BMR Legal
ADVOCATES

Mukesh Butani

MLI Interpretation in the Indian context & impact on key treaties

IFA YIN Conference
Agra
November 9, 2019

Overview of Presentation

- Setting the Context
- Relevance of Vienna Convention on Law of Treaties
- Interpretation of OECD Model Convention & Challenges
- Interpretation of International law and Indian constitution

Setting the Context

- MLI, an outcome of BEPS Action Plan ("AP") 15 under Inclusive Framework ("IF"), offering solutions for governments to plugs loopholes in international tax treaties by transposing results from BEPS project into bilateral tax treaties.
- No 'a la carte' - MLI does not permit treaty-by treaty choices.
- Co-exists with existing treaties.
- Contains minimum standards for 'Prevention of Treaty abuse' (Action 6) and 'Improvement of Dispute Resolution' (Action 14).
- Treaty partners to notify existing treaty provisions, 'Covered Tax Agreements' ('CTAs').
- As of 30 October 2019, 37 jurisdictions deposited their instruments of ratification, acceptance or approval ('ratification instrument') with OECD Secretariat along with their list of reservations and notifications ('MLI positions').
- Treaty partners can unilaterally choose to reserve right for entire Article or sub-set ('opt out') for not applying MLI provision(s).

India's MLI position:

Signed MLI on June 7, 2017 and deposited its instrument of ratification (with OECD) on June 25, 2019

Illustration:
India, in its final position continues to apply PPT (interim measure) plus Simplified Limitation of Benefit ('SLOB').

India expressed intention to adopt Limitation of Benefits provision in addition to or in replacement to PPT, subject to bilateral negotiation.

Rationale: Possibly to allow flexibility in effective implementation of minimum standard provision under Article 7.

Relevance of Vienna Convention on Law of Treaties ('VCLT') in interpreting Treaty Provisions

BMR Legal ADVOCATES

- **VCLT, an international law on treaties between states.**
- **Widely recognized as an authoritative guide for interpretation.**

Article 31
• 'Good faith' principle in accordance with the ordinary meaning to be given in their context and in the light of its object and purpose. • The context of a treaty shall comprise, in addition to the test, 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.

Article 38
• Nothing in Article 34 (General Rules regarding Third States), Article 35 (Treaties providing for Obligations for Third States), Article 36 Treaties providing for Rights for Third States), Article 37 (Revocation or Modification of Obligations or Rights of Third States), precludes a rule set forth in a treaty from becoming binding upon a third State as a customary rule international law, recognized as such.

Observation of Indian Judiciary on importance of VCLT

BMR Legal ADVOCATES

Ram Jethmalani v. UOI (2011) 8 SCC 1 (SC)

"While India is not a party to the Vienna Convention, it contains many principles of customary international law. The principle of interpretation, (Article 31) of the Vienna Convention, provides a broad guideline as to what could be an appropriate manner of interpreting a treaty in the Indian context."

Awas Ireland Ltd and Ors v. DGCA 2015 SCC OnLine Del 8177

"The provisions of Article 51(c) of the Constitution when read with Article 26, 27 and 31 of the Vienna Convention clearly cast an obligation on the contracting State to not only remain bound by the terms of a treaty entered into by it but also obliges the State not to cite internal law (read municipal law), as a justification for failure to perform its obligation under a treaty. An international Convention, i.e., a treaty, is required to be interpreted in good faith, in accordance with the ordinary meaning given to the terms of the treaty, in their context, and in the light of its stated object and purpose."

Interpretation of MLI (Literal v. Contextual)

BMR Legal
ADVOCATES

- Delhi Income Tax Appellate Tribunal ("ITAT") has held that treaties should not be interpreted as a statute but instead be interpreted as agreements. Hence, ordinary meanings given to words in a treaty, within their context, and object and purpose of treaty, should be used for interpretation, as held in ***New Skies Satellites N.V. v. ADIT*** [2009] 121 ITD 1 (ITAT Delhi).

