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"The Ramifications of Implementing the Multilateral Tax Instrument in India – Meeting BEPS Minimum Standards and Amending Bilateral Treaties"

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Abstract

Owing to an increase in Base Erosion and Profit Shifting which highlights the tax evasion tactics of Multinational Corporations that reduce the tax bases for the country, the Organization for Economic Cooperation and Development has begun to comprehend tax planning schemes which abuse the gaps and inconsistencies in tax laws, further resulting in the shift of profits by MNCs to no/low tax jurisdictions. The BEPS Action Plan seeks to develop the consistency of international tax rules, strengthen its focus on economic substance, and guarantee a much more transparent tax environment. As an active member of the G20 and an associate of the BEPS project, India has been committed to the BEPS outcome. To implement the BEPS minimum standards, India has been amending its internal tax laws as well as bilateral tax agreements. This paper uses an analytical research methodology to determine the ramifications of implementing the Multilateral Tax Instrument as per the BEPS Action Plan in India and its tax environment.

Keyword: Multilateral Tax Instrument, BIT, BEPS Action Plan

I. INTRODUCTION

The Indian administration has been sensitive to the effects of Base Erosion and Profit Shifting[2], indicating the tax circumvention tactics of Multinational Corporations[3] that reduce the tax bases for the nation. The Organization for Economic Cooperation and Development[4] has begun to grasp tax planning schemes which abuse the gaps and disparities in tax laws, further resulting in the shift of profits by MNCs to no/low tax dominions. Political leaders, media channels, and civil societies around the country have voiced mounting apprehension regarding tax strategies by big players that look to reduce taxable income or shift profits to low-tax jurisdictions which see little or no economic activity. It is fairly true that there are several 'gaps and inadequacies' in the internal laws that have led to inefficiently controlled foreign company rules, transfer mispricing, and double taxation prevention treaty abuse by MNCs to elude from paying taxes. In an endeavor to confront this problem, the OECD and

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[2] Hereinafter referred to as BEPS.
[3] Hereinafter referred to as MNCs.
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G20[5] countries have keenly worked on the BEPS project, furnishing their commendations on the BEPS action plans[6].

As an active member of G20 and an associate of the BEPS project, India has been steadfast to the BEPS outcome. To implement the BEPS minimum standards, India has been amending its internal tax laws as well as bilateral tax agreements. Formerly, the OECD had issued several suggestions and reports for each of the 15 actions points in the BEPS project. It was understood that it would take several years to revise the many bilateral tax treaties[7] so as to give effect to the references in the BEPS Action Plan. Action Point 15[8] offers an inquiry of the tax and public international law issues associated with the development of a multilateral instrument to aid countries that request to do so to instigate measures developed in the progression of the work on BEPS and amend bilateral tax treaties. The BEPS report determined that a multilateral instrument is necessary/viable and that discussions should be set up quickly.

The BEPS Action Plans are designed in accordance with three essential ideologies -

- Offering consistency in internal laws that affect cross-border undertakings: These actions consist of aspects relating to the elimination of harmful tax practices the further lead to tax evasion strategies.
- Strengthening the basic requirements in global standards so as to safeguard the association of taxation with the position of financial activity and value creation: There are features in the action plan that prevent tax treaty abuse (treaty shopping), reinforce guidelines concerned with the creation of a permanent establishment for taxation, and certifying that the transfer pricing outcomes are in harmony with value creation in relation to intangible.
- Cultivating transparency as well as confidence for industries and governments: This relates to transfer pricing documentation, which offers substantial information to the revenue authorities in relation to global operations and monetary information of corporations.

II. RECOGNIZING TREATY SHOPPING AND PREVENTING TREATY ABUSE

Article 6 of the Multilateral Tax Instrument offers a binding requirement to amend the preamble of the Covered Tax Treaties, by incorporating a language that clearly reflects the intent of the contracting nations to circumvent double non-taxation and treaty shopping. Also, Article 7 of the Instrument provides for a Principal Purpose Test[9] and a Limitation on

[5] Group of Twenty, an international forum for the governments and central bank governors, of which India is a member.
[6] A set of 15 Action Points also known as the BEPS Action Plan.
[7] There are more than 3000 bilateral tax treaties.
[8] Action Point 15 of the BEPS Action Plan: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.
[9] This rule seeks to deny tax treaty benefits if one of the principal purposes of the transaction or arrangement was to obtain treaty benefits; hereinafter referred to as PPT.

