SATURDAY INTERNATIONAL TAX GYAN !!!

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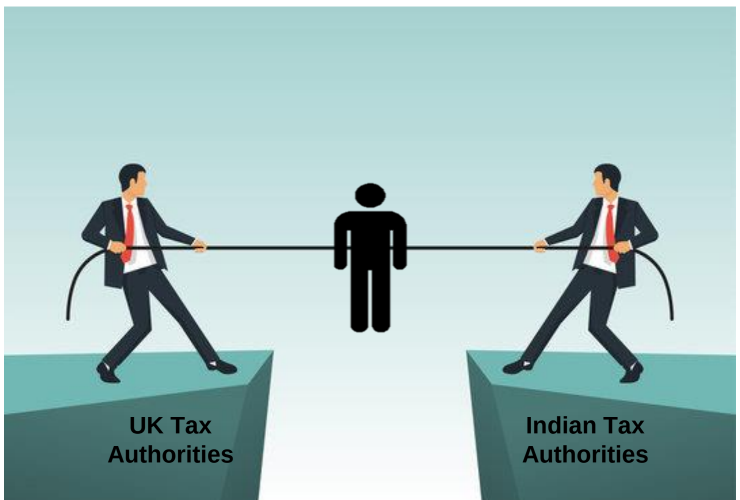
SITG No. 142

MLI For Beginners PART- 6



Application of Methods for Elimination of Double Taxation

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Date : 25.02.2023

Background

- In the previous MLI series we had discussed about single residency of Dual resident entities(Article 4) and India's position in the same. In this series we will discuss about the ways of eliminating double taxation.

- Lets first understand what is double taxation which we will talk in this part of the series. Where a person, is a resident of one country but earns income in some different country, then such income could be taxable in both the countries. When such income is taxable both the countries, double taxation comes into play.

- Before MLI, there were 2 major ways of eliminating this kind of taxation as used in the DTAAs. These were:
  - Exemption Method
  - Credit Method

- **Exemption Method** means the income earned would be totally exempt in resident country if it is taxable in the source country.

- **Credit Method** means tax paid by the person in the source country will be allowed as credit in the resident country.

Sethji, if we already had these methods of eliminating the double-taxation, then why MLI?

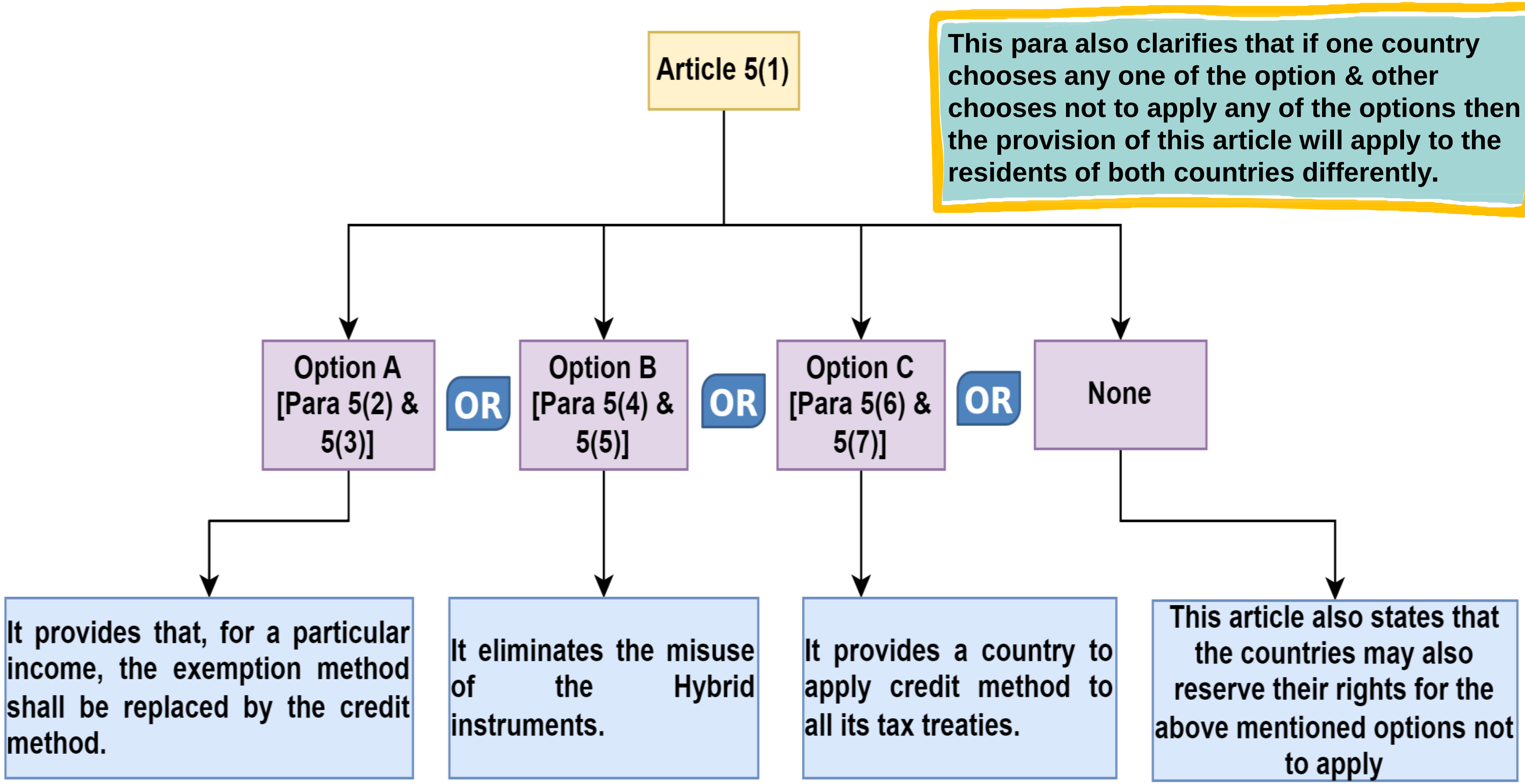
Nattu Kaka, There were several reason for which an update was required in the existing CTAs

