Analysis

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

Speed read

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting is the final output of action 15 of the OECD's BEPS project and is the result of 18 months' work by an ad hoc group of 99 countries chaired by Mike Williams of the UK. It is intended to enable the implementation of treaty related recommendations of four BEPS action items across multiple tax treaties without separate renegotiation. The substantive provisions of the Convention are divided into four main parts concerning: hybrid mismatches; treaty abuse; avoidance of PE status; and dispute resolution. Provision is made for mandatory binding arbitration, but only on an 'opt-in' basis, as broad international consensus on the use of arbitration could not be reached.

Sandy Bhogal
Mayer Brown
Sandy Bhogal heads the UK tax practice at Mayer Brown. His experience ranges from general corporate tax advice to transactional advice on matters involving corporate finance, banking, capital markets, asset finance and property. He also has significant experience with corporate tax planning, as well as with advising on the development of domestic and cross-border tax-efficient structures. Email: sbhogal@mayerbrown.com; tel: 020 3130 3645.

Kitty Swanson
Mayer Brown
Kitty Swanson is an associate in the tax practice at Mayer Brown. She advises on the tax aspects of a wide range of domestic and cross-border matters and transactions, including mergers and acquisitions, fund structuring, domestic and international reorganisations, real estate transactions, employment-related matters, banking and structured finance, and insurance matters. Email: kswanson@mayerbrown.com; tel: 020 3130 3431.

Background

A number of BEPS action items – Action 2 (hybrid mismatch arrangements), Action 6 (treaty abuse), Action 7 (avoidance of permanent establishment (PE) status) and Action 14 (improving dispute resolution mechanisms) – aimed to develop tax treaty measures to address specific BEPS concerns. Action 15 proposed a multilateral instrument to facilitate the implementation of these treaty related measures across the extensive network of bilateral tax treaties (which totals more than 3,000 treaties) and thereby avoid the need for each treaty to be renegotiated separately.

After an initial report in September 2014 concluded that a multilateral instrument was both desirable and feasible, the OECD's Committee on Fiscal Affairs mandated the establishment of an ad hoc group to create a multilateral instrument and open it for signature by 31 December 2016. The group met six times between May 2015 and November 2016 (with a sub-group of 27 countries meeting five times to develop the arbitration provisions). The result was the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the 'Convention'), published by the OECD on 24 November 2016, plus an explanatory statement described as reflecting an agreed understanding of the provisions of the Convention and how they are intended to apply.

The Convention opened for signature on 31 December 2016 and will enter into force approximately three months after it has been ratified by five jurisdictions. (This is not expected to be immediate, as there will be a formal signing ceremony in June 2017, so it is anticipated that many jurisdictions will wait.) For those countries that ratify later, it will enter into force approximately three months after they have ratified it. The Convention will come into effect for a particular treaty for tax periods beginning at least six months after it enters into force for the relevant jurisdictions, except for withholding taxes, for which it will apply where the event giving rise to such taxes occurs on or after the first day of the next calendar year beginning on or after the date it enters into force for the relevant jurisdictions.

How does the Convention work?

The Convention aims to enable the maximum possible number of tax treaties to be updated without separate bilateral negotiations, so as to manage time and administration costs, as well as prevent inconsistent implementation. However, the Convention is also designed to be flexible to encourage participation. It therefore includes a number of optional provisions, as well as the ability for signatories to express reservations in respect of many provisions (either in respect of some or all of the treaties to which it is a party). It therefore constitutes a form of international tax 'pick and mix', with each signatory to the Convention choosing how it should apply to their bilateral treaties (as well as the treaties to which these choices should be applied, as it does not apply automatically to all treaties entered into by signatory jurisdictions).

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A particular bilateral tax treaty will only be amended by the Convention where:

- both parties are signatories to the Convention and have made a notification that they wish that treaty to be covered; and
- the options chosen by those parties are not incompatible, which in some cases requires both parties to the treaty to have made the same choices (although other provisions allow different choices to be made).

In addition, a number of provisions of the Convention are intended to modify existing provisions of bilateral tax treaties and so will typically only apply to treaties containing a corresponding provision (that will either be modified or replaced as a result). Therefore, not all treaties will be

updated by the Convention, even where both parties to the treaty have agreed to the same provisions. Depending upon the options chosen and reservations and notifications made, the provisions of the Convention may apply to a particular treaty in whole, in part or not at all.

