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India's Experience with Tax Treaties and the OECD's Multilateral Instrument: A Short History

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1. Prologue - India's journey with Treaties & Investment

Tax treaties in India predate the Vienna Convention. At the time of Independence, the Income Tax Law (Indian Income-tax Act, 1922) had provisions for granting relief against double taxation in India and UK and other dominions.[1] But there was no provision for enabling the government to enter into double tax avoidance agreements with other countries. A special provision was enacted on the eve of Independence.[2]

"49AA. The Central Government may enter into an agreement with Pakistan for the avoidance of double taxation of income, profits and gains under this Act and under corresponding law in force in Pakistan, and may, by notification in the Official Gazette make such provision as may be necessary for implementing the agreement."

Pursuant to the above provision, an agreement for avoidance of double taxation was entered into with Pakistan in the year 1947. That was the first double taxation avoidance agreement entered into by India.

The Income-tax and Business Profits Tax (Amendment) Act, 1948, extended the provisions of the said sections to the UK. But business was growing and it came to be realised soon that providing for tax relief only for transactions with Pakistan and the UK (and dominions) was not sufficient. In 1953, the following section was inserted in place of the old section 49A and 49AA enabling treaties to be entered into with any country:

"The Central Government may enter into an agreement –

(a) with the Government of any country outside India for the granting of relief in respect of income on which have been paid both income-tax (including super-tax) under this Act and income-tax in that country, or

(b) with the Government of any country outside India for the avoidance of double taxation of income, profits and gains under this Act and under the corresponding law in force in that country;

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement."[3]

Constitutional blessings

Many milestones have been crossed since those early days of India's forays into the global economy. One of the most important milestones was that the Constitution of India came to recognise that it is important for India as a member of the global community to enter into treaties with other countries. The following provisions were made in the Constitution:

As a Directive Principle of State Policy, "the State shall endeavour to foster respect for international law and treaty obligations in the dealings of organised peoples with one another".[4] This Article, however, does not lay down that international treaties or agreements entered into by India shall have the force of municipal law without appropriate

[1] Indian Income Tax Act of 1922, Section 49 and Sec 49 A
[2] Sec 49AA of 1922 Act
[3] Finance Act 1953, Sec 49A
[4] Articles 51 of the Constitution of India

legislation. In several circumstances it requires legislation for treaties to be binding on municipal courts.

Article 246 effects a distribution of legislative power between the union and the states. It provides "Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the 'Union List')".[5]

The Seventh Schedule to the Constitution contains 3 Lists; Union, State and Concurrent. Entry 13 and 14 in the Union List are relevant. They read as follows:

"13. Participation in international conferences, Associations and other bodies and implementing of decisions made thereat.

14. Entering into treaties and agreements with foreign countries and implementing of treaties, agreements and conventions with foreign countries."

Our Constitution further provides that, the executive power of the union shall extend (a) to matters with respect to which Parliament has power to make laws, and (b) to the exercise of such rights, authority and jurisdiction as are exercisable by the Government of India by virtue of any treaty or agreement. [6]

Thus, the power of the executive to exercise the powers of the Government of India by virtue of any treaty or agreement gets special recognition in Article 73, which enables endorsement of the rights under treaties and agreements, which the executive is obliged to observe as part of its duties.

Vienna Convention

Tax agreements are not different from other international agreements. Hence, the principles set out in the Vienna Convention as agreed on May 23, 1969,[7] are recognised as applicable to tax treaties. But the Vienna Convention has been understood as only setting out and as declaratory of customary international law. They have served as a framework for dispute resolution in international law.

Articles 31, 32 and 33 of the Vienna Convention are often referred in interpretation of tax treaties. They are reproduced below;

"Article 31.—(1) A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

(2) The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

(3) There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

[5] Article 246 (1) ibid

[6] Article 73 (1) ibid

[7] Vienna Convention on the Law of Treaties

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
(c) any relevant rules of international law applicable in the relations between the parties.
(4) A special meaning shall be given to a term if it is established that the parties so intended.
Article 32.—Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:
(a) leaves the meaning ambiguous or obscure; or
(b) leads to a result which is manifestly absurd or unreasonable.
Article 33.—(1) When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
(2) A version of the treaty in a language other than one of those in which the text is authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
(3) The terms of the treaty are presumed to have the same meaning in each authentic text,
4) Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted."

India's Position

The Vienna Convention, undoubtedly, has the effect of making governments more serious about their obligations under international treaties. Once the executive enters into a treaty, it would be, ordinarily speaking, quite embarrassing for the Parliament to reject the treaty, thanks to the Vienna Convention. This is in spite of the fact that the Vienna Convention has not been ratified by India.

