.A.A.R. No such mechanism is provided under the P.P.T.

Accordingly, the P.P.T. has the potential of becoming a quick way for a tax officer to unilaterally deny tax treaty benefits instead of complying with the conditions or process provided under G.A.A.R. It is hoped that the Indian government amends the tax law or issues necessary administrative directions to ensure that the P.P.T. is not casually invoked by tax officers to deny tax treaty benefits. For now, no such clarification has been proposed in the Finance Bill, 2020, although the M.L.I will become effective in India from April 1, 2020.

CONCLUSION

With the M.L.I. becoming applicable to Indian tax treaties from April 1, 2020, onwards, going forward it is imperative that any Indian inbound or outbound cross-border structuring of investment or business operations should factor in the B.E.P.S. and M.L.I. impact, especially if the structuring involves availing of tax treaty benefits (in India or overseas).

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[1] The A.P. is comprised of a judge of the High Court (retired or not) as a chairperson, one member of Indian Revenue Service, and one member who is an academic or scholar having special knowledge.

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