- Mumbai ITAT in ***Mashreqbank PSC v. Dy. DIT (International Taxation)*** [2007] 14 SOT 1 (ITAT Mum.) has held that a literal or legalistic meaning is to be avoided if it defeats the object of a treaty. Therefore, a harmonious interpretation should be adopted.

- Reasonable to conclude that interpretation of MLI may be based contextually, rather than literally.

Interpretative value of OECD Model Convention

BMR Legal
ADVOCATES

Indian Jurisprudence:

- Tribunals and courts have ruled inconsistently though on facts of each case both in favor of, and against, relying on OECD Commentary for treaty interpretation.
- In ***UOI v. Azadi Bachao Andolan*** (2003) 132 Taxman 373, SC referred to OECD MC and Commentary for interpreting the term ''liable to tax'' in article 4(1) of India-Maurtius treaty. However, reference for interpretation was limited.
- SC in ***CIT v. P.V.A.L. Kulandagan Chettiar*** [2004] 137 Taxman 460 (SC), held that Section 90 of Income-tax Act, 1961 (”Act”) enables government to formulate its policy through treaties. Hence, to interpret a particular treaty, it would be unnecessary to refer OECD Commentary.
- Mumbai ITAT in ***Metchem Canada Inc. v. DCIT*** [2006] 100 ITD 251 (ITAT Mumbai), held that for contextual interpretation, unless a contrary intention is specifically expressed, it is only axiomatic that a clause or expression in treaty shall have same meaning as normally assigned to it in OECD's tax literature.
- Delhi HC in ***Asia Satellite Telecommunications Co. Ltd. v. DIT*** [2010] 332 ITR 340, held that when technical terms are used in a treaty and are same as in domestic law, then OECD Commentary can always be relied upon.

Interpretative value of OECD MC (an international soft law)

BMR Legal ADVOCATES

- Delhi ITAT in ***Gracemac Corpn. v. ADIT*** [2010] 42 SOT 550, held that OECD Commentary contains views of authors; Commentary cannot be equated with law enacted by Parliament or decisions of SC. Therefore, while interpreting provisions of domestic law or tax treaty, reliance cannot be placed on OECD Commentary.
- **If OECD MC and Commentary cannot be entirely relied upon for purpose of contextual interpretation, OECD BEPS Action Plans ("AP") incorporated in treaties with MLI, shall become a matter of Indian judicial interpretation.**
- **Will contextual meaning provided in relevant APs and Explanatory Statement become meaningless?**
- **Conversely, if wider acceptance is given to OECD MC to interpret India's tax treaties, it could lead to better (i.e. more harmonious and contextual) interpretation of MLI.**

Interpretative value of OECD MC - Challenges

BMR Legal
ADVOCATES

- India not a member of OECD.
- India a member of the Governing Board of OECD's Tax Development Centre.
- Since 2008, India has expressed selectively stated its reservations on various provisions in OECD MC and Commentary.
- **Can India's act of expressing reservations be taken to mean ratification of "unreserved" clauses of OECD MC and Commentary?**
- Considering Indian jurisprudence, it may be argued that OECD MC and Commentary have evolved as "international customary law" for interpretation of treaties.
- Being a non-OECD member, can India deny acceptance of OECD MC, Commentary and Explanatory Statement for interpreting tax treaties. How will courts interpret?
- Interpretation of MLI without precise (domestic) interpretation tools could be challenging and may lead to litigation, leaving courts to lay down principles.

Fiction on interpretation

- ‘Good faith’ principle under VCLT is the primary reason why Indian courts referred to OECD Commentary for interpretation.
- Article 31(2) of VCLT provides for contextual interpretation for an agreement relating to treaty, made between the parties in connection with conclusion of treaty.
- Purpose of Article 27 of VCLT is to re-assert the fundamental principle that treaties obligations must be performed in good faith.
- Reference to OECD Commentary or Explanatory Statement useful to interpret MLI. Such references would be countered by countries through reservations.
- India’s tax treaties have no reference to OECD Commentary; treaties have evolved as an amalgam of UN and OECD MCs.
- India considering to develop its own model. Such model with interpretation tools should be made available to tax payers.