The Constitutional provisions on India's treaty obligation and the persuasive effect of the Vienna Convention created many interesting case studies. More of that will be dealt with latter, but for now, let us see how the law relating to double tax avoidance agreements was shaping up in India.

The provisions that prevailed at the time of Independence and the change brought about by the Finance Act, 1953, have been referred to *infra*.

The provision, as it stood after its amendment by the Finance Act, 1953, was carried forward verbatim in the Income-tax Act, 1961, (section 90) when it was enacted on April 1, 1962.

The first major amendment was brought about,[8] when section 90 was cast in the following new form:

Agreement with foreign countries

> *"90. The Central Government may enter into an agreement with the Government of any country outside India—*

[8] Finance Act, 1972

(a) for the granting of relief in respect of income on which have been paid both income-tax under this Act and income-tax in that country, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country,

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement."

The insertion of two new clauses for the exchange of information and for recovery of taxes was to counter tax-evasion, as explained thus[9]:

"Some of the taxpayers having transactions with outside countries resort to dubious methods for evading their liability under the tax laws. Tax evasion is thus closely linked with transactions involving over-invoicing and under-invoicing in import and export business operations through secret foreign bank accounts and smuggling of valuable articles into and out of India. Cases of taxpayers who thwart the attempts of the administration to collect tax dues by either retaining their assets abroad or transferring them secretly outside India are also not unknown. With a view to enabling the tax administration to tackle the problem of tax evasion having international ramifications, the Finance Act, 1972 has substituted a new section for the existing section 90 in order to empower the Central Government to enter into agreements with foreign countries not only for purposes of avoidance of double taxation of income but also for enabling the tax authorities to exchange information for the prevention of evasion or avoidance of taxes on income or for investigation of cases involving tax evasion or avoidance or for recovery of taxes in foreign countries on a reciprocal basis."

This was the first time that treaties in India came to be looked upon as anti-evasion tools.

The second was the amendment by Finance (No. 2) Act, 1991, under which sub-section (2) to section 90 was inserted; it was a watershed event in India's treaty history inasmuch as it is by this amendment that the taxpayer was given the right to be governed by the domestic law or by the treaty, whichever was more beneficial. Section 90(2) read as follows;

"(2) Where the Central Government has entered into an agreement with the Government of any country outside India under subsection (I) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

The rationale for the above was explained thus;[10]

"Since the tax treaties are intended to grant tax relief and not put residents of a contracting country at a disadvantage vis-à-vis other taxpayers, section 90 of the Income-tax Act has been amended to clarify that

[9] Central Board of Direct Taxes ('CBDT') Circular No. 108 dated March 20, 1973.

[10] CBDT Circular No. 621 dated December 19, 1991

any beneficial provision in the law will not be denied to a resident of a contracting country merely because the corresponding provision in the tax treaty is less beneficial."

At this juncture, it is pertinent to allude to some of the disputes that arose, particularly on the aspect of the alleged executive overreach, in matters of treaty negotiation and enforcement. The root of such dispute is article 73 of the Constitution. The power of the executive to exercise the powers of government by virtue of any treaty or agreement gets special recognition in Article 73, which enables endorsement of the rights under treaties and agreements, which the executive is empowered to enter into. Article 73, while not binding on Parliament, which is supreme, has the effect of recognising treaty override when it places limitations on the executive to exercise its right, authority and jurisdiction in consonance with treaty obligations in the light of the fact that the boundary line in the Constitution between the powers of the executive and the legislature is often blurred. It was pointed out that the interpretation of domestic law has to be done within the legitimate limits imposed by treaty obligations.[11] It is because of the provision in Article 73 that executive power extends inter alia "to the exercise of such rights, authority and jurisdiction as are exercisable by the Government of India by virtue of any treaty or agreement." It was noted that Parliament itself has provided for double tax avoidance agreement as part of the income-tax law so that any ambiguity in the interpretation of law would be resolved with reference to the treaty.[12]

In a certain case, the issue whether the non-resident taxpayer had Indian income under Indian law was bypassed by the Appellate Tribunal by resolving the issue with reference to the double tax avoidance agreement between India and the then Federal Republic of Germany, which relieved the non-resident of liability, ignoring such liability under domestic law.[13] The argument before the High Court was that the tribunal had no jurisdiction to interpret the agreement not only with reference to the merits of the case but also in view of the fact that it was for the tax administration to implement it. The High Court, after referring extensively to judicial precedents in other countries and leading texts on international tax, law held that the procedure embodied in all the agreements are justiciable under domestic law. It was held that if an issue under the domestic law could be agitated before the tribunal, there was absolutely no reason why a claim based upon the treaty cannot be so agitated.

