Multilateral Instrument to Prevent International Tax Abuse

Dr. Anuradha Girme, Assistant Professor, New Law College, Bharati Vidyapeeth (Deemed to be) University

Poorti Kulkarni, LL.M., New Law College, Bharati Vidyapeeth (Deemed to be) University, Pune

ABSTRACT

In recent years, there has been huge increase in trade and business, not only in our country itself but worldwide also. We can say that; the world is truly moving towards our very own ancient India concept i.e. "*Vasudhaiva Kutumbakam*" which means the world is one family. As in past few decades, the companies have taken advantage to expand globally and conduct business across continents. This expansion has also brought with it questions on the taxation. Due to which, the urge was found to strengthen the international tax laws. The multilateral instrument is one of the most important and innovative initiative of the last decade in international tax law. It is designed to amend bilateral tax treaties. As sheer number of countries and tax jurisdiction is involved in this expansion process, the possibilities of tax avoidance are heightened. Currently, this game of tax avoidance is quite complicated matter.

This article aims to attain a better understanding and overview of MLI, along with its purpose and significance. Moreover, it will elucidate various form of tax abuse and delve into how the MLI serve as potent solution to this pervasive issue in the realm of international taxation. It also emphasis on its practical implementation, comparative analysis with DTAA and loopholes in existing tax treaties or bilateral agreement while enforcing it.

Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting (MLI), which was signed in June 2017, aim was not to only focus upon the provision but also on its relation with the tax treaties.

Therefore, to resolve issue related to tax in this international market the need was felt to implement MLI which can subsequently help in preventing treaty abuse by the entities operating in multiple countries under the BEPS (Base Erosion and Profit Shifting) Action Plan.

KEY WORDS: Tax treaty, International Tax, Multilateral Instrument, MLI, BEPS, Multilateral Convention to Implement Tax Treaty.

I. FOREWORD

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS is an international treaty that aims to stop tax evasion and profit shifting by multinational enterprises. This convention is also known as (Multilateral Instrument) MLI, initiated by the Organization for Economic Co-operation and Development (OECD). It is a unique instrument that allows countries to modify their existing bilateral tax treaties with other countries without having to renegotiate each treaty individually. The basic reason behind its implementation is to prevent tax treaty abuse, improve dispute resolution, and increase transparency. More than 100 jurisdictions have collaborated to create a new Multilateral Convention that aims to facilitate the rapid implementation of tax treaties. Out of 100, 79 jurisdictions have rectified, accepted, or approved the BEPS MLI, and around 185 bilateral tax treaties are covered under it.[i] The Convention is entitled "The Multilateral Convention to Implement Tax Treaty related measures to Prevent Base Erosion and Profit Shifting". The expansion of this Convention is to enable speedy implementation of tax treaties which is a direct result of the Base Erosion and Profit Shifting (BEPS) Project. This was instigated by the Organization for Economic Cooperation and Development (OECD) in the year 2013.

"The term Base Erosion and Profit Shifting (BEPS) describes the tax planning techniques employed by multinational corporations to exploit gaps and inconsistencies in tax laws in order to evade paying taxes. These practices have a great effect on developing nations, as these nations often rely on taxes received from corporates. These practices usually cause yearly loss in revenue of developing nations, due to BEPS the estimated loss is between USD 100-240 billion. To address this issue, over 135 jurisdictions[ii] and countries are collaborating within the OECD/G20 inclusive framework on BEPS to implement certain measures aimed at shortening tax abuse and avoidance, crafting a crystal-clear tax environment and improve global tax regulations."[iii]

The BEPS (Base Erosion and Profit Shifting) Project aimed to address the challenges posed by the digital economy. This project also develops certain action points that countries could implement to prevent base erosion and profit shifting. It is cause of concern for both developed as well as developing countries like India. To prevent this issue, the OECD has come out with this BEPS Plans. Whereas, it allows countries to implement a wide range of tax treaty-related measures developed as part of the BEPS project.

II. PRESENT SENERIO

India has implemented several reforms in recent years to attract foreign investment and promote growth across various sectors. However, the increasing globalization of businesses and cross border trade has also led to various taxation issues. There are many MNEs (Multinational Enterprises) operating worldwide often use those tax jurisdictions which has lower tax rates. As a result, there have been concerns about the fairness and transparency of the taxation system and the impact of cross-border trade on national tax revenue. Therefore, it is alleged that Cross border trade has led to various taxation issues.