Benefits[10] rule as mandatory requirements. Traditionally, the Indian jurisprudence has maintained their stand on disallowing the approach of the tax authorities to refute treaty benefits on the grounds of treaty shopping.

Taking instances from the Judiciary, the decision of the Apex court in the case of Azadi Bachao Andolan[11], held that in a situation where there is a nonexistence of a LOB clause in the tax treaty, treaty benefit would prevail. A similar opinion was advocated in the Vodafone case[12] as well. The Bombay High Court held that in the absence of LOB guidelines in a tax treaty, the party cannot be deprived of treaty benefits unless the tax authorities establish on facts that the establishment has been interpolated during the transfer of shares to a third party exclusively with an intent to avoid tax. As far as treaty negotiations are concerned, India has been consistently stressing upon the inclusion of a clause in the tax treaties to combat the issue of treaty shopping where MNCs reap the benefits of an advantageous tax dominion.

For instance, the clause that determines the eligibility to claim immunity from capital gains tax was presented in the India-Singapore tax treaty to amend their bilateral Avoidance of Double Taxation Agreement. The treaty also provides for an expenditure test that requires a minimum threshold for annual expenditure of the alienator and consideration of the affluence of the entity for allowing treaty benefits[13]. Several tax treaties which India has settled contains LOB rules on the lines of those agreed upon in the India-US tax treaty. On the other hand, certain treaties like the India-Kuwait and India-Finland tax agreements contain a clause with reference to arrangement of affairs with the main resolution of avoiding taxes, namely the PPT rule. The India-Luxembourg tax treaty, apart from the PPT rule, also comprises of a provision for supremacy of domestic anti-abuse provisions. This means that the treaty does not stop a country from applying its internal law on prevention of tax avoidance or tax evasion.

As far as the statutory front is concerned, the Indian legislature has recognized that treaty shopping results in tax leakages. It has been functioning to stiffen the rules in the Indian tax law for allowing tax treaty benefits. India has included various clauses in its domestic laws such as:

- Directing to furnish a tax residency certificate along with a self-declaration confirming certain basic information (which is a prerequisite), as a minimum threshold to claim tax treaty benefits.
- The facility of imposing higher withholding tax in the nonexistence of Indian PAN/ specified documents.

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[10] The rule limits the availability of tax treaty benefits that meet certain conditions (based on legal nature, ownership and general activities of the entity); hereinafter referred to as LOB.

[11] Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 706.

[12] Vodafone India Service Pvt. Ltd. v. Union of India, (2014) 361 ITR 531.

[13] *India and Singapore sign new protocol to income tax treaty*, EY GLOBAL TAX ALERT, (Mar. 2, 2017), http://www.ey.com/Publication/vwLUAssets/Protocol_to_amend_India_and_Singapore_income_tax_treaty_enters_into_force/$FILE/2017G_00954-171Gbl_Protocol%20to%20amend%20IN%20and%20SG%20income%20tax%20treaty%20enters%20into%20force.pdf.

- Controlling interest deduction on borrowings from non-resident associated enterprises.
- Reporting and taxing of indirect transfers materially modifying the ownership structure or control of an Indian entity.
- Adoption of a place of effective administration as an onset for determining residency.

