

# International Taxation: Resilience or Decline of MLI

**PARTHASARATHI SHOME\***

(Website [www.parthoshome.com](http://www.parthoshome.com))

**CHAIRMAN**

**INTERNATIONAL TAX RESEARCH & ANALYSIS  
FOUNDATION (ITRAF)\*\*, BANGALORE**

**VISITING FELLOW, LONDON SCHOOL OF  
ECONOMICS (TAX LAW)**

*\*Opinions expressed are the author's and should not be attributed to others*

**\*\* [www.itraf.org](http://www.itraf.org)**

# Agenda

2

- Introduction
- Actions 15, 7, 4, 8, 9, 1, 13
- Action 2 Hybrid Mismatch Arrangements
- Action 6 Treaty Abuse
- Action 14 Dispute Resolution
- Indian Domestic Legislation on Treaty Abuse: GAAR

# Introduction

- BEPS Action 15 envisages the formulation of the MLI, also called the Convention (2015 Final Report).
- The G20/OECD Multilateral Instrument (MLI) was drawn up to comprise all 15 BEPS Actions, noteworthy in its comprehensiveness.
- The structure of MLI contains Articles which are provisions pertaining to corresponding subjects of other BEPS Actions (did the correspondence exercise in my last year's FIT presentation).
- For India, the MLI represents a major commitment in the implementation of its international taxation convictions, even as challenges in advancing international taxation perspectives had already been emerging in its domestic law and treaty aspects.
- In this sense the MLI could be seen as a cross-check for most countries.

# BEPS Actions

- The BEPS Reports contain 15 Actions.
- Actions 8, 7, 4, 9 and 10 are aimed at protecting the tax base associated with value creation and thereby preventing base erosion.
- Action 1 addresses the emerging taxation challenges from international business carried out through the digital economy.
- Others address ever newer challenges, are focused on below.
- In what follows I consider all with different intensities.

# Action 8: Aligning Transfer Pricing Outcomes with Value Creation

- One orientation in the BEPS Action is to evolve a scheme of taxation based on ‘value creation’.
- The focus is on cross-border transactions involving capital – both financial and ‘intangibles’ such as goodwill or reputation.
- The idea is to ensure that a legal owner of intangibles will become less relevant while activities performed within the intangibles cycle of development, enhancement, maintenance, protection and exploitation will become more relevant.

## Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

- This Action is aimed at amending the definition of permanent establishment (PE).
- The current definition of PE, through exclusion, allows an entity resident in one state to carry on substantial economic activity in another state without being legally required to pay any tax in the latter state.
- The amended definition would align the taxation to value creation to economic activities being carried on in the other state to capture a wider tax base internationally.

## **Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments**

- Intra-group financial payments are often used to reduce the tax burden by MNEs. Entities in low tax jurisdictions are over-capitalized while thin capitalization is employed in entities in high tax jurisdictions.
- Intra-group financial payments such as interest expenses, financial and performance guarantees, derivatives, and captive insurance arrangements have lowered the tax base in countries where economic activities are actually carried out.
- To counter it, the tax base on account of value created through economic activity carried in a state would be protected against base erosion through Action 4. It would limit the deductibility of interest expense and other financial payments.

# Action 9

- This Action narrows down on transfer pricing of risks and capital.
- It would address how transfer pricing principles may be used to achieve the objective of preventing tax base erosion using interest deductibility.



# Action 1: Addressing the Tax Challenges of the Digital Economy

- This Action deals with tax challenges of the digital economy and addresses the flip side of value creation which is value consumption.
- It would evolve a scheme of taxation based on the digital footprint in the state where the consumption of products and services occurs.
- However, the OECD's recommendation on Action 1 has turned out to be weak, pushing the primary analysis to a future date.

# Action 13: Apprehension of BEPS Overreach in Accounts and Administration

10

- An increasing cynicism of BEPS comprises the likely impact of the proposed new documentation requirements under BEPS on MNEs.
- It is being proposed that MNEs operating in multiple jurisdictions have to meet tax compliance requirements of each of the jurisdictions in which they operate.
- For enhancing transparency, tax administrations would require:
  - ✓ A ‘master file’ containing information relevant for all MNE group members, providing a high–level overview of their global business operations, transfer pricing policies, and global allocation of income and economic activity. The master file is to be made available to all relevant country tax administrations.