Fiction on treaty Interpretation and Constitution of India

BMR Legal ADVOCATES

- Article 51(c) of Constitution provides that India shall respect all the provisions related to international law and shall make its best efforts to fulfill its treaty obligations.
- However, Article 37 provides that provisions contained in part IV (Directive principles) shall not be enforceable by any court. Nevertheless they are crucial in the governance and its the duty to ensure that these principles are applied while making laws.
- Lord Denning in ***Corocraft v. Pan American Airways*** (1969) 1 All E.R. 82; 87, observed that "it is the duty of these courts to construe our Legislation so as to be in conformity with international law and not in conflict with it." (Quoted in ***Keshavananda Bharati v. State of Kerala*** AIR 1973 SC 1461)
- **Cases decided by High courts and the Supreme Court reflect the dualist approach of the Indian legal system.**
- Justice Krishna Iyer in ***Jolly George Verghese & Anr vs The Bank Of Cochin*** 1980 AIR 470, 1980 SCR (2) 913 stated "Even so, until the municipal law is changed to accommodate the Covenant what binds the court is the former, not the latter.
- SC in ***State Of West Bengal vs Kesoram Industries Ltd. And Ors*** AIR 2005 SC 1646, held the "doctrine of dualism" and that "a treaty entered into by India cannot become law of the land and it cannot be implemented unless Parliament passes a law as required under Article 253". SC drew distinction between interpretation of legislation in conformity with international principles and giving effect to a Treaty provision in absence of Municipal Laws.

Fiction on treaty Interpretation and Constitution of India (Cont.)

BMR Legal
ADVOCATES

- Madras HC in ***T. Rajkumar v. Union of India***, 2016 SCC Online Mad 2001 dealt with constitutionality of Section 94A(1) of the Income Tax Act, 1961.
- Court stated that effect of Article 253 was only to remove fetters placed on the legislative competence of Parliament by Articles 246, 249 and 250 and lists mentioned in Seventh Schedule.
- It enabled the Parliament to make laws on any matter mentioned in any of the three lists to implement an international obligation.
- Nothing in Article 253 suggests that a law enacted would be placed on a higher pedestal than a law made under Article 246(1).
- Court opined that nowhere did the Constitution consider such a dichotomy.
- Provisions of VCLT and other such rules of international law did not influence the legislative powers of Parliament.

Interpretative Value of Explanatory Statement to MLI

- Discourages usage of explanatory statement as an interpretational aid (as stated in Explanatory statement to MLI)
- However, explanatory statement is significant since:

- Supplementary material developed in the course of BEPS project – helpful in providing contextual and harmonious interpretation of MLI.
- Clarifies an approach taken in the convention.
- Reflects an understanding of negotiators as to how each provision in intended to affect and modify the articles covered by the convention.
- Emphasizes on the sanctity of OECD commentary 2017 MC.

Interpretative value of BEPS Action Reports

- Actions were developed in the Context of Political mandate to equip governments (with domestic and international rules and instruments) to address tax avoidance and tax profits in the place of economic activities.

- Explanatory Statement to MLI point towards importance to Final Action Reports for the purpose of interpretation of Article 3-17 of MLI.

- **Illustration**:– Terms such as ‘arrangement or transactions’, ‘relevant facts and circumstances’ ‘one of the principal purpose’ not defined. For decoding such phrases and functionality of Article 7, Action 6 BEPS report is of significance.

Relevance of Preamble under Article 6 of MLI

- Plays an important role in interpretation, since it constitutes the context of the treaty. Its importance highlighted in Article 31 (1) of VCLT.

- Recognizes that the purpose of a tax treaty is not limited to elimination of double taxation but also to not create opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

- The purpose and context of tax treaty is reflected in its preamble. Article 7 containing PPT provides substance to the preamble in Article 6.

