

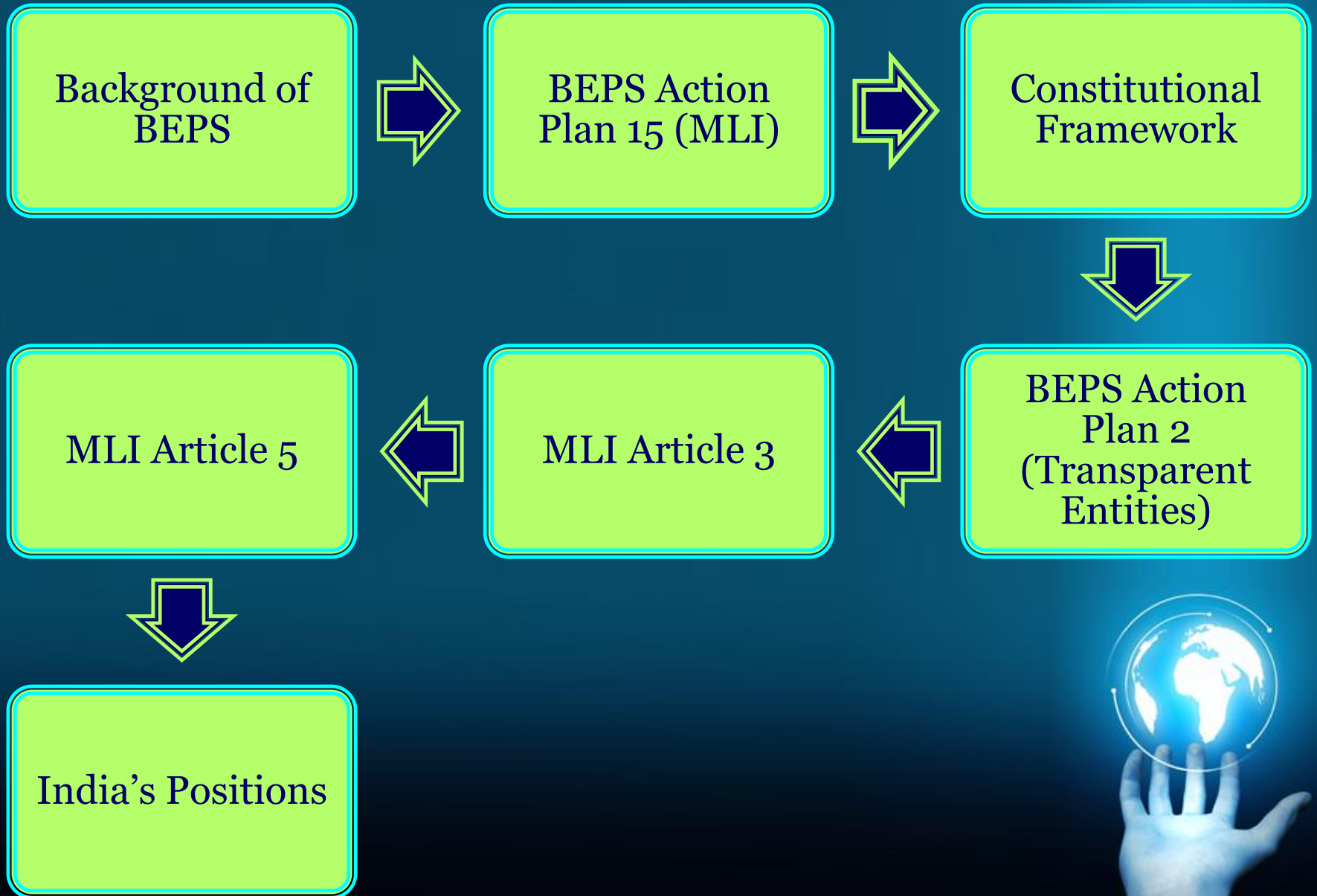
Transparent
Entities and
Elimination of
double taxation
– Article 3 and 5
of MLI

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Background of BEPS



Background

- ★ Increased integration of national economies and markets has put a strain on the international tax framework, which was designed more than a century ago
- ★ The current rules have revealed weaknesses that create opportunities for Base Erosion and Profit Shifting (BEPS)
- ★ G20 countries mandated the Organisation for Economic Co-operation and Development (OECD) to come out with recommendations to prevent BEPS. With the intention of :
 - ★ Restoring the trust of ordinary people in the fairness of their tax systems;
 - ★ Creating a level playing field among businesses; and
 - ★ Providing governments with more efficient tools to ensure the effectiveness of their sovereign tax policies



