

Dual Resident Entities and Elimination of Double Taxation as per MLI (MLI Articles 4 and 5)

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Article 4 – Dual Resident Entities

Background

- Treaty benefits available to persons who are residents of one or both of the Contracting States
- Residency is determined based on whether the person is, under the laws of a State, liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature
- Since residency is determined in the first instance under domestic law, there is a need for a tie-breaker to establish rules of preference in case of dual-residency
- Tie-breaker for persons other than individuals historically based on 'place of effective management'
- 2008 update to the OECD Model Convention – provided an alternative version of the tie-breaker test based on mutual agreement of Competent Authorities – based on the rationale that though rare, dual-residency arrangements often involved tax avoidance arrangements

Background

- India's reservations to the OECD Model Convention and Commentary (2014)
 - India will refer to a MAP for determination of the Country of residence in case of a dual resident person other than an individual if the State in which its effective place of management is situated cannot be determined
 - India does not adhere to the interpretation given in paragraph 24 that the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. It is of the view that the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management

Most of India's treaties incorporate the POEM test as the tie-breaker test for non-individuals

Background

BEPS Action 6- Preventing the granting of treaty benefits in inappropriate circumstances:

Preventing Treaty shopping

- LoB
- PPT

Clarification that treaties are not intended to be used to generate double non-taxation

- Title
- Preamble

Other situations where treaty limitations are sought to be circumvented

- Splitting up of contracts
- Dividend & Immovable property transfers
- Tie-breaker for non-individuals
- Anti-abuse for PE in third states

Abuse of domestic law by using treaty benefits

Background

- BEPS Action 2 – “Neutralising the Effects of Hybrid Mismatch Arrangements”
 - Part II of the Report - Aimed at ensuring that Hybrid entities (as well as dual resident entities) are not used to obtain unduly the benefits of tax treaties
- Part II of BEPS Action 2 notes that the work on Action 6 will address some of the BEPS concerns related to the issue of dual resident entities by providing that cases of dual residence under a tax treaty would be solved on a case-by-case basis rather than on the basis of the current rule based on the place of effective management of entities.
- BEPS Action 2 recognizes that this change, however, will not address all BEPS concerns related to dual resident entities, domestic law changes being needed to address other avoidance strategies involving dual residence.

The Outcome

OECD BEPS Action 6

Existing tie-breaker Rule in Article 4(3) should be replaced by an alternative that involves a case-to-case resolution of dual-residency situations

Changes to OECD MC and Commentary

- Update to the OECD MC in November 2017
- Revised Article 4(3) incorporated to MC in November 2017
- Replacement/ edits to paragraphs 21 to 24 of the commentary

Article 4 of MLI

- Incorporate revised Article 4(3) of the OECD MC 2017 to earlier tax treaties which would be CTAs

Typical tie-breaker test

“Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.”

Structure of the MLI Article 4

BEPS Measure – Article 4(1) of MLI

Compatibility Clause – Article 4(2)

Reservation Clause – Article 4(3)

Notifications Clause – Article 4(4)

The Text

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Article 4(1)

Where by reason of the provisions of a Covered Tax Agreement a person other than an individual is a resident of more than one Contracting Jurisdiction, the competent authorities of the Contracting Jurisdictions shall endeavour to determine by mutual agreement the Contracting Jurisdiction of which such person shall be deemed to be a resident for the purposes of the Covered Tax Agreement, having regard to its place of effective management, the place where it 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 Covered Tax Agreement except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting Jurisdictions.

The Text

Analysis of Article 4(1)

Limb 1 – The Rule

Where by reason of the provisions of a Covered Tax Agreement a person other than an individual is a resident of more than one Contracting Jurisdiction, the competent authorities of the Contracting Jurisdictions shall endeavour to determine by mutual agreement the Contracting Jurisdiction of which such person shall be deemed to be a resident for the purposes of the Covered Tax Agreement,