Nevertheless, the question of domestic law override by double tax treaties has been a constant pain point. One of the circumstances where domestic law override by treaty is resisted is where no tax is payable in the other country at all. Revenue would insist that the assessee show that his income is assessed in the other country so as to be eligible for relief under the treaty. A writ petition was filed in a certain case contending that the relevant double taxation avoidance agreement could not provide relief from Indian tax if the taxpayer did not suffer tax in the other contracting state under the laws prevailing in that state.[14] The Delhi High Court said;

"Avoidance of double taxation would mean that a person has to pay tax at least in one country. Avoidance of double taxation would not mean that a person does not have to pay

[11] Gramophone Co. of India Ltd. v. Pandey AIR 1984 SC 687
[12] Kubic Darius v. UOI AIR 1990 SC 605
[13] CIT v. Vishakapatnam Port Trust (1983) 144 ITR 146 (AP)
[14] Shiva Kant Jha, Azadi Bachao Andolan v. UOI (2002) 256 ITR 563 (Del)

tax in any country whatsoever. In Mauritius in terms of the statute a foreign company is not entitled to own any property, open any bank account, do any business. Several restrictions have been imposed in that country as a result whereof no income may be generated in Mauritius and no income-tax may be payable therein.
Does double taxation treaty envisage such a situation? In our opinion it is not."
The Supreme Court overruled the aforesaid judgement explaining the law in great detail with reference to the statute and international commentaries.[15] It referred to, with approval, the proposition of the leading tax commentator Klaus Vogel that a double tax avoidance agreement with a country with no tax should be understood as intended to avoid potential double taxation.
The petitioners contended before the High Court that the Mauritius treaty along with a circular issued by the government purportedly to guide tax assessing officers on how to assess cases under that treaty only served political expediency and was not in accordance with the permissible objectives of a double tax avoidance agreement set out in section 90 of the Income-tax Act, 1961. The High Court recorded the following findings;
While political expediency will have a role to play in terms of article 73 of the Constitution, the same is not true when a treaty is entered into under the statutory provision like section 90 of the Act.
Any purpose other than the purpose contemplated under section 90, however bona fide it might be, would be ultra vires the provisions of section 90 of the Act.
The above findings prompted the next major amendment in section 90 of the Act. The following was inserted by the Finance Act, 2003, with effect from April 1, 2004:[16]

"(a) for the granting of relief in respect of –

(i) income on which have been paid both income-tax under this Act and income-tax in that country; or

(ii) *income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment…"*

This amendment was made with a view to enlarge the scope of double tax avoidance agreements for the development of mutual trade and investment with a view to answer the issue raised in the aforesaid writ petition decided by the High Court.
The rationale for the change was explained as follows;[17]
"Double Taxation Avoidance Agreements – extending the scope to include agreements for developing mutual trade and investment
57.1 *Under the existing section 90, the Central Government may enter into an agreement with the Government of any country outside India for the granting of relief in respect of income on which have been paid both income-tax under the Income-tax Act and income-tax in that country, or for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, etc.*

57.2 *In order to encourage international trade and commerce, the Finance Act, 2003, has inserted a new clause in sub-section (1) of section 90 so as to provide that the Central*

[15] UOI v. Azadi Bachao Andolan (2003) 263 ITR 706
[16] Finance Act, 2003, Sec 90 (1) (a)
[17] CBDT Circular No. 7/2003 dated September 5, 2003

Government may also enter into an agreement with the Government of any country outside India for granting relief in respect of income-tax chargeable under this Act and under the corresponding law in that country to promote mutual economic relations, trade and investment.

2. Treaty Shopping

The first requirement that must be met by a person who seeks to obtain benefits under a tax treaty is that the person must be 'resident of a contracting state'. There may be a vast number of arrangements in real life through which a person who is not a resident of a contracting state may attempt to obtain benefits that a tax treaty grants to a resident of that state. These arrangements are generally referred to as 'treaty shopping'. Treaty shopping cases typically involve persons who are residents of third states attempting to access indirectly the benefits of a treaty between two countries.

Tax payers engaged in treaty shopping undermine tax sovereignty by claiming treaty benefits in situations where those benefits were not intended to be granted, thereby depriving countries of tax revenues.