- Interpretative impact of preamble – The new preamble assists in identifying 'benefit' under treaty and 'relevant facts and circumstances' under Article 7 of MLI. The new preamble will also affect how the purpose of relevant treaty provisions under the PPT (second main element of PPT) will be determined.

Interpretation of International Law

Article 7 (1) of Multilateral Instrument – The Principal Purpose Test (PPT)

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

Elements under PPT

BMR Legal
ADVOCATES

I. “Any arrangement or transaction”

- Commentary on Article 29(9) of the OECD MC (2017) provides that “any agreement, understanding, scheme, transactions, whether or not they are legally enforceable”, to be included.
- Since, one or series of transactions is covered by PPT, one transaction alone may result in treaty benefit or it may act in conjunction with more elaborate series of transactions.
- The term can also encompass in particular “the creation, assignment, acquisition or transfer of the income itself, or of the property, right in respect of which the income accrues, arrangements concerning the establishment, acquisition or maintenance of person who derives the income, determination of that person as a resident of one of the contracting states, and includes steps such persons may take themselves in order to establish such residence”.
- Such a broach approach to the definition is important to preclude schemes, including development of new schemes (created to override otherwise more specific prohibitions embedded in tax treaties).

II. “A benefit” under the tax treaty

- Commentary to the PPT stipulates that ‘benefit’ includes all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on state of source under Article 6 through 22 of the Convention, the relief from double taxation provided by Article 23 and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations.
- Can protection from discrimination derived from Article 24 of OECD MC can constitute benefit that can be obtained abusively. Denying benefit under Article 24 of OECD MC via PPT would violate principle of non-discrimination, which has an absolute character from which contracting states may therefore not derogate.
- Whether the authorization to initiate a mutual agreement procedure and subsequently an arbitration procedure according to Article 25 of the OECD model could be denied under the term “benefit”? – No, since these procedural rules will not themselves constitute benefit under the treaty.
- Double Taxation to also be considered as a “benefit under this convention”.

III. “Reasonable to conclude”/Burden of Proof

- The element of ‘reasonability’ aims to ensure that the taxpayers cannot circumvent the application of PPT by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain treaty benefits.
- Rather, relevant facts and circumstances are to be considered for determining application of PPT and the possibility of different interpretations of such facts and circumstances must also be objectively considered.
- Bias in favour of tax authority – Tax authorities will be tempted to presume intention simply because of the presence of the benefit.
- The threshold under PPT is set very low, since it does not require tax authorities to ‘establish’ beyond reasonable doubt.
- Burden of Proof under PPT is on tax authorities only in the initial stage (to fulfil first element of PPT) which effectively shifts on the tax payer (second element of PPT). This could undo the balance between taxpayer and tax authorities since it is much easier to prove first element as compared to the second element (exception clause to PPT).

IV. “One of the principal purposes”

- ‘One of the principal purposes’ means that obtaining the benefit under a tax convention need not be sole or dominant purpose of a particular arrangement or transactions.
- The provision does not require ‘sole purpose’; further the purpose does not have to be ‘essential’ or ‘principal’. Therefore, the rule assumes not only one principal purpose but two or three or even several principal purposes can exist.
- PPT does not try to distinguish between abusive and non-abusive situations for combating tax avoidance, and consequently it targets all transactions that potentially might be but are not always abusive.
- Dangerously low threshold - Tax treaties are designed to promote investments, free movement of goods, services and capital between jurisdictions by eliminating double taxation. A widely worded rule such as PPT may destroy treaties rather than effecting balance between eliminating double taxation and preventing abusive treaty shopping .
- Biased towards tax authorities since they need not produce full evidence to prove beyond reasonable doubt.

Methods of interpretation- *Lex Posterior v. Lex Specialis*

BMR Legal ADVOCATES

Lex Posterior

- Later-in-time principle prevails if two treaties cannot be reconciled or if the first treaty is repealed by express words or implications.
- If provisions of MLI are in conflict with tax treaty, MLI will prevail over treaty, to the extent of conflict.
- SC in ***Chandra Prakash Tiwari and Ors. V. Shakuntala Shukla and Ors.*** (2002) 3 SCR 948 (SC), upheld *lex posterior* principle.

