India-China tax treaty Protocol: some thoughts

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India recently notified a Protocol that amends the India-China tax treaty and incorporates some of the OECD recommendations put forth as part of its BEPS project. The changes would apply from the 2020 financial year. The Protocol brings about serious changes to the tax treaty in several areas, including limiting treaty abuse, tackling artificial avoidance of permanent establishment (PE) status, and introducing changes to how both countries would resolve corporate tax residence conflicts.

Pertinently, when India signed the BEPS MLI in 2017, it listed the India-China tax treaty as a covered tax agreement (CTA). However, at the time of signing the BEPS Multilateral Instrument (BEPS MLI), China excluded its treaty with India from the list of CTAs. Perhaps, this prompted India to exclude China from its final list of CTAs at the time of ratification of the Instrument.

China is yet to ratify the BEPS MLI and the question remains if it would include India in its final list of CTAs at the time of ratification of the Instrument. While the chances of that happening are nil, I am not sure if that would anyway have much practical impact. And without knowing what provisions of the BEPS MLI China would have applied to its tax treaty with India, it would not be appropriate to second guess if the Protocol is but a replacement for the MLI.

Anyhow, it is indeed commendable that India and China bilaterally negotiated and concluded a new Protocol to incorporate key BEPS-related proposals in the tax treaty. These are discussed below.

Permanent establishment

Firstly, to ensure that agency PE status in India is not avoided by multinational enterprises, the Protocol broadens the traditional definition of agency PE in Article 5 of the tax treaty to include persons who habitually play the principal role, leading to routine conclusion of contracts without material modifications by the foreign enterprise.

This is a significant change made largely in line with the OECD BEPS MLI. Previously, a foreign enterprise was deemed to have an agency PE in India where an Indian agent habitually exercised the authority to conclude contracts in the name of the foreign enterprise.

The Protocol does away with the requirement. Going forward, agents do not need an authority to conclude contracts, nor is there any requirement for habitual conclusion of contracts. Agency PE would be deemed to exist if agents play a principal role leading to the conclusion of contracts (rubber stamped by the foreign enterprise). It is not clear how courts would interpret the phrase "play a principal role" in this context.

It may not be out of place to mention here that India had, in its position statement on the OECD's 2017 update of the Model Tax Convention, stated that it would not incorporate the word "routinely" in the agency PE definition.

Further, the Protocol lowers the existing day-counting threshold to include the time exceeding 30 days spent on connected activities undertaken on the same project for the purpose of computing the period of 183 days in service, construction and installation PEs. For determination of service PE, the Protocol provides that services rendered by an enterprise for similar or connected projects shall be considered in computing the 183-day period.

Besides, the habitual maintenance of stock of goods *for purpose of delivery* would now fall under the PE definition, unless the context otherwise requires.

The Protocol does not explicitly provide for a situation where furnishing of services by a foreign enterprise would fall under the service PE definition, even if the services are not performed from within the Indian territory. Some tribunals have taken a view that employees do not need to be present in India for such services to be covered under Article 5. This is one area where confusion remains.

Treaty abuse

Secondly, the Protocol adds a new Article 27A in the tax treaty disallowing treaty benefits in cases where obtaining such benefits was one of the principal purposes of a particular transaction (unless the benefits are in accordance with the objectives of the tax treaty). While this is welcome, it needs to be seen how this plays out in practice and if genuine commercial arrangements would also run the risk of falling under the article.

Likewise, the Protocol amends the title and Preamble of the tax treaty to disallow treaty benefits attributed to tax avoidance arrangements, including treaty shopping arrangements. Again, it would be interesting to see how Indian tax courts and tribunals view this change, especially in the context of a potential retrospective application of the Preamble.

Mutual agreement procedure and corporate tax residence conflict

Thirdly, in line with the OECD's BEPS MLI, the Protocol amends the existing tie-breaker test pertaining to corporate residence to provide that both countries shall endeavour to determine corporate tax residence under the mutual agreement procedure (MAP) after careful consideration of relevant factors such as the place of effective management (POEM), place of incorporation, among others. In the absence ofmutual agreement tax relief/exemption under the tax treaty shall be denied.

The replacement of POEM as the tie-breaker rule with a case-by-case MAP resolution would bring some degree of uncertainty to how foreign businesses are taxed in India. India's POEM test under the Income Tax Act (and the guidance) is somewhat different from how POEM is understood internationally (I previously blogged about it here). Importantly, China too follows a POEM test under its domestic tax law and it is likely that both India and China would seek to enforce their own understanding of the POEM, leading to a potential deadlock.

Another major problem with this change is the MAP process itself. It is highly uncertain, cumbersome and time consuming. Some of these challenges are already described in one of my earlier blogs and I do not see the need to repeat them here.

The India-China tax treaty did not have any anti-avoidance measure so far to control treaty abuse. It cannot be disputed that in some areas, the Protocol would bring the kind of tax certainty that investors expect, especially given that India and China are important trading partners. The Protocol reflects India's commitment towards international tax standards and ensures an encouraging and strong economic, trade relations with China.