All reservations and notifications made are to be kept by a central depositary (the secretary-general of the OECD), which shall maintain publicly available lists of tax treaties affected by the Convention and reservations and notifications made. In theory, therefore, it should be relatively simple to determine the application of the Convention to any given tax treaty. However, the manner of this publication, and the ease of use of the information provided, are not yet clear, and parties to the Convention will not be required to publish consolidated versions of their treaties as updated by the Convention.

What does the Convention include?

The substantive provisions of the Convention are divided into four main parts, corresponding to the four BEPS action items whose outcomes are reflected therein:

- Part II concerns hybrid mismatches (Action 2);
- Part III concerns treaty abuse (Action 6);
- Part IV concerns avoidance of PE status (Action 7); and
- Part V concerns dispute resolution (Action 14).

In addition, Part VI provides for mandatory binding arbitration, which is also within Action 14 but will apply on an 'opt-in' basis, as broad international consensus on the use of arbitration could not be reached.

Although a detailed examination of the substantive provisions of the Convention is beyond the scope of this article, there are a number of points worth noting:

General

Some of the provisions of the Convention seek to implement minimum standards agreed during the BEPS project (e.g. agreed minimum standards to prevent treaty abuse under Action 6, and for dispute resolution via the mutual agreement procedure (MAP) under Action 14). Other provisions are intended to address best practice recommendations (e.g. amendments to permanent establishment rules under Action 7) or measures recommended by the OECD but in relation to which consensus could not be reached (e.g. mandatory binding arbitration under Action 14). This difference is reflected in the options presented by the Convention; for example, there is limited scope to make reservations in respect of treaty abuse provisions, while the arbitration provisions are optional.

Hybrids

Part II contains recommendations for dealing with transparent entities (these have not previously been addressed specifically by model treaties, although they are discussed in the commentary to the OECD model), the revised tiebreaker test for dual resident corporates (i.e. conflicts are to be resolved under the MAP with treaty benefits denied until agreement is reached), and provisions governing double tax relief methods in cases where income is not taxed in the state of source (with a choice of three options, or none), none of which is a minimum standard under BEPS Action 2.

Treaty abuse

Although the treaty abuse provisions aim to achieve a minimum standard, there is flexibility in how this is achieved. For example, a country can elect to apply the principal purpose test (PPT) alone or alongside a simplified limitation on benefits provision (LoB). Alternatively, it can elect for these provisions not to apply where either: (i) particular treaties already contain equivalent provisions; or (ii) it intends to adopt a combination of a detailed LoB, and either rules to address conduit financing structures or a PPT. (These are situations in which the country would otherwise meet the agreed minimum standards, although it is worth noting that there is not an agreed form for a detailed LoB, so this could result in varying standards.) It is also worth noting that countries that wish to adopt the PPT only can elect to permit the application of the simplified LoB on a bilateral or unilateral basis where a treaty counterparty has opted into the simplified LoB.

The amendments to treaty preambles are mandatory, except where equivalent provisions already exist, which is consistent with them being minimum standards under BEPS Action 6.

There are a number of provisions targeting specific instances of tax avoidance, including the transfer of shareholdings prior to payment of dividends (to introduce a minimum holding period for withholding tax relief) and the contribution of assets to an entity pre-sale to dilute the value attributable to immoveable property. These are not part of the minimum standards under BEPS Action 6, so countries may reserve against these.

PEs

There are provisions to implement the BEPS recommendations to target avoidance via the use of commissionaire and similar arrangements (including to prevent exploitation of the agency tests) and via splitting up contracts or fragmenting activities between group entities. There are also recommended amendments to the specific activity exemptions (with a choice of drafting) to ensure they only apply where the activities in question are preparatory/auxiliary in the context of the relevant business.

Arbitration

The arbitration provisions will only apply where both parties to the relevant treaty have opted to apply them. As per article 25(5) of the OECD model, arbitration will only apply to issues that remain unresolved by the MAP after two years and at the request of the taxpayer; however, unlike many existing arbitration provisions, it specifies a series of mandatory time limits for the arbitration process and includes rules determining when arbitration may and may not be used.

Jurisdictions opting into arbitration can opt for the arbitrators:

- to choose a proposal from those submitted by the two jurisdictions; or
- to reach a reasoned conclusion on the basis of evidence submitted.

They can also agree alternative rules on a case by case basis via the MAP. However, parties that make the appropriate notification to the depositary need not implement an arbitration decision if they agree on a different resolution of all the issues within three calendar months of the decision.

These arbitration provisions will override existing arbitration provisions, except to the extent that existing provisions involve wider obligations. In addition, a jurisdiction that opts into these may reserve the right for them not to apply to specified tax treaties that already provide for mandatory binding arbitration.