# Contd...

- ✓ A 'local file' containing detailed information on all relevant material on intercompany transactions in each country to be provided to such country's tax administration; and
- ✓ A country-by-country (CbC) report containing certain information relating to the global allocation of the MNE group's income and taxes paid, together with certain indicators of the location of economic activity within the MNE group.

# Action 2 on Hybrid Mismatch Arrangements addresses Avoidance

12

- Some elements of MLI are obviously beneficial in reducing avoidance.
- For example, Action 2 aims to ensure that Hybrid Mismatch Arrangements that exploit differences in the tax treaty of two or more tax jurisdictions to achieve double non-taxation, including long term deferral (Action 2,) are not used to obtain the benefits of a treaty.
- Thus Action 2 calls for the development of “model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities”.

# Does Action 2 on Hybrid Mismatch Arrangements protect Taxpayers?

13

## ➤ MLI Part II Article 3 Transparent Entities

- ✓ Income derived from an arrangement that is treated as fiscally transparent by either jurisdiction that is a party to a Covered Tax Agreement (CTA), shall be considered income of a resident of either jurisdiction, but **only to the extent that that jurisdiction treats such income as income of the resident.**
- ✓ A tax exemption or deduction provision to the income of the resident of the jurisdiction, shall not apply solely because the income is also designated 'income' derived by a resident of the other jurisdiction that is party to the CTA.
- **But the protection is not guaranteed.** For example, several countries including India have reserved the rights to Article 3 in its entirety.

# Action 2 Hybrid Mismatch Arrangements (contd...)

## ➤ MLI Part II Article 4 Dual Resident Entities

- ✓ If by virtue of the provisions of a CTA, a juridical person (not an individual) is deemed to be a resident of more than one jurisdiction, then the parties to the CTA must determine by mutual agreement which jurisdiction the person is a resident of (for the CTA).
- ✓ The decision must be made giving regard to the person's place of effective management, the place where the entity is incorporated or otherwise constituted and any other relevant factors.
- ✓ In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the CTA except to the extent and in such manner as may be agreed upon.

# Action 2 Hybrid Mismatch Arrangements (contd...)

## ➤ MLI Part II Article 4 (contd.)

### ➤ Indian Position

- ✓ India has listed CTAs containing provisions not subject to reservations under Article 4.
- ✓ If all jurisdictions to a particular CTA have also listed the same provision then the said provision will be replaced by the provision of Article 4(1).
- ✓ To the extent that the CTA provision is incompatible with Article 4(1), the provision of Article 4(1) shall 'supersede' the provisions listed by India.

# Action 2 Hybrid Mismatch Arrangements (contd...)

16

Article 5, Option C: When a resident of one jurisdiction derives income or owns capital which may be taxed in the other jurisdiction, the first jurisdiction will allow a tax deduction on the income equal to the income tax paid by the resident or a tax deduction on the capital equal to the capital gains tax paid by the resident, in the second jurisdiction.

- **Indian Position:** India has reserved the rights to Article 5 in its entirety.
- Thus countries have expressed their preference to maintain their final say on such matters. This is a challenge to the MLI approach.



# Action 6 Treaty Abuse

17

- **MLI Part III Article 6 Indian Position**
  - ✓ The Indian position document is silent on Article 6
  - ✓ As a minimum standard the provision in Article 6(1) (mandatory inclusion of preambular text) can therefore be taken as automatically applicable
- **MLI Part III Article 7 Prevention of Treaty Abuse**
  - ✓ While pertaining to a minimum standard, Article 7 provides 3 options to fulfil the mandatory obligation of Action 6:

# Action 6 Treaty Abuse (contd...)

18

- ✓ Only parties wishing to adopt a detailed LOB provision are permitted to reserve Article 7 in its entirety. A detailed LOB must be combined with either rules to address conduit financing structures or a principal purpose test (Article 7(15)(a))

## ➤ Indian Position

- ✓ India has opted for the PPT provision for nearly 40 CTAs and the SLOB provision for about 10 CTAs.
- ✓ While the PPT is automatically applicable as a minimum standard, the SLOB is only applicable if all parties to a CTA opt for the same
- ✓ India has also introduced a general anti-avoidance rule (GAAR) in its domestic law, as have other countries.
- ✓ What then is the role of BEPS Action 6 Treaty Abuse?