Moreover, the Indian government codified the General Anti-Avoidance Rule[14] which was made effective from 1st April, 2017. The Indian GAAR supersedes tax treaties, which is in accordance with the OECD interpretation on anti-avoidance rules. It also includes a specific treaty override provision which has been included in certain recent bilateral tax treaties that India has entered into as well as in recent revisions to treaties such as with Singapore[15]. The PPT rule, as recommended under Article 6[16] is affiliated to the main purpose test as provided under the Indian GAAR. As a result, the GAAR and LOB/PPT rule may affect intermediate holding corporations for investing into India, which lacks substance and have been interposed only to avail tax treaty benefits. Foreign stakeholders that have made investments or are doing commerce in India need to evaluate their existing operational structure, provisions, contracts and investment methods to contemplate whether they are suitably strong to withstand a potential challenge under the anti-avoidance rules.

III. GUIDANCE BY OECD ON INTANGIBLES

The 'arm's length' principle has been the foundation of transfer pricing rules. Transfer pricing can divest governments of their reasonable share of taxes from MNCs and open them up to potential double taxation. No nation, whether underprivileged, developing or prosperous, would want its tax base to run down because of transfer pricing. The 'arm's length' principle is embedded in treaties and appears in the form of Article 9(1)[17] of the OECD Model Tax Conventions. The severe inadequacy and exploitation of the existing universal rules for transfer pricing has resulted in the distribution of profits which is not in line with the economic activity that results in profits. The BEPS Action Plan has come as a remedy to this disparity through Action 8[18], as it points out how misallocation of the profits created by valuable intangibles has added to base erosion and profit shifting. To overcome this issue, the OECD introduced guidance to make sure that the transfer pricing rules secure results that see operational profits owing to the economic activities which generate them. It provides guidance on the implementation of the approach to hard-to-value intangibles.[19]

The look at the guidance, after undergoing a revision, arranges for a comprehensive definition of intangible. This 'brushed up' definition of intangible recognizes the existence of intangibles, regardless of the reporting of intangibles in financials by MNCs. The guidance also explains that lawful ownership does not essentially create a right to all of the return that is generated by the abuse of the intangible. The reviewed guidance by OECD on intangible

[14] Hereinafter referred to as GAAR.
[15] India-Singapore Protocol to Update Bilateral Avoidance of Double Taxation Agreement (DTA).
[16] Article 6, BEPS Action Plan.
[17] Article 9(1), Articles of the Model Convention with Respect to Taxes on Income and on Capital.
[18] Article 8, BEPS Action Plan.
[19] *OECD releases final reports on BEPS Action Plan*, EY Global Tax Alert, (Oct. 6, 2015).

offers transparency on the method to be followed for identification of the intangible, ownership (legal or economic), approach for the comparability and choice of transfer pricing method for deciding the 'arm's length' price. In this view, several aspects of the revised guidance are adhering to the customs followed by the Indian tax system. For example, the revised guidance highlights augmenting or replacing the contractual prearrangement through inspection of the actual conduct of the parties created on the basis of the roles performed, assets expended, and risks anticipated, also comprising of the control of essential functions and economically substantial risks, at the same time.

The guidance goes on to state that under continuing contracts of sole distributor rights of the trademarked product, the determination of the distributor may enhance the worth of its own intangible, namely its distribution rights. A similar approach of argument has been assumed by several Indian taxpayers where the expenses sustained by them is for abusing the intangible in their recommended territory, in that way, increasing the worth of 'their intangible' and not that of the legal owner of the intangible. Also, the reviewed procedures suggest that the payment for such tasks can come in numerous forms such as separate compensation, decrease in price of goods, and decrease in royalty rates, which is parallel to the judgment given in case of Sony Ericsson.[20] Notably, a number of court rulings, such as the one given in the Maruti Suzuki case[21] have stressed upon the fact that tax authorities need to prove the existence of an 'arrangement' between an Indian entity and the foreign entity for the marketing spend before putting forward concerns over compensation outstanding in the name of the Indian entity for developing marketing intangible.

The courts in India have, time and again, acknowledged the role of OECD Guidelines for ascertaining the comprehensive and established accountabilities of the Indian taxpayer and foreign entity, defining the 'existence of transactions' and involvement of each side to value creation. Therefore, the guidance on the intangibles is expected to affect both the tax authorities as well as the taxpayers, guaranteeing a critical analysis of the prevailing practices and arrangements.