1. **MNCs were misusing the Hybrid Instruments*.**
2. **Methods used for the prevention of double taxation were causing double benefit to the residents of certain countries.**

To cop with these issues MLI was required.

***Hybrid Instruments** means the instrument which is considered as debt in one country and equity in another

Article 5(1)- Compatibility Clause



Article 5(2) & 5(3)- Option A

- **Para 2 of Article 5** is the main provision in relation to option A.
- This para provides that the provisions of CTA which alternatively provides the resident state to exempt the income derived by a resident shall apply credit method instead.
- Option A provides the resident country to change the exemption method of preventing double taxation(as already applicable in the CTA) to the credit method when any income is exempt or is taxed at reduced rate in the source country.
- **Para 3 of the article 5** is a compatibility clause which describes that the Option-A would apply to the CTAs where the resident country exempts the income which is either exempt or is chargeable at a reduced rate in the source country.

Article 5(4) & 5(5)- Option B

- **Para 4 of Article 5** is the main provision in relation to option B.
- This para completely addresses the issues of hybrid mismatches arrangement, especially where the dividend is deductible in the source/payer country.
- Option B provides that in case where the dividend is deductible in the source country as an expense(dividend is deductible just like interest in case of Hybrid instruments), **then the resident country shall not exempt such income but shall tax the same and provide credit of tax, if any, paid in the source country**.
- **Para 5 of the Article 5** is a compatibility clause which describes that the Option B would apply to a CTA which requires the resident state to exempt dividend income derived by its residents where such dividend is deductible in the payer state.

Article 5(6) & 5(7)- Option C

- **Para 6 of Article 5** is the main provision in relation to option C.
- It provides for a country to apply the credit method to all its tax treaties in case where exemption method is applied.
- Aims at eliminating all the instances of the double non-taxation arising due to exemption method being followed for elimination of double taxation.
- **Option C provides that resident country provides tax credit for the lower of tax paid by the person in the source country or actual amount of tax payable in the resident country.**
- **Para 7 of the article 5** is a compatibility clause which describes that Option C would apply in place of the provision of the CTA which provides for exemption method for elimination of double taxation.

This method is currently followed in many OECD countries as a part of their existing DTAAs.

Article 5(8) & 5(9)

Article 5
(Application of Methods for elimination of Double Taxation)

Para 8
(Reservation Clause for the entire article not to apply)

This para gives the country a choice to reserve their right for this clause.
For Instance:
1. Country A chooses for option A and country B reserves its right, then Country A cannot unilaterally apply option A.
2. Where one country is silent on this clause and other has chosen any option(Say option A) then this option A will be applied on the resident of such other country. Provisions already applicable in CTA will apply to the former country.
3. Where both countries have chosen different options, then option as adopted will be applicable on the resident of both countries.

Para 9
(Reservation Clause in relation to option C not to apply)

This para gives the country a choice to reserve their right specifically for option C.
For Instance:
1. Country A has chosen to apply option A and reserved a right for option C to restrict the other to apply option C.

India’s Position

- India, as per its notification, has **chosen to apply** Option C of the Article 5 in place of the provisions of the CTA.

- Therefore, following could be the circumstances:
  - Where India’s treaty partner has chosen any option under the article, then the respective option as chosen by the countries will applicable to their resident. **Countries like Netherlands, Slovak republic, etc. have chosen one of the option.**
  - Where India’s treaty partner has chosen to reserve its right for this article, then India cannot unilaterally apply any option. **Countries like Bulgaria have chosen to reserve its right.**
  - Where India’s treaty partner are silent over the article, then option C chosen by India will be applicable on their residents. **Countries like Australia, Japan, etc. are silent over the article.**

Documents can be referred for Interpretation of MLI

Basic Documents:

- BEPS Action Plan 15
- Explanatory Statement to MLI
- MLI Positions adopted and deposited by Various MLI signatories with OECD
- Report on BEPS Action Plan 2,6,7,14
- Existing tax treaty
- OECD Model Convention of Tax treaty and OECD Commentaries
- Synthesized text of MLI between parties to CTA

Other Documents available on OECD website:

- List of Signatories and parties to MLI
- Frequently Asked Questions (FAQs) on MLI
- Flow chart on matching of reservations and notifications of MLI
- Legal note on functioning on MLI under public international law
- Step by step on applying the MLI
- MLI Matching Database

Link of OECD Website: https://www.oecd.org/

Reference of Previous SITG of MLI for beginners Series

S.NO	Particulars	Link
1.	Basic (BEPS)	Click here
2.	Introduction to MLI	Click Here
3.	Structure and Framework of MLI	Click here
4.	India’s position on MLI	Click Here
5.	Dual Residency of Entities	Click Here

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