Due to all these unmoral practices followed by the multinational enterprises, several countries have raised this question on the aggressive and harmful tax practice. Therefore, Organization for economic cooperation and Development (OECD) made BEPS plan to mitigate harmful tax practice. These projects aimed to address the challenges posed by the digital economy, which allows multinational enterprises to shift profits to low-tax jurisdictions.

III. SCOPE AND COVERAGE OF MLI

The Multilateral Convention has several noteworthy features that render it a potent instrument for preventing tax avoidance and profit shifting. As several MNEs use different strategies which exploit inconsistencies and loopholes in tax laws, leading to the artificial transfer of profits to jurisdictions with little or no tax rates, and consequently resulting in minimal or no corporate tax being paid. Therefore, imitative taken by OECD will help in reducing these practices and also provide various alternatives to make transparent tax environment. Following are the multiple features provided by MLI: -

It allows countries to implement the BEPS measures without having to renegotiate each treaty individually. This saves time and resources, and ensures that the measures are implemented more quickly. In addition, sometimes the renegotiation's outcome will be uncertain. Therefore, OECD Model of Tax Convention is not binding, it gives freedom to states to deviate from the model when negotiating tax treaties.[iv]

The MLI includes a mechanism for resolving disputes between countries. This mechanism is designed to ensure that disputes are resolved quickly and efficiently, which reduces the risk of double taxation and enhances tax certainty. Finally, the MLI includes provisions that require countries to exchange information on tax matters.

It also enhances transparency and allows countries to detect and prevent tax evasion and profit shifting.

The MLI has been signed by over 100 countries, including all of the G20 countries. This demonstrates the widespread support for the BEPS project and the need to prevent tax evasion and profit shifting by multinational enterprises. The MLI is a significant step towards achieving this goal and is likely to have a significant impact on the international tax landscape in the coming years.

It is important to note that the Multilateral Convention does not substitute existing tax treaties, but rather amends them in a coordinated, prompt, and consistent manner. These measures are aimed at addressing issues such as treaty abuse, enhancing dispute resolution, countering the impressions of hybrid mismatch arrangements.

"The main objective of the Multilateral Convention is to reduce chances for taxpayers to do unethical use of gaps and discrepancies in tax regulations, and also to transferral of taxable income from top to toe jurisdictions with respect to payment of international taxes. The preamble of the MLI highlights this goal, emphasizing the importance of ensuring that existing double taxation agreements are interpreted in a manner that eliminates

double taxation with regards to the taxes listed under DTAA, while also averting tax evasion and reducing opportunities to exploit the gaps."[v]

IV. PRIOR TO MLI - DTAA

Prior to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting (MLI), there were certain gaps in the existing Double Taxation Avoidance Agreements (DTAAs) that allowed multinational enterprises (MNEs) to exploit loopholes and engage in tax avoidance practices. As the rapid growth of cross-border trade and business has increased the complexity of international taxation, leading to a need for stronger and more comprehensive regulations.

Double Taxation Avoidance Agreements (DTAAs) are international treaties signed between two countries to avoid double taxation on income that is earned in one country but is also subject to taxation in another country. The primary purpose of DTAAs is to prevent double taxation of the same income in both countries and to encourage international trade and investment. DTAAs are legal documents, and their provisions are often subject to interpretation by the tax authorities of the contracting states. These interpretation of their provisions leads to differences of opinion between the two countries, which resulted in disputes and delays in the implementation of the DTAAs between the countries. The differences in interpretation used to arise due to differences in legal systems, language barriers, and varying interpretations of tax laws. Likewise, there are multiple gaps in DTAAs which are required to be filed which are described further.

Abuse of Treaty: One of the significant challenges in the implementation of DTAAs between the countries is the abuse of the treaty provisions by taxpayers. Some taxpayers may use the provisions of DTAAs to reduce their tax liability in both countries, leading to a loss of revenue for the countries involved. This can lead to disputes and tensions between the two countries.

Treaty Shopping: Another issue that arises is treaty shopping. Treaty shopping is the practice of using a treaty signed by one country to benefit a third country. For instance, a company may set up a shell company in a treaty country to take advantage of the lower tax rates and reduced withholding taxes under the treaty. This can result in revenue loss for the countries involved and can lead to disputes between the countries.

Transfer pricing: It is another issue that arises in the implementation of DTAAs between the countries. Transfer pricing refers to the pricing of goods and services between related parties in different countries. Transfer pricing is used to shift profits from one country to another to take advantage of lower tax rates. This can lead to disputes between the tax authorities of the two countries.