Introduction to BEPS

- ★ The OECD released the final BEPS package in October 2015 to
 - ★ Prevent double taxation
 - ★ Prevent no or low taxation by shifting of profits
 - ★ Ensure fair share of tax revenues
 - ★ Prevent treaty abuse
- ★ What's in the BEPS Package?
 - ★ Minimum standards
 - ★ Reinforced international standards on tax treaties and transfer pricing
 - ★ Common approaches and best practices for domestic law measures
 - ★ Analytical reports with recommendations (digital economy and multilateral instrument)
 - ★ Detailed report on measuring BEPS



BEPS Action Plan 15 – Developing a Multilateral Instrument to Modify Bilateral Tax Treaties



Overview of BEPS Action 15

- ★ Objective is to facilitate countries interested in implementing tax treaty-related BEPS measures
- ★ A multilateral instrument (MLI) – over 100 countries – ‘modify’ bilateral tax treaties between them
- ★ Minimum standard provisions – have to be applied; others – optional, reservations possible
- ★ Treaty between 2 countries changed only if **both** countries accept the provisions (without reservations)
- ★ Notification – countries need to notify existing treaties containing provisions referred to
- ★ Interpretation – using existing treaty – otherwise explanatory statement
- ★ Not an amending protocol – operates alongside existing treaties



Constitutional Framework of MLI



CONSTITUTION DAY



Constitutional framework

- ★ The Constitution of India accepts the federal principle as the basis of constitutional organisation
- ★ The division of powers and functions between the centre and states being one of the essential characteristics of our Constitution, it becomes incumbent to consider in their entirety and applicability the following issues:
 - ★ In whom does the power to make and implement treaties reside?
 - ★ What position do treaties enjoy under the Constitution? Are treaties superior to the Constitution or the law of the land?
 - ★ Do treaties under the Constitution, in order to be effective, require ratification and/or approval ?
 - ★ If yes, in whom does the power lie and what would be the effect of non-exercise of that power on treaties ?



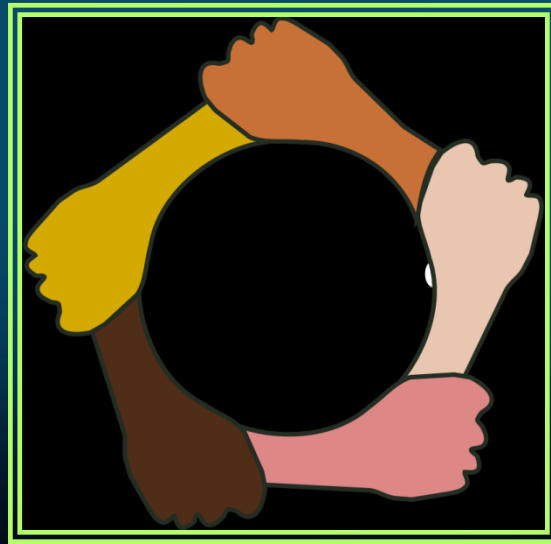
Constitutional framework

- ★ The various provisions that govern India's 'foreign affairs/ treaties' are laid down in Articles 51, 73 and 253 read with a number of entries enumerated in List I of Schedule VII of the Constitution
- ★ By virtue of Articles 245 and 246 read with the above said entries of List I of Schedule VII, only Parliament has power to legislate on the subject of

“entering into treaties and agreements with foreign countries and implementing of such treaties, agreements and conventions”



BEPS Action Plan 2 – Neutralising the Effects of Hybrid Mismatch Arrangements



Overview of BEPS Action Plan 2

- ★ MLI incorporates the recommendations in the BEPS Action Plan 2 Final Report
- ★ Hybrid mismatch arrangements
 - ★ exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax countries to produce a mismatch in tax outcomes where the mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement
- ★ Thus, a taxpayer with activities in more than one country may have opportunities to escape/ reduce tax through the use of hybrid mismatch arrangements
- ★ To address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity



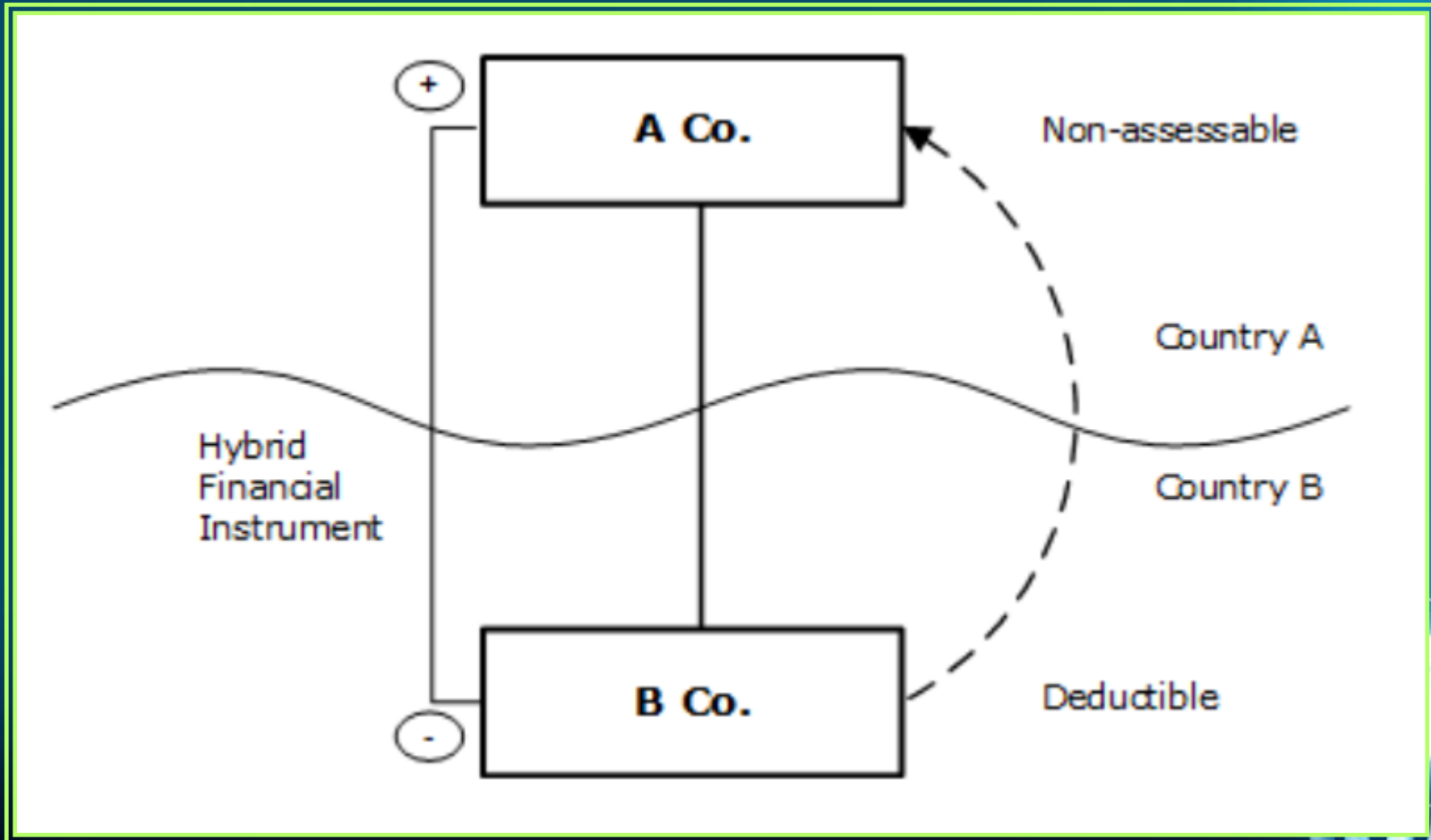
Overview of BEPS Action Plan 2

- ★ Action 2 of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) calls for domestic rules targeting mismatches that rely on a hybrid element to produce the following three tax advantage outcomes:
 - ★ Deduction no inclusion (D/NI): Payments that give rise to a deduction under the rules of one country but are not included as taxable income for the recipient in another. (refer illustration below)
 - ★ Double deduction (DD): Payments that give rise to two deductions for the same payment
 - ★ Indirect deduction no inclusion (indirect D/NI): Payments that are deductible under the rules of the payer country and where the income is taxable to the payee, but offset against a deduction under a hybrid mismatch arrangement