UK implementation

Although the ad hoc group that developed the Convention was chaired by Mike Williams of HM Treasury, the UK has already indicated an intention to make a number of reservations regarding certain provisions of the Convention (at an open day for stakeholders held on 12 December 2016).

In particular, taking each of the relevant BEPS actions in turn, HM Treasury noted the following points:

- Action 2: The UK plans to make a reservation in respect of provisions that would amend the rules governing the elimination of double taxation for transparent entities. However, it does intend to adopt the new corporate residence tiebreaker test, which is consistent with recent/current UK treaty policy (see, for example, the 2013 UK/Iceland treaty).
- Action 6: The UK plans to adopt the PPT but will not adopt the simplified LoB, nor will it elect to accept the simplified LoB on either a bilateral or a unilateral basis where a treaty counterparty adopts this provision. It also does not intend to adopt the new rules targeting avoidance via dividend transfer transactions.
- Action 7: The UK does not plan to adopt most of the provisions targeting abuse involving PEs, other than the anti-fragmentation rule and the revised definition of closely related persons.
- Action 14: The UK intends to adopt the provisions to amend/improve the MAP in their entirety and also to adopt the optional provisions on mandatory binding arbitration (without making a reservation either as to the scope of such arbitration or to exclude issues from arbitration where a decision has previously been made by a court).

It has also been stated that HMRC will produce and publish consolidated versions of UK treaties as amended by the Convention, notwithstanding that other countries are taking a different approach. Australia, for example, has stated that it will not produce consolidated versions of its treaties but will produce guidance for taxpayers instead.

Where does this leave us?

Although the Convention has been designed to be palatable to the maximum possible number of jurisdictions, it seems likely that its inherent flexibility may cause difficulties in determining its effect, as it is not clear how easy it will be to determine which treaties are to be amended (or in what manner) as a result of the various notifications and reservations to be made by signatories to the Convention.

In addition, the implementation process is likely to involve a number of details that are yet to be worked through, as the Convention throws up important (non-tax specific) issues regarding treaty interpretation, and the multilateral amendment of bilateral treaties is unprecedented in the tax sphere.

Businesses operating internationally would therefore be advised to monitor developments to consider the impact on their operations once the Convention comes into effect for UK treaties. ■

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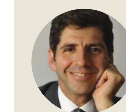
Briefing

Private client briefing for January



Andrew Goldstone
Mishcon de Reya
Andrew Goldstone is a partner and head of tax at Mishcon de Reya LLP where he advises UK and international high net worth families and trustees on all aspects of tax and estate planning. Email: andrew.goldstone@mishcon.com; tel: 020 3321 7205.

Katie Doyle
Mishcon de Reya
Katie Doyle is an associate in the private tax group of Mishcon de Reya LLP. Her clients include high net worth individuals and families, both domestic and international, whom she advises on a range of taxation and trust issues. Email: katie.doyle@mishcon.com; tel: 020 3321 6339.

Speed read

An AG opinion confirms that there is an indirect incompatibility between TCGA 1992 s 80 and EU law. There are tribunal decisions on the nature of foreign currency and the implications of this for CGT purposes; and on the factors to be taken into account when assessing a CGT main residence election. The High Court rules on the application of the rectification test to a defective IHT double-trust arrangement. The government has published details of new tax changes affecting non-doms in the long-awaited draft Finance Bill 2017.

TCGA 1992 s 80 and EU law

In *Trustees of P Panayi Accumulation & Maintenance Settlements v HMRC* (Case C-646/15), on 21 December 2016, Advocate General Kokott of the CJEU provided an opinion on the First-tier Tribunal ruling in this case, centred on the compatibility of TCGA 1992 s 80 with the freedom of establishment, freedom to provide services and the free movement of capital under the Treaty on the Functioning of the European Union.

Section 80 provides that the migration of a trust resulting from trustees ceasing to be UK resident is a deemed disposal for CGT purposes of the trust fund at market value. The CJEU ruling in *National Grid Indus BV* (Case C-371/10) confirmed that while the state can charge tax during periods of residence, tax cannot be charged at the time of migration with no option to defer payment.

AG Kokott made the following points:

- The taxation on migration is a restriction on the freedom of establishment but this is permissible as it preserves the allocation of taxation powers between member states.
- The taxation of UK resident beneficiaries of a trust under TCGA 1992 s 87 on benefits received by them does not render a migration exit charge unjustified.
- Proportionality of the tax charge should be assessed on a case by case basis but it will be disproportionate where there is no option to defer payment, as is the case for s 80.