Lack of Effective Dispute Resolution Mechanisms: Disputes between the tax authorities of the two countries can arise due to differences in interpretation of the treaty provisions, abuse of the provisions, and transfer pricing. In many cases, there is a lack of effective dispute resolution mechanisms, which can lead to long delays in resolving

disputes. This can result in increased compliance costs for taxpayers and can deter investment and trade between the two countries.

In conclusion, it is very challenging to implement DTAAs due to several inconsistencies and gaps, including the interpretation of treaty provisions, abuse of the provisions, treaty shopping, transfer pricing, and lack of effective dispute resolution mechanisms. To address these issues, it is essential to have clear and unambiguous treaty provisions, effective enforcement mechanisms, and efficient dispute resolution mechanisms which can help in ensuring that DTAAs implemented between the countries should be free from gaps and implement in a way that promotes international trade and investment while preventing double taxation and tax avoidance.

V. VARIOUS FORMS OF TREATY ABUSE

Base Erosion and Profit Shifting (BEPS) is a tax avoidance strategy used by multinational enterprises (MNEs) to exploit gaps in tax laws and shift profits from high-tax to low-tax jurisdictions. This involves using complex structures to artificially allocate profits to low-tax jurisdictions and avoid taxes in high-tax jurisdictions. BEPS has a significant impact on the tax base of countries and has led to the development of various measures, including the MLI, to prevent tax abuses. There are multiple forms of tax abuse done by the MNEs to prevent themselves from paying high amount of tax.

Aggressive tax planning is also a form of tax abuse where multinational enterprises (MNEs) exploit loopholes in tax laws to reduce their tax liabilities. This involves using aggressive and complex tax planning strategies that are often considered to be on the boundary of legality or even beyond it. Aggressive tax planning has been a significant challenge for tax authorities.

Apart from this, abuse in Double Taxation Avoidance Agreements (DTAAs) is a situation where taxpayers exploit gaps or inconsistencies in the provisions of a DTAA to avoid or minimize their tax liability. This can be done by artificially structuring their affairs in a way that allows them to benefit from lower tax rates, exemptions, or deductions that would not be available under domestic law alone. The MLI has provisions to address this type of abuse and strengthen the effectiveness of DTAAs in preventing tax avoidance. For instance, an MNE might use a DTAA to artificially shift profits from a high-tax jurisdiction to a low-tax jurisdiction by taking advantage of differences in the definitions of taxable income or by exploiting gaps in the rules for determining the source of income. Another example is treaty shopping, where a taxpayer uses a DTAA between two countries to route their investments through a third country with more favorable tax provisions.

As tax abuse and treaty abuse is a significant issue in the realm of international taxation. Therefore, MLI has come up with multiple provisions to prevent these types of tax abuse like “it includes a crucial provision, known as the Principal Purpose Test (PPT), which supports tax authorities in preventing any form of "treaty abuse" as part of Article 6 of (BEPS) project. Article 7 of MLI, which list down the provision related to treaty abuse

prevention, also adds the PPT, when the countries in double tax treaty agrees to sanction the MLI, then the double tax treaty will be all because of PPT”[vi] This will help in denying tax benefits, several signatory countries have settled to incorporate it in their double tax treaties. These included countries like UK, Netherlands and most EU Countries.

VI. RATIONAL TO BRING MLI

The need for the MLI arose due to the above discussed complexity and inefficiency of the existing bilateral tax treaties between countries. These bilateral treaties were developed to prevent double taxation of income earned by individuals and companies in different countries, but they did not anticipate the sophisticated tax avoidance strategies used by multinational companies. These strategies have resulted in significant revenue losses for countries, and they have highlighted the need for a more comprehensive and coordinated approach to international taxation.

The Organisation for Economic Co-operation and Development (OECD) released the mandate for the negotiation of the Multilateral Instrument (MLI) in 2015. An ad-hoc group was established to oversee the preparation of the MLI, and participation in this group was open to all interested countries on a voluntary basis. This included non-OECD or G20 members, and each country's participation was on an equal basis. India has been an active participant in the negotiation of the MLI, as it is one of the countries involved in the ad-hoc group.[vii]

A major challenge encountered during the implementation of the BEPS project was the complex process of renegotiating the web of over 2000 tax treaties, which involved the participation of over 100 countries. Sometimes it takes around 8-10 years to renegotiate that treaty. Therefore, the primary aim was to efficiently amend existing bilateral treaties in a coordinated manner, while also eliminating the necessity of renegotiating each tax treaty. This is because the process of renegotiating a single treaty can take several years to complete. As it sets a standard template, which are designed to implement the recommended measures to avoid tax abuse viz. Treaty shopping, floating artificially subsidiary companies etc.