No wonder revenue authorities have been wary of treaty shopping. An early glimpse of this was seen in a filing before the Authority for Advance Rulings.[18] A US based group sought to invest in infrastructure projects through funds established in Mauritius. The group sought AAR's opinion on the tax consequences of the arrangement. The revenue department objected to the maintainability of the petition to the AAR citing an apparent tax avoidance motive in the arrangement. To quote from the ruling;

" It is pointed out that the scheme for making investments in India in infrastructural and other core sectors has been initiated by the American company and the Indian financial service company. The American company could have, therefore, directly contributed to the CT and secured other investors also to participate directly. But, since the interest and dividend income realised, in that event, from India by the American company would not be entitled, under the DTAA between India and USA, to any tax concession, this arrangement has been devised to secure the concessional tax advantages that are available under the DTAA between India and Mauritius by putting up, as a front, a Mauritian subsidiary (the IC) for making the investment. It is contended that the transaction in question is thus a transaction by the American company designed, prima facie, for the avoidance of Indian income-tax and that the application should be dismissed on this ground."

The AAR eventually dismissed this plea of the revenue department based on several considerations. But such a trace of suspicion of treaty shopping is ingrained in most high profile tax disputes where treaty benefit is claimed by a taxpayer.

The treaty shopping discussion prominently featured in the Shiva Kant Jha case, referred to above.

[18] (1997) 224 ITR 473

In the writ application to the High Court, the petitioner contended that mere issue of a tax residency certificate by the Mauritius authority is not determinative of the tax payer's real residence in Mauritius and that it encourages treaty shopping in a case where the company has no base in Mauritius; hence, the non-resident company should not be allowed to take benefit thereof as this would encourage fraud.

The respondent countered by equating investing through Mauritius as a local industrialist setting up a unit in a backward area to avail himself of fiscal incentives. In the words of the Court;[19]

"Economic activities in different States by grant of exemption to the industries are done in terms of the provisions of the statutes. Such exemptions are granted in furtherance of the legislative policy so as not only to put the local resources including human resources to optimum use but also for development of the country. Such benefits and exemptions are granted by way of payment of sales tax and electricity subsidy etc. but the same principle cannot be said to be applicable for the purpose of double taxation avoidance scheme."

The Court rejected the comparison as above and went on to hold that treaty shopping as pointed out by the petitioners was indeed happening, leading to defrauding the revenue department. It said,

"*In any event, taking undue advantage of a scheme only for the purpose of avoidance of tax cannot but be deprecated. Treaty shopping which amounts to abuse of the Indo-Mauritius Bilateral treaty, may amount to fraudulent practice and cannot be encouraged.*

…

The core issue is as to what should be done when on investigation it is found that the assessee is a resident of a third country having only paper existence in Mauritius without any economic impact with a view to take advantage of the double taxation avoidance scheme. … In any event, having regard to the facts and circumstances of the case, only by production of a residential certificate, an assessee cannot be held to be entitled to take benefit of the treaty although it neither pays income-tax in India nor in Mauritius. Such an action would be ultra vires the Income-tax Act."

In an appeal to the Supreme Court, it was contended on behalf of the government that if it was intended that a national of a third state should be precluded from the benefits of the DTAC, then a suitable term of limitation to that effect should have been incorporated therein. As a contrast, the court's attention was drawn to the Article 24 of the Indo-US Treaty on Avoidance of Double Taxation, which specifically provides the limitations subject to which the benefits under the treaty can be availed of. One of the limitations is that more than 50 per cent of the beneficial interest or, in the case of a company, more than 50 per cent of the number of shares of each class of the company, be owned directly or indirectly by one or more individual residents of one of the contracting states. Article 24 of the Indo-US DTAC is in marked contrast with the Indo-Mauritius DTAC.

It was urged that in the absence of a limitation clause, such as the one contained in Article 24 of the Indo-US Treaty, there are no disabling or disentitling conditions under the Indo-Mauritius Treaty prohibiting the resident of a third nation from deriving benefits thereunder. They also urged that motives with which the residents have been incorporated

[19] (2002) 256ITR 563

in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction.
The Supreme Court sided with the argument that in the absence of a limitation of benefit clause in the India-Mauritius treaty on the lines of the India-USA treaty, treaty shopping cannot be prevented.[20]

The Court proceeded to explain;
"Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc.

Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit". Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty.

Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses.

There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This Court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy."

[20] (2003) 263 ITR 706

So reasoning, the Supreme Court eventually held that the central government was within its right to guide a tax officer to the effect that he should rely on tax residency certificate that may be produced by a Mauritius taxpayer to give it the benefit of the India-Mauritius tax treaty.