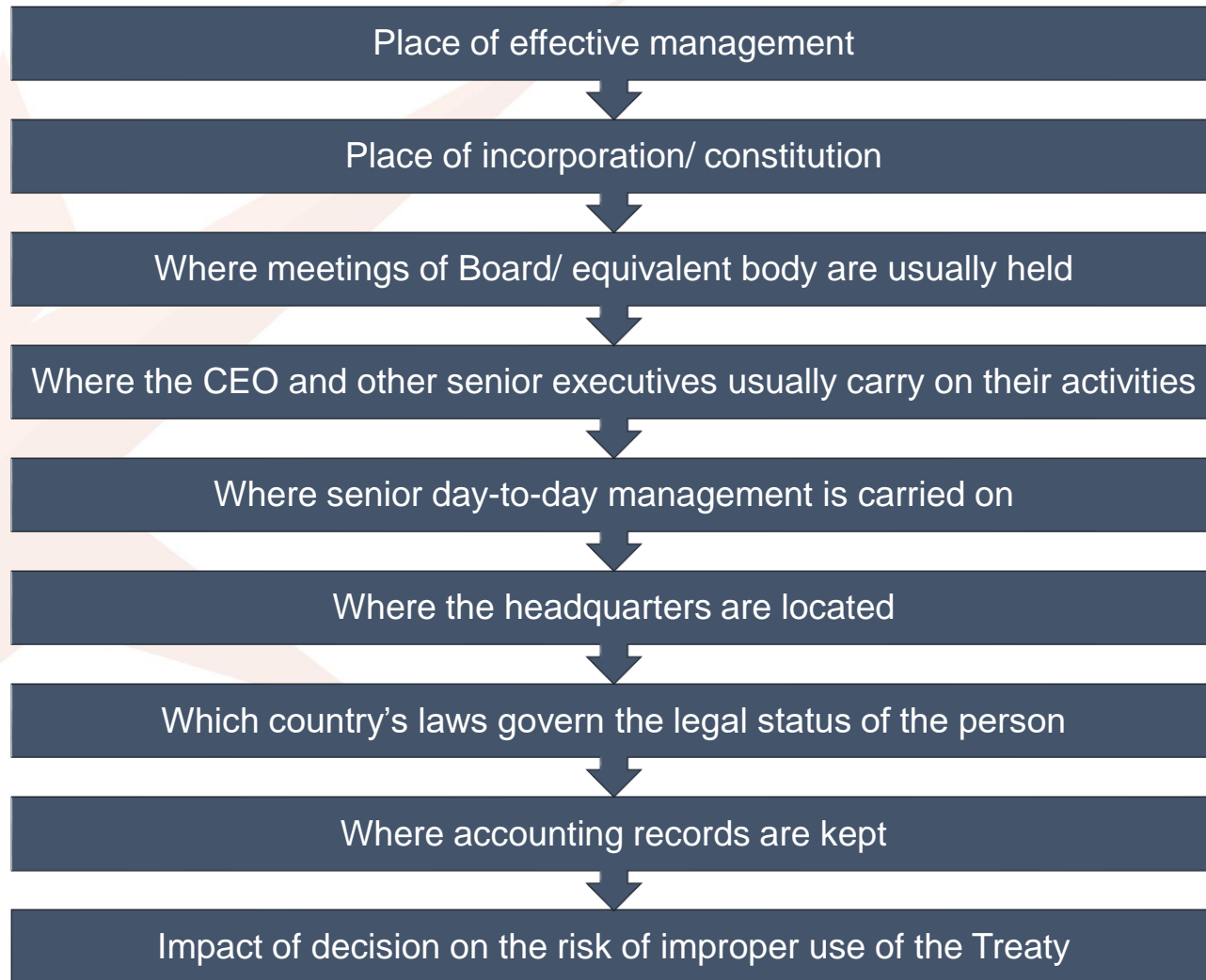
Limb 2 – Relevant factors

having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors

Limb 3 – Consequences

In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the Covered Tax Agreement except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting Jurisdictions

Factors relevant for Article 4(1)



The Mechanics

Resolution of dual-residency situations under Article 4(1) will take place under the **MAP mechanism** in Article 25 (or its equivalent)

Request for initiation MAP to resolve dual residency may be made **as soon as it is probable** that the person will be considered a resident of each Contracting State under paragraph 1 (in any event before 3 years from the first notification of taxation measures denying reliefs/ exemptions on account of dual residency)

Competent Authorities to deal with such requests **expeditiously**

Competent Authority decision to **clarify the period of time** covered by the decision

Key changes

- Determination by - Tax Authority vs. Competent Authority
 - Would it mean tax authorities would not have powers during assessment to question and determine residency or its powers will be limited to denying treaty benefits?
- POEM as the determining factor vs. Various factors to decide the tie-break
- Possibility of not arriving at tie-break – Low (Earlier) vs. Now ?