Another challenge was that it relied on countries implementing the measures unilaterally. This meant that countries could choose which measures to implement and when to implement them. This led to a patchwork of measures across different countries, which made it difficult to prevent tax evasion and profit shifting. The MLI addresses this challenge by providing a framework which allows countries to modify their existing bilateral tax treaties to include the BEPS measures. This ensures that the measures are implemented consistently across different countries.

VII. IMPACT OF MLI

From the above, now we got the basic understanding about MLI. "There are several considerations to keep in mind when assessing the impact of the Multilateral Instrument (MLI).

Firstly, some jurisdictions may choose not to sign or ratify the MLI, which means that their tax treaties will remain unaffected by its provisions. However, it is possible that the minimum standards related to tax treaties, agreed upon under the OECD's BEPS Project, may still be met by these jurisdictions or that other elements of the MLI may be incorporated into their tax treaties through bilateral negotiations.

Secondly, parties to the MLI have the option to exclude certain tax treaties from its scope by choosing not to list them as *Covered Tax Agreements*.

Furthermore, the minimum standard is not imitated in certain provisions of MLI. In Such cases the signatories have option exploit such inconsistency as no provision talks about minimum standard. This means that their tax treaties will not be impacted by that particular aspect of the MLI. For example, signatories can make reservations against Articles 12-15 of the MLI, which deal with permanent establishments, to ensure that the definition of a permanent establishment in their tax treaties remains unchanged. All of these factors must be considered when evaluating the potential impact of the MLI."[viii]

The Multilateral Instrument (MLI) is intended to modify tax treaties that are reflected as Covered Tax Agreements (CTA). A CTA refers to an agreement for the escaping of double taxation that is at present in power between members to the MLI. Both parties involved in the CTA must have notified their intention to modify the agreement using the MLI. In other words, the MLI can only be used to modify a tax treaty if both parties to the treaty have agreed to do so through the MLI process.[ix]. This is how one can know whether the existing tax treaty is modified by MLI or not.

The impact of the Multilateral Instrument (MLI) can be quantified using a mathematical formula. "All the bilateral nations entered into tax tries is reflected by the formula (n-1)/2, which can be expressed as (n2 - n)/2. In this particular formula, the letter 'n' reflects the nations entered into tax treaties. In reality, the tax treaties which are in existence are lower than the bilateral relations. Therefore, the actual impact of the MLI will depend on the number of jurisdictions that have entered into tax treaties and have also agreed to modify them using the MLI".[x]

In conclusion, the Multilateral Instrument (MLI) is a significant and innovative initiative in international tax law that has the potential to combat tax avoidance and promote cooperation among countries. Its standardized approach to amending bilateral tax treaties to prevent base erosion and profit shifting (BEPS) can increase transparency, certainty, and fairness in cross-border taxation. By strengthening anti-abuse clauses and introducing new provisions to prevent tax avoidance by multinational enterprises (MNEs), the MLI can help

countries protect their tax base and revenue streams. Overall, the impact of MLI on international taxation is expected to be far-reaching and positive.

VIII. OUTLINE OF MUTILATERAL INSTRUMENT

The Multilateral Instrument (MLI) consists of seven distinct parts, each comprising a range of articles that address various aspects of the agreement:

1. Preamble - this section outlines the context and objectives of the MLI and provides a broad introduction to the agreement.
2. Part I (Article 1-2) - covers the scope of the MLI and provides interpretation of key terms used throughout the agreement.
3. Part II (Article 3-5) - addresses the issue of hybrid mismatches, which occur when a particular financial instrument or entity is treated differently for tax purposes in different jurisdictions.
4. Part III (Article 6-11) - focuses on the prevention of treaty abuse, including measures to counteract treaty shopping and other forms of tax avoidance.
5. Part IV (Article 12-15) - provides guidelines to avoid permanent establishment status and sets out a common definition of the term.
6. Part V (Article 16-17) - deals with improving the resolution of tax disputes, including mutual agreement procedures between tax authorities.
7. Part VI (Article 18-26) - outlines the use of arbitration to resolve disputes that cannot be resolved through other means.
8. Part VII (Article 27-39) - covers final provisions, such as the process for signing and ratifying the MLI, and the rules for withdrawing or modifying a country's participation in the agreement.