That was the year 2003, when the central government's purported support to 'treaty shopping' received judicial benediction. A little over a decade later, the tide seems to have turned, going by the alacrity with which the government jumped on to the Base Erosion and Profit Shifting bandwagon. Looking back, it seems the government must have been flooded with compunction, reflecting upon its tacit support to treaty shopping in those early days when the floodgates of development were thrown open!

3. Base Erosion and Profit Shifting

The OECD noted that the integration of national economies and markets has increased substantially in recent years. This has put a strain on the international tax framework, which was designed more than a century ago. The current rules, including treaties, have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS). International tax required a bold move to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created. In September 2013, G20 leaders endorsed the ambitious and comprehensive Action Plan on BEPS. Reports drawn up under BEPS include new or reinforced international standards as well as concrete measures to help countries tackle BEPS. It represents the results of OECD and G20 countries working together with the participation of an increasing number of developing countries.

OECD identified 15 action plans to address BEPS in a comprehensive manner and set deadlines to implement those action plans. One of the major findings in the BEPS study was that existing double tax avoidance agreements are prone to abuse. Action Plan 6 of the OCED/G20 BEPS specifically deals with tax treaties. The BEPS project identifies treaty abuse and, in particular treaty shopping, as one of the most important sources of BEPS concern.

The global community noted that taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries, therefore, have agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping.

They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's domestic law and bilateral treaty considerations.

According to this Action Plan, treaty abuse is sought to be tackled in the following ways;

- First, there will be a clear statement in the treaty preambles that the states that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

- Second, a specific anti-abuse rule – the limitation-on-benefits (LOB) rule – that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. These conditions, which are based on the legal nature, ownership in and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its state of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies.

- Third, in order to address other forms of treaty abuse, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) will be included in the OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

The report recognises that each of the LOB and PPT rules has strengths and weaknesses and may not be appropriate for, or accord with the treaty policy of, all countries. Besides, the domestic law of some countries may include provisions that make it unnecessary to combine these two rules to prevent treaty shopping.
Given the risk to revenues posed by treaty shopping, countries have committed to ensure a minimum level of protection against treaty shopping (the "minimum standard"). That commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Countries will implement this common intention by including in their treaties: (i) the combined approach of an LOB and PPT rule described above, (ii) the PPT rule alone, or (iii) the LOB rule supplemented by a mechanism that would deal with conduit financing arrangements not already dealt with in tax treaties.

4. Multilateral Instrument

The OCED realised that whatever noble measures might have been developed in the BEPS project would be of no avail unless the countries had the wherewithal to implement those measures keeping their respective domestic laws and bilateral treaties in mind. This again would have proved to be a herculean task if each country were to renegotiate its bilateral tax treaties with the other countries in the light of BEPS recommendation. BEPS Action Plan 15 to mandate development of a multilateral instrument on tax treaty measures to tackle BEPS was in recognition of the need to consider innovative ways to implement the measures recommended in BEPS.

Action Plan 15 provides;
"Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis

of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution."

Thus, the main objective of the multilateral instrument will be to modify existing bilateral tax treaties in a synchronised and efficient manner to implement the tax treaty measures developed during the BEPS project, without the need to expend resources individually renegotiating each treaty bilaterally. As a result, the mandate for developing the multilateral instrument will be limited in scope to modifying existing bilateral tax treaties to implement treaty-related measures developed in the course of BEPS project.

Accordingly, on November 24, 2016, more than 100 jurisdictions concluded negotiations on a multilateral instrument that will modify the application of existing bilateral tax treaties to implement the tax treaty measures developed through the OECD/G20 BEPS project. The multilateral instrument allows for the relatively rapid inclusion of measures against treaty shopping, artificial avoidance of the permanent establishment status and hybrid mismatches, as well as improvements of the dispute resolution mechanism in existing bilateral tax treaties.

On June 7, 2017, 68 jurisdictions including India signed the MLI to modify a large number of bilateral tax[21] treaties entered into by them. In addition, six jurisdictions expressed their intent to sign the MLI. This has resulted in over 1100 treaties being potentially subject to change. At the same time, significant jurisdictions such as US and Brazil have not signed the MLI. As on August 17, 2017, 71 jurisdictions have signed the MLI.[22]

MLI will apply only to those countries that have signed the MLI, ratified it in accordance with domestic law (if required under the domestic law) and deposited such instrument of ratification with the OECD depositary; and 3 months have passed from the date five instruments of ratification have been deposited with the depositary.