Points to ponder

- Where resolution is not arrived under MAP – whether it will be resident as per both the respective Tax Treaties? (*although it may not be entitled to relief / exemption of relevant Treaty*)
- Whether the tie-breaker rule to apply only vis-à-vis the respective Tax Treaties or even Tax Treaties with third countries?
- Where resolution is not arrived under MAP – whether the relief or exemption under Treaty will be granted to third persons (which is dependent on the determination of tax residence of the Entity) ?
- Practical difficulties, such as:
 - Treatment prior to the application by taxpayer under MAP/ During the course of pendency of application under MAP
 - Upon non-resolution of tie-breaker
 - Upon resolution of tie-breaker in favour of a country – Impact vis-à-vis benefits obtained by applying Tax Treaty of other country

The Mechanics

Paragraph 2 – Applicability

- Paragraph 1 to apply in **place of or in absence** of provisions of a CTA that provide for rules for determining whether a person other than an individual shall be treated as resident of one of the Contracting Jurisdictions in cases in which that person would otherwise be treated as resident of more than one Contracting Jurisdictions
- Paragraph 1 shall not apply, however, to the provisions of CTA specifically addressing the residence of companies participating in dual listed-company

Paragraph 3 – Contracting Jurisdictions may reserve the right that:

- Paragraph 4(3)(a) – Entire Article not to apply to CTAs
- Paragraph 4(3)(b) – Entire Article not to apply to CTAs that already address cases of DREs through MAPs
- Paragraph 4(3)(c) – Entire Article not to apply to CTAs that already address cases of DREs by denying tax treaty benefits without requiring the CAs to endeavour to reach mutual agreement
- Paragraph 4(3)(d) – Entire Article not to apply to CTAs that already address cases of DREs through MAPs and also situations where MAP cannot be reached
- Paragraph 4(3)(e) – Last sentence in paragraph 1 to be replaced by – no relief or exemption under CTA if no Mutual Agreement is reached between the CAs
- Paragraph 4(3)(f) – Article not to apply to CTAs with Parties that have made above reservation under Article 4(3)(e)



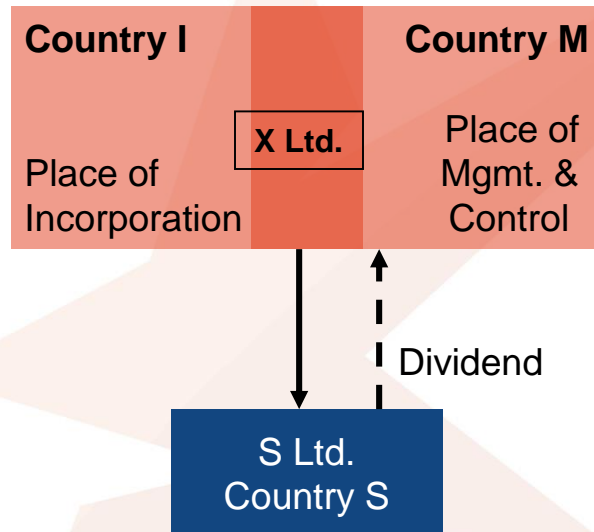
Impact on India's treaties

Sr. No.	Countries	Existing Article 4 in tax treaty with India	Options, Reservations and Notifications opted by Countries	Impact on India's CTA with the Country
1	Cyprus	Article 4(3) – Where POEM is situated. If by POEM it cannot be determined, then CA to decide.	Reservation under Article 4(3)(a) of the MLI	Article 4 would not apply
2	Singapore	Article 4(3) – Where POEM is situated	Reservation under Article 4(3)(a) of the MLI	
3	Australia	Article 4(3) – Where POEM is situated	Article 4(3)(e) – Australia / Japan reserved the right to replace the last sentence of Article 4(1): In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the CTA	India has not opted for 4(3)(f) – Modified Article 4 of MLI will apply with the last sentence replacement India has not opted for 4(3)(f) – Modified Article 4 of MLI will apply with the last sentence replacement
4	Japan	Article 4(2) – Determined by the competent authorities		