Lex Specialis

- Prevalence of a special rule over general rule.
- For MLI, in case of a conflict between MLI and tax treaty, the rule is "specific" prevails.
- In ***Sanwarmal Kejriwal v. Vishwa Cooperative Housing Society Limited*** **1990 SCR (1) 862 (SC),** ***DIT-II v. OHM Ltd*** [2013] 352 ITR 406 (HC Delhi) and ***CIT v. Copes Vulcan Inc.*** [1987] 167 ITR 884 (HC Madras), Indian courts have upheld the principle.

Examples – upholding *Lex specialis* Principle

BMR Legal
ADVOCATES

- The wordings of the PPT rule also seem to be in consonance with *lex specialis* principle.
- Article 7(1) begins with the words “Notwithstanding any provisions of [a tax treaty]”.
- This depicts that PPT will take precedence over other specific treaty rules. The rule of precedence under the PPT actually raises the bar to avail treaty benefits to an extreme level.
- Taxpayers who are residents of a contracting states, beneficial owners of an income who are entitled to treaty benefits under the MLI’s LOB rule and comply with all other potential treaty specific anti-abuse rules, may nevertheless be deprived of treaty benefits under PPT.

- **Even if one considers PPT as a general treaty rule (treaty GAAR) , the *lex specialis* derogate *legi generali* maxim cannot be applied to let a specific rule (MLI LOB) override an application of PPT to a case covered by both rules. This follows the principle that a written law (rule of precedence included in PPT) generally prevails over unwritten principles and maxims *lex specialis*.**

Challenges/Recommendations on PPT

BMR Legal
ADVOCATES

- In so far as PPT hands vast discretion power to the executive, its suitability to prevent treaty abuse is questionable due to lack of certain degree of legal certainty.

- The adoption of PPT is highly dependent on tax authorities approach – varying significantly across jurisdictions. This may lead to defragmentation of a common approach in interpreting and application of the PPT provision.

- Further PPT raises serious doubts about an appropriate judicial review of tax administrative decisions that may be issued under PPT.

- Tax treaties result from negotiation on tax allocation rights (desired to achieve a particular economic goal), a balance on relative investment and trade flows, considering size and composition of the two economies. The amendment to tax treaty network via the MLI (especially PPT) ,may disturb the originally agreed balance/position of particular tax treaties. **Example**: exemption from tax on dividends & tax sparing credits to promote FDI. The application of PPT may deny tax benefits in the form of tax sparring credits or an exemption from tax on dividends.

Challenges/Recommendations on PPT

- The process of implementation of MLI required analyzing the wordings of its provisions from the perspective of constitutional democracy – since adoption of it will lead to abrogation of some of country's sovereignty in the area of tax.

- Parliaments should insist that governments prepare a guidance/framework on the application of PPT in their jurisdiction before they proceed for ratification.

- The reservation in article 7(15)(a) of the MLI permits countries or jurisdictions to opt out of the PPT and meet the minimum standard for preventing treaty abuse by adopting *"a combination of a detailed limitation on benefits provision and either rules to address conduit financial structures or principal purpose test"*. This provision gives option to countries to renegotiate the PPT in appropriate manner while fulfilling the minimum standard under MLI.

Annexure

Impact on key treaties

- Leaving aside USA and Brazil who have not signed the MLI, Germany, Hong Kong & Mauritius have not notified India as a CTA & hence, October 1, 2019 date shall not impact those treaties.

- The preamble to the treaty with various jurisdiction reveals that the emphasis is on taxes on income, with an exception for Canada, France, Germany, Netherlands, Sweden, United Arab Emirates (UAE) and United Kingdom (UK), which also emphasize upon 'tax on capital'. DTAA with Mauritius is an outlier in the sense that beside the actual objective of avoidance of double taxation & prevention of fiscal evasion, an added objective, 'encouragement of mutual trade & investment' is identified in the object clause. It will be interesting to see if Mauritius & India enter into bilateral negotiation to align preamble of its treaty in line with Article 6 of the MLI.