IV. ADDRESSING THE TAX CHALLENGES OF A DIGITAL ECONOMY

Resolving the digital issue, specially recognizing suitable tax rules to deal with digital business, has been put up as the number one Action[22] in the BEPS Action Plan. Digitalization has further aggravated the essential defects in international tax rules. The ability to do significant business in a country without a substantial physical presence has long been a difficulty, especially in relation to services. The main changes that economies are facing due to digitalization are:

- The closer association it requires and enables between producers and consumers;

[20] Sony Ericsson Mobile v. Commissioner of Income Tax, (2015) 374 ITR 118.
[21] Maruti Suzuki India Limited v. Commissioner of Income Tax, (Delhi High Court).
[22] Article 1, BEPS Action Plan.

- The digital facilities that are often provided with no direct charge to users, while their inputs are monetized through revenue created through services provided to other consumers, especially marketing; and,
- The ability that digitalization gives for some firms to re-characterize themselves as pure intermediaries between producers and consumers.

The numerous unilateral and protective measures presented or proposed by countries (diverted profits tax, equalization levy, etc.) may be essential in the short term but are only temporary solutions. Corporate environment is becoming complex and vibrant with the introduction of new business models combined with e-commerce transactions. The relation between revenue generating activity and geographic location is much more concealed as compared to the former model wherein a geographic link with some commercial activity required taxation in the said dominion. India has adopted a similar outlook on this front, with tax proceedings on account of numerous e-commerce disputes such as online advertising, subscription for e-databases, and costs for bandwidth. Talking about the Indian perspective, the following key facets need to be reaffirmed in lieu of inclusive worldwide growth:

- Existence of a business presence or interconnection with a jurisdiction.
- Accumulation/foundation of income.
- Characterization of income.

Even though Action 1 of BEPS talks about some of the problems relating to permanent establishments/source rules, the basic issue in relation to the digital world in India is characterization of income. This problem has not been addressed by Action 1. As an active member of the G20 and a participant of the BEPS project, India is devoted to the BEPS results. It can be fairly assumed that several recommendations suggested in various actions impacting digital industries will be instigated through amendments to the tax law and tax treaties.

V. AVOIDING ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENTS

Action 7[23] deals with avoiding the artificial avoidance of permanent establishment (PE) status. This plan comprises of modifications to the definition of PE in the OECD Model Tax Convention[24], which speaks about tactics used to avoid having an assessable presence or a PE in a country under tax treaties. These modifications are directed to safeguard that where the undertakings that an agent conducts in the State are envisioned to result in the regular supposition of contracts to be executed by a foreign enterprise, that enterprise will be deliberated to have a taxable presence in that country. Usually, the foreign enterprises would not be taxable in the source State as they do not have a PE in that State.

Several MNCs in India function via a subsidiary to ‘market’ the products of the corporation. Normally, the Indian subsidiary is given a remuneration that is taxable in India, while the

[23] Article 7, BEPS Action Plan.
[24] Articles of the Model Convention with Respect to Taxes on Income and on Capital.

foreign body is not taxable in India on the profit of the sales, in the non-existence of a PE in India. The suggested extension of the definition of agency PE in the perspective of conclusion of contracts and the inability of the Indian subsidiary to be regarded as an 'independent agent' could uncover a part of the foreign body's profit on sale of products to be taxed in India, conditional to the actualities of the case. The Indian revenue authorities have construed the term 'conclude contracts' extensively to include several activities which enable conclusion of contracts.

VI. CONCLUSION

The BEPS Action Plan seeks to develop the consistency of international tax rules, strengthen its focus on economic substance, and guarantee a much more transparent tax environment. Having regard to the BEPS recommendations, business models are likely to be exposed to increased scrutiny by tax authorities. The MLI is a breakthrough in the implementation of the BEPS Project. With minimum standard and strategies for avoidance of tax payment being tackled by the MLI, the network of the Indian bilateral tax treaties will undergo a dynamic change and go a long way towards decreasing base erosion and profit shifting.