Impact on India's treaties

Sr. No.	Countries	Existing Article 4 in tax treaty with India	Options, Reservations and Notifications opted by Countries	Impact on India's CTA with the Country
5	Netherlands	Article 4(3) – Where POEM is situated	Opt in without any reservations	Article 4(1) will apply without any modification of last sentence
6	UK			
7	Russia			

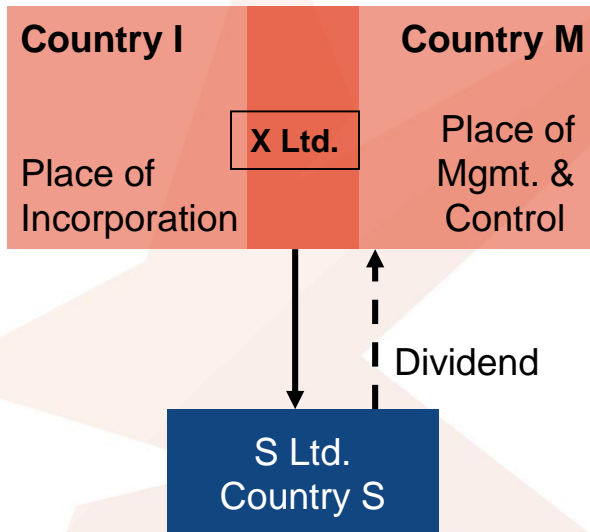
Case Study 1



Facts and Assumptions

- X Ltd. is a company incorporated in Country I; However, it is entirely managed and controlled from Country M;
- As per the domestic laws of Country I, since X Ltd is incorporated in Country I, it is considered as a tax resident of Country I;
- As per the domestic laws of Country M, since X Ltd is managed and controlled from Country M, it is considered as a tax resident of Country M;
- S Ltd., a subsidiary of X Ltd., is incorporated and managed from Country S and also a tax resident of Country S;
- S Ltd declares dividend to X Ltd;

Case Study 1



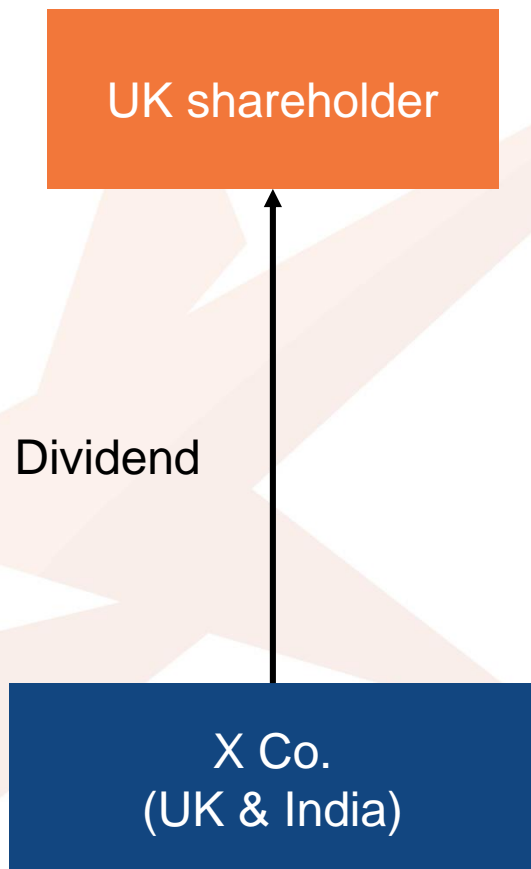
Facts and Assumptions

- Withholding tax rates vis-à-vis dividend under the domestic law / treaties assumed to be as under:
 - S – I Tax Treaty : 10%
 - S – M Tax Treaty : 15%
 - Country S domestic law : 20%

Issue

- At what rate should S Ltd withhold tax on dividends?

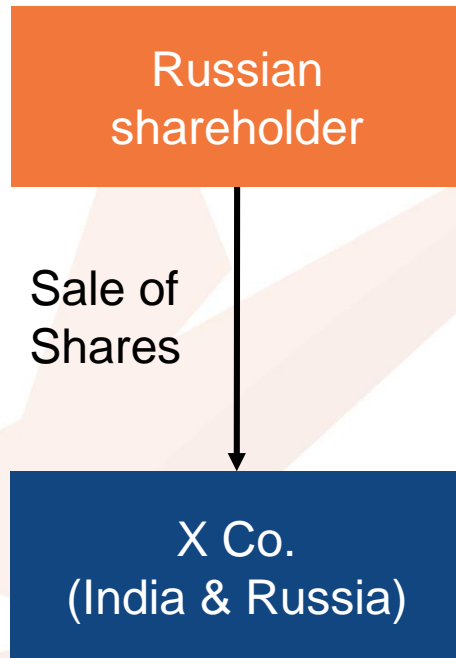
Case Study 2



- X Co. is dual-resident of India (under POEM) and UK (based on incorporation)
- Competent Authorities have been unable to determine residency by mutual agreement
- Will Article 11(2) of India – UK treaty apply?