Overview of BEPS Action Plan 2

Illustration on Deduction no inclusion (D/NI):



Overview of BEPS Action Plan 2

- ★ In broad terms, hybrid mismatch arrangements can be divided into the following categories based on the particular hybrid technique that produces the tax outcome:
 - ★ *Hybrid instruments* exploit a conflict in the tax treatment of an instrument in two or more countries.
 - ★ *Hybrid entities* exploit a difference in the tax treatment of an entity in two or more countries (generally a conflict between transparency and opacity)
- ★ Hybrid entities and instruments can be embedded in a wider arrangement or structure to produce indirect D/NI outcomes



Overview of BEPS Action Plan 2

- ★ This report sets out those recommendations:
 - ★ Part I contains recommendations for changes to domestic law and
 - ★ Part II sets out recommended changes to the OECD Model Tax Convention
- ★ Action Plan 2 proposed implementation as regards transparent entities is as below:
 - ★ Amendment to Model Tax Convention 2017 (Article 1 replaced)
 - ★ Amendment to Commentary to Model Tax Convention (Under Article 1, Paragraphs 2 to 16 inserted)
- ★ MLI enables the bilateral tax treaties to be amended to incorporate the changes envisaged in BEPS Action Plans
- ★ Part II – Article 3 of the MLI incorporates the suggestions of Action Plan 2 to amend the bilateral tax treaties, for the purposes of Fiscally Transparent Entities (TE)



MLI Article 3 – Transparent Entities



Article 3 – Transparent Entities

- ★ Transparent entities - partnerships, trusts and other non-corporate entities which are treated as fiscally transparent under the domestic taxation laws
- ★ Article 3 of Part II of the MLI, which deals with Hybrid Mismatches, states that:
 - ★ Income derived
 - ★ by or through an entity or arrangement that is treated as wholly or partly fiscally transparent
 - ★ shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction



Illustration I

- ★ P is a partnership firm established in State P
- ★ A and B are P's partners who reside in State P
- ★ Both States P and S treat P as a transparent entity
- ★ P derives interest income from State S that is not attributable to a permanent establishment (PE) in State S
- ★ Impact?

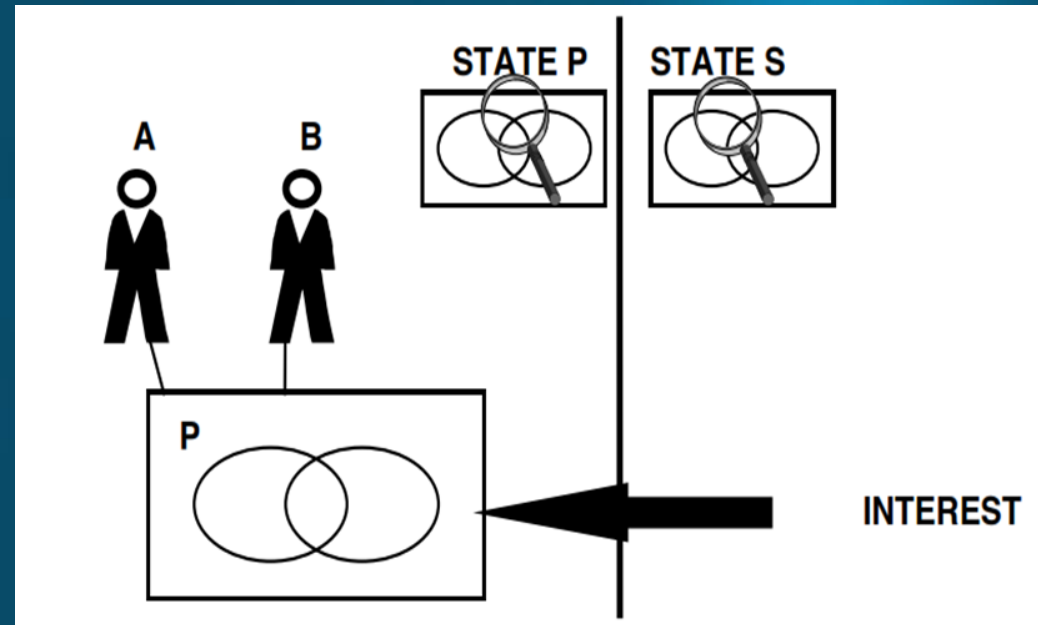
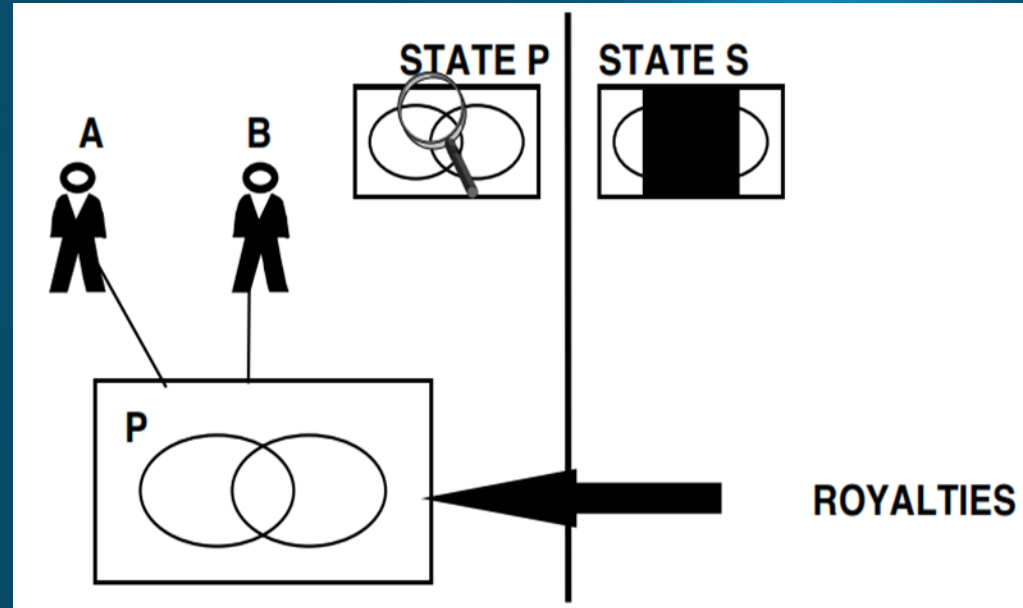