# Action 14 Dispute Resolution

19

- **MLI Part V Article 16 Mutual Agreement Procedure (MAP)**
  - ✓ A person aggrieved by the taxation in any of the parties to a CTA due to the provisions of the CTA may approach the competent authority in either of the jurisdictions even if a remedy is available through the domestic law of the jurisdiction where the person was aggrieved. Parties must present the case within three years of the objection being raised by the person.
  - ✓ If such objection appears justified and the jurisdiction is unable to reach a satisfactory solution, the competent authorities of the parties to the CTA must aim through mutual agreement to resolve the case with a view to avoiding taxation not in accordance with the CTA.

# Action 14 Dispute Resolution: Indian position

0

## ➤ Indian Position

- ✓ India has reserved the right to the first part of the first provision, thereby disallowing aggrieved persons to approach the competent authority of any party to the CTA (as per Article 16(5)(a)).
- ✓ India reserves this provision on the basis (as permitted by the MLI) that it intends to meet the minimum standard by allowing the resident of the jurisdiction, aggrieved by a provision of the CTA, to approach the competent authority of that particular jurisdiction (instead of either jurisdiction).
- ✓ In the case of provisions based on nationality, residents will be allowed to approach the competent authority of the jurisdiction where the national belongs.

# Action 14 Dispute Resolution: Indian position (contd...)

India has listed CTAs:

- containing provisions similar to contents of Article 16(1): for cases to be presented within 3 years, of at least 3 years, and cases to be solved by mutual agreement between parties;
- not containing provisions similar to the contents of Article 16(2): mutual agreement to be implemented notwithstanding any time limit in domestic law;
- not containing provisions similar to the contents of Article 16(3): resolving issues of interpretation or application of CTA provisions through mutual agreement; or for consultation regarding cases not provided for by the CTA.

# Indian Domestic Legislation on Treaty Abuse

22

## ➤ **General Anti-Avoidance Rule (GAAR)**

- ✓ India applied GAAR from 1 April 2017
- ✓ The GAAR complements the provisions combatting treaty abuse in the MLI
- ✓ Anti avoidance rules allow authorities to analyse agreements and transactions than was previously permitted
- ✓ GAAR and similar provisions are formulated to impact companies which lack substance

## ➤ **According to the Indian GAAR :**

- ✓ An arrangement may be declared an impermissible avoidance arrangement (IIA)

# Indian Domestic Legislation on Treaty Abuse (contd...)

23

- ✓ The one thing to remember is that sometimes tax authorities may ask for more powers than envisaged by policymakers who also have to keep in mind growth and productivity of the economy and, therefore, its business interests
- ✓ In the Indian case, the final 2017 GAAR legislation which was reflective of the Shome Committee on GAAR, emerged as quite distinct than the original 2012 GAAR legislation that had to be set aside
- ✓ Thus containment with resilience is of the essence of legislation that has great in-built powers of application and possesses the sharp edge of implementation
- ✓ Only perspicacity and taxpayer focus will lead to a win-win solution

# Concluding Remarks

24

- More fundamental than how the revenue pie is shared among tax administrations is how accountability and compliance costs would be dealt with between global tax authorities and MNEs. MNEs have been productive in technology, in supply, and in raising standards of living globally.
- For MNE tax performance, they must be segmented into good and bad performers. There are likely to be good taxpayers even among those who fall above the high threshold that BEPS Action 13 has stipulated for the detailed 3-step—master file, country-by-country, local—reporting of their global operations. I have shown using an econometric model that MNEs in India have habitually paid more tax than domestic companies in terms of revenue or profit. Perhaps MNEs are more cautious or subject to deeper scrutiny. (P. Shome ed. (2016), *BEPS*, Ch 5, Wolters Kluwer, New Delhi).
- A heavy handed reporting applied to all MNEs is detrimental to global productivity and growth. Otherwise Action 13 could be scaled back in future deliberations reflecting concerns over lagging global growth that were in any event the main motivator of G20's revival while BEPS and revenue increase were only its outcomes.



# References

25

Bernardi, L., Frascini, A. and Shome, P. (edited). 2006. *Tax Systems and Tax Reforms in South and East Asia*, Routledge, Oxford.