Each of these parts and articles plays a crucial role in the MLI, working together to help ensure that the agreement is effective in addressing issues related to international tax treaties.

The Multilateral Instrument (MLI) incorporates a range of measures to address Base Erosion and Profit Shifting (BEPS) issues. These provisions are designed to ensure compatibility with existing tax treaties and typically contain a compatibility clause. This clause states that the MLI provision will apply instead of, or in the absence of, any provision in the Covered Tax Agreement.

The compatibility clause plays a vital role in ensuring that the MLI provisions are integrated with existing tax treaties, while avoiding conflicts or ambiguities between the two. By clarifying which provision will take precedence, the compatibility clause helps to ensure that the MLI's measures are implemented effectively and consistently across all participating jurisdictions.

Overall, the compatibility clause is an important feature of the MLI, enabling the agreement to function effectively alongside existing tax treaties while also addressing the BEPS issues.[xi]

IX. CONCLUSION

In conclusion, the MLI is an important step in the fight against tax avoidance and base erosion. Through its standardized approach to amend bilateral tax treaties, the MLI can help countries implement anti-abuse measures and address in existing gaps. The abovementioned Convention is a significant international treaty with objectives to avert tax evasion and profit shifting by multinational enterprises. It also provides strong framework for countries to implement the BEPS measures in a coordinated manner, which enhances transparency, improves dispute resolution, and reduces the risk of tax evasion and profit shifting. The MLI is a significant step towards achieving a more equitable and efficient international tax system.

Moreover, it consists of anti-abuse provision in the form of PPT provision. It also introduces a subjective element in tax treaties that was not into existence. This subject nature of this provision makes it difficult which may give rise to legal uncertainty. Therefore, it is important to know its impact as fundamental reason behind this project is to prevent the tax evasion and tax abuse. Although, it is still relatively new, its impact on international taxation is expected to be significant. There are Countries like Austria, Belgium, Japan, Luxembourg, Singapore, UAE and United Kingdom notified tax treaty as CTA with India. These jurisdictions have deposited their rectification on 30 June, 2019 with OECD secretariat. This represents an important tool for countries seeking to protect their tax abuse and promote sustainable economic growth.

---

[i] "*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS",* available at https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (last visited on 05.Feb.23)

[ii] "*Members of the ECD/G20 Inclusive Framework on BEPS",* available at https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf (last visited on 05.Feb.23)

[iii] "*Inclusive Framework on Base Erosion and Profit Shifting (BEPS)*", available at https://www.oecd.org/tax/beps/about/ (last visited on 06.Feb.23)

[iv] "*The OECD recommends that the Member States follow the OECD Model. That recommendation in its most recent version was adopted on October 23, 1997. The English language version of the recommendation contains the following statement: THE COUNCIL / ... / RECOMMENDS the Governments of member countries / ... / when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention."*

[v] David Kleist, "*The Multilateral Convention to Implement tax treaty Related Measures to Prevent BEPS- Some thoughts on Complexity and Uncertainty*", available at https://sciendo.com/pdf/10.1515/ntaxj-2018-0001, (last visited on 07.Feb.23)

[vi] *Aidana Abdaliyeva*, "*OECD BEPS-Multilateral Instrument: Treaty Abuse*", available at https://www2.deloitte.com/content/dam/Deloitte/kz/Documents/tax/tax_brochures_2020/20200807%20MLI%20discussion%20document_August%202020.pdf (last visited on 04.Feb.23)

[vii] *Ibid.*

[viii] *SUPRA* note 6 at 12

[ix] Damini Agrawal, "*Impact of MLI on Indian Tax Treaties under International Taxation",* available at https://taxguru.in/income-tax/impact-mli-indian-tax-treaties-international-taxation.html ,(last visited on 05.Feb 23)

[x] "*Some jurisdictions may be parties to multilateral tax treaties such as the Nordic Tax Treaty, which contains rules that are bilateral in their nature and essentially function in the same way as would bilateral tax treaties between all the parties."*

[xi] "Art. 3(4), Art. 4(2), Art. 6(2), Art. 7(2), Art. 7(14), Art. 8(2), Art. 9(2), Art. 9(5), Art. 10(4), Art. 11(2), Art. 14(2), Art. 16(4) (a) (i), Art. 16(4)(a)(ii), Art. 17(2), and Art. 26(1) of the MLI"