“However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed... 10 per cent of the gross amount of the dividends”

Case Study 3



- X Co. is dual-resident of India (based on incorporation) and Russia (based on control/management)
- A Russian resident shareholder sells shares of X Co. to a Russian buyer
- Competent Authorities have been unable to determine residency of X Co. by mutual agreement
- What is the taxability of gains under the India - Russia treaty ?

“13(4) Gains from the alienation of shares of a company which is a resident of a Contracting State may be taxed in that State.

13(5) Gains from the alienation of any property other than that mentioned in paragraphs 1, 2, 3 and 4 shall be taxable only in the Contracting State of which the alienator is a resident.”

Article 5 – Application of Methods for elimination of Double Taxation

Structure of the MLI Article 5

Choice of Option (Asymmetrical allowed) – Article 5(1) of MLI

BEPS Measures – Article 5(2) (**Option A**), Article 5(4) (**Option B**), Article 5(6) (**Option C**)

Compatibility Clause - Article 5(3) (**Option A**), Article 5(5) (**Option B**), Article 5(7) (**Option C**)

Reservation Clause – Articles 5(8) and 5(9)

Notifications Clause – Article 5(10)

MLI-Article 5- Elimination of Double Tax

- Article 5 of MLI provides 3 options:
 - A) If COR normally exempts **income** arising in COS, it will NOT EXEMPT such income which is also exempted by COS or COS taxes at a lower rate. If COS taxes at a lower rate, COR will provide credit for the same.
 - B) If COR normally exempts **dividend** income arising in COS, it will NOT EXEMPT such income if COS gives a deduction for such dividend. If COR taxes dividend, COR will provide credit for the same.
 - C) **Credit method** of tax has to be followed to eliminate double tax.
- If one country does not choose option C, it can choose that the other country also should not apply Option C. [Article 5(9) of MLI]
- Except for Option C where one country can restrict the other country from applying Option C or where another Country has reserved application of entire Article 5, this Article can apply differently in each country.
- This is asymmetric application of MLI provision.

Impact on India's treaties

Sr. No.	Countries	Existing tax treaty with India	Options, Reservations and Notifications opted by Countries	Impact on India's CTA with the Country
1	Egypt	Exemption Method	Egypt is yet to submit ratification instrument	To be seen. As of now, position is not clear
2	Slovak Republic	Exemption Method	Slovak has also opted for Option C and notified India under CTA	Option C would apply for both Treaty Partners
3	Bulgaria / Greece	Exemption Method	Reserved the right for entirety to Article under 5(8)	Option C would not apply
4	Netherlands / Austria	Article 23(2) of both Treaties (Exemption method vis-à-vis specified incomes)	India has not applied any Option vis-à-vis these Treaties and is silent on it. Netherlands / Austria have chosen Option A.	Option A would apply to Dutch / Austrian residents. Asymmetrical application

The Text

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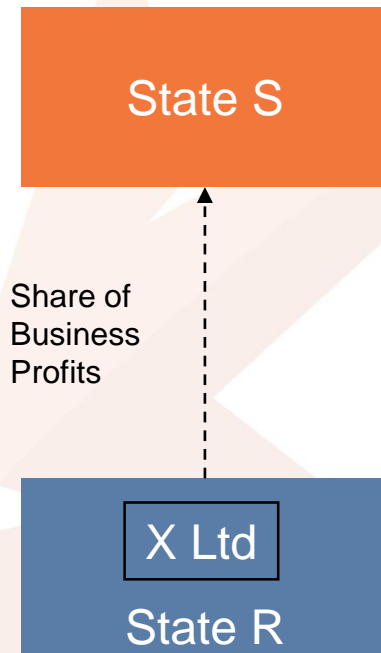
Article 5(6) – Option C

a) 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), the first-mentioned Contracting Jurisdiction shall allow:

- i) 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;
- ii) 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

Example 1



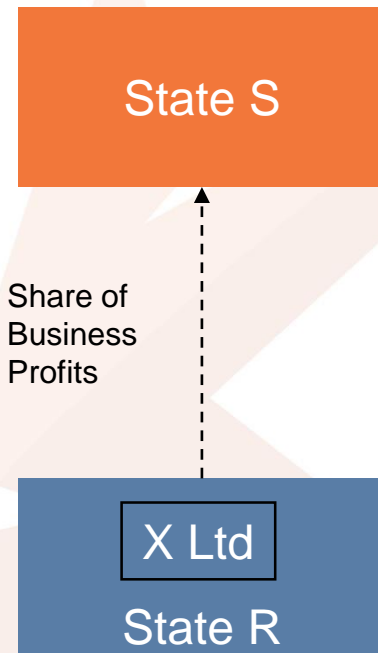
Facts and Assumptions

- X Ltd is established in State R, which constitutes a resident of State R and has fixed place of business in State R
- X Ltd is taxed on its worldwide income in State R
- All the members of the X Ltd are resident of State S
- State S treats X Ltd as fiscally transparent and taxes the members on their respective share
- All the income of X Ltd constitutes business profits attributable to PE in State R

Issue

- Which state will provide relief from double taxation under Article 23 A or 23 B?

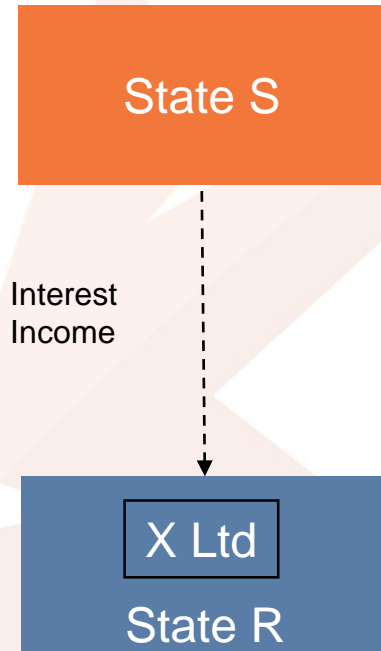
Example 1



View

- State R will tax the entire income of X Ltd
- State R will not be obliged to provide relief
- State S may tax the income because of the residence of the members of X Ltd
- State S will be required to provide relief under Article 23B as that income may be taxed in State R (as a source / PE state) regardless of the fact that State R considers that the income is derived by an entity resident of State R

Example 2



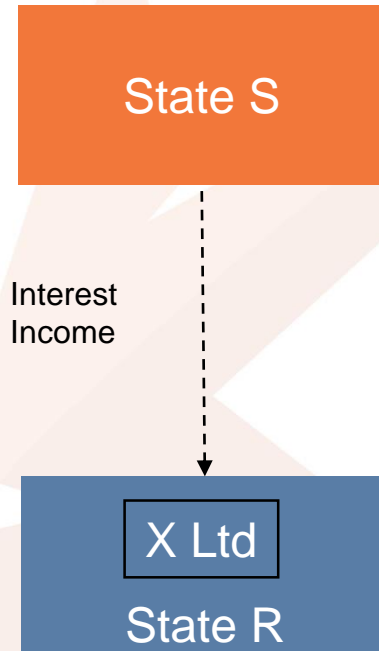
Facts and Assumptions

- X Ltd is established in State R, which constitutes a resident of State R
- X Ltd is taxed on its worldwide income in State R
- All the members of the X Ltd are resident of State S
- State S treats X Ltd as fiscally transparent and taxes the members on their respective share
- All the income of X Ltd constitutes interest arising in State S, not attributable to PE in State R

Issue

- Which state will provide relief from double taxation under Article 23 A or 23 B?

Example 2



View

- State R may tax the income as the income is derived by a resident of State R
- State R will be required to provide credit to X Ltd under Article 23 A or 23 B for the tax paid in State S
- The credit will be the lower of
 - 10% of gross amount of interest (max amount of tax that may be paid in State S)
 - Tax payable in State R on that interest
- State S will be not be obliged to any provide relief since that income does not arise in State R and is not attributable to PE in State R



Thank You

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