Illustration II

- ★ P is a partnership firm established in State P
- ★ A and B are P's partners who reside in State P
- ★ **State P treats P as a transparent entity while State S treats it as a taxable entity**
- ★ P derives royalty income from State S that is not attributable to a PE in State S
- ★ Impact?



MLI Article 5 – Application of Methods for Elimination of Double Taxation in respect of transparent entities



Article 5 – Elimination of double taxation in respect of transparent entities

These provisions are pari-materia similar to paragraph 2 of Article 3 of MLI

Option C of Article 5 states that:

- ★ Where a resident of a Contracting Jurisdiction derives income or owns capital
- ★ *which* may be taxed in the other Contracting Jurisdiction in accordance with the provisions of a Covered Tax Agreement
- ★ (except to the extent that these provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction),



Article 5 – Elimination of double taxation in respect of transparent entities

- ★ The first-mentioned Contracting Jurisdiction shall allow:
 - ★ as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other Contracting Jurisdiction;
 - ★ as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other Contracting Jurisdiction

- ★ Such deduction shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable to the income or the capital which may be taxed in that other Contracting Jurisdiction



Illustration III

on paragraph 2 of Article 3 and Article 5

- ★ An entity X established in State R constitutes a resident of State R and is therefore taxed on its worldwide income in that State
- ★ State S treats X as a fiscally transparent entity and taxes the members of X
- ★ All the members of X are residents of State S
- ★ All the income of X constitutes business profits in State R
- ★ In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Option C of Article 5 of MLI with respect to the income of X; **as the only reason** why State S may tax that income is because of the **residence of the members of X**
- ★ State S, on the other hand, will be required to provide relief under Option C of Article 5 of MLI with respect to the entire income of X



Article 3..... (Other Provisions)

- ★ Paragraph 3 of Article 3 is an enabling provision which states that, Contracting Jurisdiction's right to tax the residents shall not be affected
- ★ Paragraph 4 is the compatibility clause, which addresses the relationship between Article 3(1) and existing provisions of the same type.
- ★ Paragraph 4 provides that Article 3(1) or the existing provisions of the CTA shall determine which State has the taxing rights of fiscally transparent entities based on residence
- ★ Paragraph 5 is the right of reservation provided in the MLI for incorporating the provisions of Article 3 in the bilateral tax treaties
- ★ Paragraph 6 provides the procedure for adopting Article 3 in its entirety or with reservations, depending upon whether the CTA has or does not have similar provisions



Article 5..... (Other Provisions)

- ★ Option A of Article 5 addresses the situations arising from the exemption method followed by countries to avoid double taxation
- ★ In case of income being exempt in the State of residence and also in the source State; there would be no relieving of double taxation by the State of residence
- ★ However, in situations where income is taxed at a reduced rate by the source State, the country of residence will relieve such double taxation
- ★ E.g. interest, royalties, etc.