Baistrocchi, Eduardo (edited). 2017. *A Global Analysis of Tax Treaty Disputes*, Cambridge University Press, London.

Baker, Philip and Piston, Pasquale. 2015. 'The Practical Protection of Taxpayers' Fundamental Rights,' General Report, *International Fiscal Association*, 2015 Basel Congress, Volume 100B.

Gupta, Sunil. 2016. 'BEPS Actions: Concerns, Ramifications, Conclusions', in Shome ed. (2016, Chapter 11).

Manohar, Navneet. 2014. 'Computation of MAT', in Shome (2014, V.4, Appendix).

Nuggehalli, Nigam, , 2016. 'Multilateralism in the BEPS Initiative: Pros and Cons', in Shome ed. (2016, Chapter 9).

Rohtagi, Roy. 2005. *Basic International Taxation: Principles*, Vol. I (2nd ed.), Oxford University Press, Richmond, United Kingdom.

# References contd...

26

Shome, Parthasarathi and Schutte, Christian. 1993. “Cash-Flow Tax, Staff Papers, Vol. 40, No. 3, pp 638-662, International Monetary Fund, Washington D.C.

\_\_\_\_\_. 2011. “Fiscal Stimuli and Consolidation,” in Olivier J. Blanchard, David Romer, Michael Spence, and Joseph E. Stiglitz ed., *In the Wake of the Crisis: Leading Economists Reassess Economic Policy*, International Monetary Fund, M.I.T Press, Cambridge, Massachusetts.

\_\_\_\_\_ (Chairman). 2012. *Expert Committee on General Anti-Avoidance Rules (GAAR)*, Government of India.

\_\_\_\_\_. 2012. *Tax Shastra: Administrative Reforms in India, United Kingdom and Brazil*, Business Standard Books, New Delhi.

\_\_\_\_\_. 2012. “Rebalancing and Structural Policies—An Indian Perspective,” *Oxford Review of Economic Policy*, Volume 28, Number 3, pp. 587–602.

\_\_\_\_\_ (edited). 2013a. *Indian Tax Administration: A Dialogue*, Orient Blackswan, New Delhi. Paper: “Introduction”.

# References contd...

27

\_\_\_\_\_. 2013b. “Political Economy of Debt Accumulation and Fiscal Adjustment in a Financial Crisis,” in Deepak Mohanty ed. *Monetary Policy, Sovereign Debt and Financial Stability: The New Trilemma*, Cambridge University Press, India.

\_\_\_\_\_. 2014. *Taxation Principles and Applications: A Compendium*, Lexis Nexis, New Delhi. See various chapters on VAT and GST in an international context.

\_\_\_\_\_ (edited). 2015. *The G20 Development Agenda: An Indian Perspective*, Cambridge University Press, New Delhi.

## Papers:

“Introduction- Group of G20”, Chapter-1.

“Greening the G20 Agenda: A Way Forward”, Chapter-7.

\_\_\_\_\_ (Chairman). 2015. *Tax Administration Reform in India: Spirit, Purpose and Empowerment (Volume- 4)*, Report of the Tax Administration Reform Commission (TARC), Ministry of Finance, Government of India, New Delhi.

# References contd...

28

\_\_\_\_\_ (edited). 2016a. Base Erosion and Profit Shifting (BEPS): The Global Taxation Agenda, International Tax Research and Analysis Foundation (ITRAF), Wolters Kluwer, New Delhi. See chapters:

“Introduction- A Review of Chapters”, Chapter-1.

“Impact of Firm Characteristics on Firm Revenue and Tax”, Chapter-5

\_\_\_\_\_ (edited). 2016b. Insights into Evolving Issues of Taxation: Existing and Continuing Challenges, International Tax Research and Analysis Foundation (ITRAF), Wolters Kluwer, New Delhi.

See chapter: “Introduction- Taxation Issues under Discussion and Continuing Challenges”, Chapter-1.

\_\_\_\_\_. 2018a. “Contours of Tax Design”, London School of Economics Working Paper No. 11, Law Programme/Tax, London, June. Available at:

[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3199902](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3199902)

\_\_\_\_\_. 2018b. “General Anti Avoidance Rule (GAAR): A Critical Analysis”, London School of Economics Working Paper, Law Programme/Tax, London, December (forthcoming).