- Historically, India's DTAA with Mauritius, Singapore, UAE, Netherlands & Cyprus did not have a LOB clause. All the DTAAs, barring Cyprus have been amended in the past few years [India-Mauritius DTAA on July 19, 2016, India-Singapore DTAA on February 27, 2017, India- UAE DTAA on October 3, 2007] to reflect India's resolve on LOB clause

Impact on key treaties

- India's DTAA with countries such as Hong Kong, Malaysia, South Korea, UAE and UK contain a general LOB clause. Though the wording varies the general LOB clause, as reflected in Article 28 & 29 of the respective treaties highlight main purpose test, treaty shopping arrangements, bona-fide business test etc aligned more or less to Article 7 of MLI. In particular, DTAA with Hong Kong seems to contain the strictest LOB test; understandably due to its lateness of treaty negotiations, whilst in the midst of MLI framework finalisation.

- Protocol to DTAA between India and China, signed on June 5, 2019, reflects the MLI's wording in Article 27 A of the amended treaty. This truly reflects the MLI implementation to its fullest extent. Equally important is to note that the revised preamble to the treaty contain, 'develop economic relationship and to enhance cooperation in tax matters' (optional provision under Article 6(3)) as objectives besides the minimum standard under Article 6(1) of MLI.

Impact on key treaties

- Specific LOB clauses with lower capital gains tax, in particular for DTAA with Mauritius & Singapore, which were inserted on renegotiations in 2016 & 2017. South Korea perhaps has the widest specific LOB encompassing dividends, royalty, FTS, capital gains and other income. On the other hand, India's protocol with Switzerland covers specific LOB clause, as applicable for South Korea, other than for capital gains.

- India's treaty with Hong Kong, Malaysia, Singapore & South Korea [mostly similarly worded] contain reference(s) to application of domestic anti-avoidance provisions of contracting states to be made applicable. India's GAAR in its application is wider and beyond the beneficial ownership and general/ specific LOB clauses under DTAA.

- India has recently notified protocol amending India-Spain treaty on August 27, 2019 incorporating Articles of Exchange of Information, Assistance in the collection of taxes and Limitation of Benefits (LOB). Such unique LOB clause is not worded on the lines of OECD Model Convention. The LOB clause has been inserted on four accounts:

  (i) Strengthening the applicability of domestic GAAR
  (ii) Benefits under the convention restricted to subject of fulfilment of beneficial ownership
  (iii) Strengthening domestic Controlled Foreign Corporation (CFC rules)
  (iv) Principle Purpose Test

Impact on key treaties

- The PPT test states that the benefit under India- Spain treaty shall be denied if the main purpose or one of the main purposes of creation, existence, incorporation, registration or presence of such a resident or the transaction carried out by such resident was to obtain benefit under the treaty. Under Article 29 of the OECD Model, entitlement of benefits restricts the benefit on two accounts; one being fulfilling qualified residents (SLOB + Detailed LOB) and other being one of the principal purposes of arrangement or transaction. Hence the benefit under India-Spain treaty can be denied if the creation or incorporation (on entry into force of the protocol) of the resident was to obtain benefit under the India-Spain treaty.

- It is interesting to note that though the date of entry into force of protocol is December 29, 2014, it was notified by the Ministry of Finance on August 29, 2019.

Disclaimer

The author acknowledges contribution of his associate Riya Gupta for research and presentation.

All information contained in this presentation is prepared for International Fiscal Association. No part of this document may be reproduced / shared / divulged or referred to in part or in full without the prior written consent of BMR Legal. The ideas / views presented in this document are those of BMR Legal and may not be replicated or used without the written consent of BMR Legal. While considerable care has been taken in gathering the thoughts/ information included in this document, BMR Legal has not validated such information and hence does not confirm accuracy of such information. This document is preliminary and is purely indicative of the approach followed by BMR Legal.