Article 5..... (Other Provisions)

- ★ Option B of Article 5 allows Contracting Jurisdictions not to apply the exemption method with respect to dividends that are deductible in the source State i.e. Contracting Jurisdiction of the payer
- ★ Option B is the basis whereby the MLI addresses the issue of treaty abuse in case of hybrid financial instruments which have opposite effect in the two states
- ★ Paragraphs 7 to 10 are the enabling provisions for Article 5



Illustration IV

ABC Ltd.,
Incorporated in Stated A

**Considered as a opaque entity
and subjected to tax in State A**

Payment of
interest

Withholding
of taxes

State A

State B

Interest taxed
in State B in
the hands of P

Member P:
Resident of
State B

State C

Interest taxed
in State C in
the hands of Q

X LLC
Incorporated in State B

Member Q –
Resident of
State C

**Considered as a transparent entity and
members are liable to tax in State B**



Impact after MLI

- ★ Which treaty to be applied by ABC Ltd. for withholding of tax on interest payment?
- ★ How the MLI will affect the grant of credit by the respective states, where the interest is taxed?



Impact of MLI on India



India's Position

MLI	Model Article	Comments	India's Position
Art. 3 – Transparent entities	1	Deals with taxation of transparent entities	Opted Out
Art 5 – Application of methods for elimination of double taxation	23A/ 23B	Addresses the situation of the Source State exempting any income or taxing income at a reduce rate; or grant credit to the extent of tax paid in the source state	Opted Out



India-UK MLI Impact

★ Article 4(1)(b) of the India-UK Tax Treaty provides that:

“in the case of income derived by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries”

★ Since, UK has not reserved the rights for the provisions of paragraph 1 of Article 3, to not apply to its CTAs, paragraph 1 will apply in the absence of or in place of similar provisions in all of its CTAs (to the extent that its treaty partners have not made a reservation).



India-UK MLI Impact

- ★ The India-UK Tax Treaty (refer Article 4(1)(b) set out above) contains specific provisions allowing for the granting of treaty benefits where income derived by a fiscally transparent entity, such as a trust or partnership is subject to tax in its hands or in the hands of the partners or members of such transparent entity
- ★ The courts in India have also had an opportunity to consider the eligibility of transparent entities to treaty benefits. In *Linklaters LLP vs. ITO* and *Clifford Chance vs. DCIT* it was held that a UK partnership was eligible to claim benefits of the India-UK Treaty, where the partners were subject to tax in the UK



Transparent Entities (TEs)

- ★ Generally, a partnership does not need to comply with the 'liable to tax' requirement in order to be eligible for treaty benefits to the extent that the partnership is treated as transparent in its jurisdiction of formation/ taxation, and income is not taxed in the hands of the partnership
- ★ However, treaty benefits should be available to the extent the partners of such a TE are subject to tax (in their residence state) on the same income
- ★ India's position is that neither a TE nor a partner is entitled to a treaty benefit, since the country follows the entity-level approach to taxation
- ★ However, treaty benefits are provided to the TE or its partners, but only if a treaty explicitly provides for this, e.g., under the India-US and India-UK tax treaties



Transparent Entities (TEs)

- ★ As stated above, Indian courts have taken varying positions on this subject. For instance, a court has held that since Linklaters LLP and Clifford Chance hold a UK partnership and the partners were subject to tax in the country, they are eligible to claim the benefits of the India-UK treaty
- ★ However, in Schellenberg Wittmer, the Authority for Advance Rulings (AAR) took a contrary view and held that a Swiss general partnership was not entitled to treaty benefits since it is a TE
- ★ In light of the above, TEs may continue to face challenges in claiming treaty benefits, and this could result in double taxation, wherein India may subject the TE to taxation at entity level, while the resident state may not grant credit for taxes paid in India





THANK YOU

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