After the MLI comes into force, it will not automatically apply to all the treaties of a country that is party to the MLI but will apply only to those treaties where both parties to such treaty have conveyed their intention (by way of notification) for such treaty to be covered by the MLI. If a treaty is notified to be covered by the MLI, it is called 'Covered Tax Agreement'. MLI will be applicable to a bilateral tax treaty only if both parties to such treaty notify it as a covered tax agreement.

It is noteworthy that significant treaty partners with substantial business with India, such as Germany, China and Mauritius, which have signed the MLI, have not notified it as being applicable to their tax treaties with India. In other words, these countries have not notified their treaties with India as covered tax agreements. For example, MLI does not apply to the India-Germany Double Tax Avoidance Agreement A covered tax agreement will be required to meet certain prescribed minimum standards – that for prevention of treaty abuse under BEPS Action Plan 6 (Preventing the Granting of Treaty Benefits in Inappropriate

[21] https://www.osler.com/en/resources/regulations/2017/canada-signs-multilateral-tax-agreement
[22] http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf

Circumstances) and that for the improvement of dispute resolution under BEPS Action Plan 14 (Making Dispute Resolution More Effective). Signatories to the MLI will have hardly any leeway to opt out of adherence to the minimum standards, though they may opt out of provisions other than minimum standards (by way of reservations).

The multilateral instrument provisions will not be included in specific bilateral treaties through an amendment of the texts of those treaties. Instead, the provisions need to be read and applied alongside the existing bilateral treaties. Individual countries, it seems, will decide for themselves whether they want to prepare consolidated versions of their treaties that are subject to the changes and additions based on the multilateral instrument for internal purposes.

5. Multilateral Instrument and India

MLI is an outcome of the BEPS project. It is a vehicle for jurisdictions to give effect to selected law and policy changes considered necessary to tackle tax base erosion and profit shifting. India has historically considered itself a victim of the scourge of tax base erosion and profit shifting and was a major contributor to the BEPS project of the OECD.

Broadly, the MLI machinery is structured to tackle BEPS of four categories – 'hybrid mismatches', 'treaty abuse', 'dispute resolution' and 'avoidance of PE status'. Of these, jurisdictions must comply with the stipulations under 'treaty abuse' and 'dispute resolution'. These are called 'minimum standards'.

It will be pertinent to examine how India's proposed treatment of the various clauses of MLI are likely to alleviate base erosion and profit shifting that it claims to be afflicted with. The following section deals with that.

Dual Resident Entities – One of the clauses is on 'Dual Resident Entities' under the broad category 'hybrid mismatch'. The Competent Authority ('CA') of a jurisdiction determines whether a person (other than an individual), i.e., companies, LLPs or other incorporated entities, is to be considered a resident of one or more states. For this purpose, it will need to consider its Place of Effective Management ('PoEM'), where it is incorporated or has been constituted and any other relevant factors. Where the CA is unable to determine the place of residency, such a person will not be entitled to the treaty benefit. India has adopted this standard for all its covered tax agreements. While OECD's commentary suggests that countries should take into account (a) where a person's board of directors or equivalent body generally meet, (b) where the CEO and other senior executives usually carry out their activities, (c) where its day-to-day senior management activities are conducted, (d) where its headquarters are located, (e) which countries' laws govern its legal status and (f) where its accounting records are kept, etc., India's domestic PoEM test prescribes an active and passive income test that is usually only applicable in the context of certain anti-avoidance measures. The country's position on the MLI is likely to have significant ramifications for Indian MNEs with operations outside India, since these are now aligned with domestic tax law-related requirements. However, it seems unlikely that treaty partners will agree to the dual residence of a taxpayer being resolved in favour of India just because it meets the

requirements of the PoEM tests in its domestic laws. The manner in which the CA will address this issue remains to be seen.

Preamble to tax treaties – Article 6 includes a minimum standard for a treaty to have a suitable 'preamble', excluding its use to reduce taxation through tax evasion or avoidance, or treaty shopping (artificially using conduit entities to structure arrangements in order to obtain treaty benefits). The MLI mandates default wording to be applied as a modification to the existing preamble. India has not taken any position on this provision. Since Article 6(5) of the MLI stipulates that the language used in the provision will be included in that of the existing preamble, and that even if the language used in existing treaties is not notified to the Depository, the language used in the preamble should be included in all India's treaties. The addition of this provision will make a significant impact on the interpretation of the 'object and purpose' of tax treaties. The preamble of the MLI is likely to have a significant impact on the interpretation of the position approved by the courts, since it has a specific provision for prevention of tax evasion through treaty shopping.

Treaty abuse – According to the MLI, Article 7 of BEPS applies to prevention of treaty abuse and relates to the BEPS minimum standard to include a Principal Purpose Test ('PPT'), a Detail Limitation of Benefit, an anti conduit rule, a PPT and Simplified Limitation of Benefit. India has opted to apply the S-LoB as a supplement to the PPT rule. It is important to note that the S-LoB only applies to a CTA when the other party has opted to apply it. If one party applies the S-LoB and the other does not, only the PPT rule (and not the S-LoB) will apply. Since India is only one of 12 countries to have opted to apply the S-LoB, only a PPT is likely to apply to its CTAs, since it has not chosen a reservation to negotiate a detailed LOB with its treaty partners (who have not chosen S-LoB).

The PPT rule could be broader in its ambit than GAAR under the ITL, since GAAR is only triggered if the main purpose of an arrangement is to obtain a tax benefit. Furthermore, in order for GAAR to be triggered, one of the other 'tainted' elements also needs to be satisfied, i.e., creation of rights or obligations that are not at arm's length, abuse of the ITA and lack of commercial substance or bona fides. Therefore, it is unlikely that GAAR will apply if the PPT rule is met. It is yet to be seen how the interplay between GAAR and the PPT rule will pan out in the treaties.

Countries that have favourable tax treaties with India make substantial investments in the country. To counter tax treaty abuse, BEPS has introduced its minimum standards, which require implementation of the PPT rule, which can have an impact on intermediate holding structures or investment holdings without adequate substance. Investors, therefore, will need to review their group structures in order to invest in India.

PE – Commissionaire arrangements – The scope of a Dependent Agency PE has been enhanced. A common test for DAPE is its "authority to conclude contracts" and its "habitual exercise" of this authority. The MLI expands the scope of a DAPE and includes the phrase "if the agent 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...." India has chosen to opt for this option in all its covered

tax agreements. However, this provision is only applicable to CTAs if the other party agrees to do the same.

Most of India's tax treaties use the phrase "authority to conclude a contract." Judicial precedents in the country have interpreted the term as having the "authority to conclude a contract" if a person has the authority to negotiate all the elements or details of a contract, "bind" a foreign enterprise in its business activities and decide on the final terms of the contract.

However, it is relevant to note that India's position on the OECD's commentary has been that if a person has attended or participated in negotiations in a state, such a person can (in certain circumstances) be sufficient by itself to conclude that it has exercised the authority to conclude contracts in the name of the enterprise. Furthermore, a person authorised to negotiate the essential elements of a contract (and not necessarily all its elements and details) on behalf of a foreign enterprise can be said to be exercising its authority to conclude contracts.

Consequently, the phrase "authority to conclude a contract" is widely interpreted by Indian courts in line with the OECD's commentaries and the position taken by India. Therefore, irrespective of the changes mandated by the MLI, India's existing tax treaties with other countries are interpreted broadly.

The MLI proposes to include the phrase "or habitually plays the principal role leading to conclusion of contracts that are routinely concluded without material modification by the enterprise". Although the term "principal role" has not been defined or explained in the MLI, one can draw a reference from Action 7 of the BEPS report, which includes a commentary to aid its interpretation.

In India's tax treaties, an agent is generally not considered to be independent in the following scenarios:

The agent works wholly or almost wholly for an enterprise, i.e., the principal, and the conditions are not at arm's length.

Its activities are only performed for one or more related principals (e.g., the India-Australia or India-Belgium tax treaties).

The arm's length condition is not provided for in the MLI and, therefore, it needs to be evaluated whether its condition is met. This may not help closely related enterprises avoid being accorded a dependent agent status. Therefore, a foreign enterprise, with agents being closely related enterprises that work in India on the arm's length condition, will need to re-evaluate their PE exposure.

Entities that play a leading role in concluding contracts between a foreign enterprise and Indian customers (although without any authority to conclude contracts) and entities

engaging distributors (including companies using subsidiaries for marketing functions) also need to revisit their existing models.

PE – exemption from specific activities – activities listed under Article 5(4) of the OECD's MC (or a combination of two of these) need to be preparatory or auxiliary activities on a stand-alone or overall basis to qualify for an exemption to constitute a PE. India has opted to apply this provision with Option A for its CTAs, and has thereby created an overall requirement for each exempted activity to be of a preparatory or auxiliary nature. However, this provision is only applicable to CTAs where the other party also chooses this option.

Corresponding adjustments – India will apply the provision of allowing corresponding adjustments in the event of transfer pricing adjustment made in the case of the other party to a transaction. This will open up access to bilateral Advance Pricing Agreements (APAs) and transfer pricing-related disputes in Mutual Agreement Procedures (MAP) for several treaties. India has refused access to disputes pertaining to transfer pricing under MAP or bilateral APAs till date in the absence of Article 9(2) in its tax treaties – especially with European countries. Adoption of Article 9(2) in India's tax treaties would facilitate settlement of transfer pricing-related disputes through MAP and bilateral APA negotiations.

Arbitration – The MLI enables countries to include mandatory binding treaty arbitration (arbitration) in their tax treaties. However, arbitration is only applicable between countries that expressly opt to apply it to their CTAs. Unless a country makes a specific reservation with respect to the scope of cases that are eligible for arbitration, all treaty-related disputes that are not resolved through MAP could be subject to arbitration.

India has opted not to apply Arbitration.

That India has chosen not to apply arbitration is ostensibly due to its concerns about its 'sovereignty'. Although this could be a hindrance to an improvement of its tax treaty dispute resolution framework, and its concerns about its sovereignty may not have much of a standing from a legal perspective, India's policy concerns as regards even-handedness, amongst others, is understandable, and there is little content in the MLI to address such apprehensions.

Many more territories are in favour of adopting arbitration, but some are keen to first see how it is applied in practice. Some other territories argue strongly against using this option. India's experience with international arbitration in the context of investment-protection treaties is perhaps the reason for its decision to not opt for the arbitration clause. In fact, most developing countries feel that their domestic mechanisms serve them better than arbitration.

6. Conclusion

The above discussion gives a fair idea of the far reaching impact that the MLI is likely to have over the landscape of international tax in India. The key to success in getting the desired result out of it seems to lie in a balanced and reasoned approach. Any transgression may be seen as attempt at overkill and may risk judicial retribution.

Multilateral treaties are not new in India. Similar legal considerations as bilateral treaties apply to multilateral treaties. Even in the field of taxation, India has had experience of entering into multilateral treaties. An instance is the multilateral tax treaty signed by Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka.

The experience with the multilateral instrument is however, new. Unlike in the existing multilateral double tax treaties, which essentially adopt a multi-party approach to OECD or UN style bilateral treaties, the multilateral instrument will give legal effect to BEPS treaty-related measures in areas where base erosion and profit shifting have been found to be pronounced.

Some technical difficulties are expected to be encountered in India. The objective of the multilateral instrument is to preclude the necessity of countries having to re-negotiate bilateral treaties. Therefore, existing bilateral treaties will remain the same, only to be read with the changes suggested by the multilateral instrument in the relevant clauses. Section 90 of the Income-tax Act, 1961, provides that a bilateral agreement entered into by the Government of India with the government of the other country is the relevant document with reference to which tax consequences will be determined. The law nowhere provides that the bilateral agreement needs to be read with the modification suggested in a multilateral instrument, which, for all purposes, is a different document. Unless this legislative mandate is provided in the Income-tax Act, it may be difficult to read multilateral instrument provisions into bilateral treaties.

Subject to such technical nitty-gritty, the multilateral instrument marks a new dimension in the evolution of India's tax treaty law. No country in the world today can claim to be immune to the effects of developments in other parts of the world. As Mr. Bolger, the then Prime Minister of New Zealand prophetically, commented in his speech of June 6, 1997;

"We live in a globalized world economy…Individual countries, no matter how large or powerful, cannot themselves deal with such transnational issues as climate change, capital flows, resource conservation and drug trafficking…The role of Government in international relations is increasingly one of identifying and aligning self-interest with the values most of its electorates hold to be important, and then protecting and projecting those values into its dealings with other Governments and international organisations…In an inter-dependent world, pure sovereignty – the complete control of one's own affairs – is not possible."[23]

[23] National Commission to Review the Working of the Constitution – A Consultation Paper on Treaty Making Power under our Constitution. January 2001.

Hence, countries are evolving towards a new mantra of concerted action among themselves. The multilateral instrument exemplifies such concert. Does acceding to the multilateral instrument indicate that a country is giving in too much to the international will in supersession to its own interest? No, says the Australian Government, Department of Foreign Affairs and Trade. In its words;

"Ratification of international treaties does not involve a handing over of sovereignty to an international body. Treaties may define the scope of a State's action, and treaties which Australia ratifies may influence the way in which Australia behaves, internationally and domestically. Implicit, however, in any Australian decision to ratify a treaty is a judgment that any limitations on the range of possible actions which may result are outweighed by the benefits which flow from the existence of a widely endorsed international agreement." [24]

The same, it may be hoped, will be the Indian view too.

[24] http://dfat.gov.au/international-relations/treaties/treaty-making-process/Pages/treaty-making-process.aspx