International Bar Association

Practical aspects of dealing with the MLI: an instruction manual - Taxes Committee newsletter article, August 2018

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Fouad G Sayegh
Walder Wyss, Geneva
fouad.sayegh@walderwyss.com

Report on a conference session at the 18th Annual Tax Planning Strategies US and Europe conference

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Session Co-Chair
Raul-Angelo Papotti *Chiomenti Studio Legale, Milan*
Dirk JJ Suringa *Covington & Burling LLP, Washington, DC*

Speakers
Robert Birchall *Charles Russell Speechlys, London*
Sophie Chatel *Centre for Tax Policy and Administration, OECD, Paris*
Nadine Gelli *De Pardieu Brocas Maffei, Paris*
Margriet Lukkien *Loyens & Loeff, Amsterdam*
Stefan Mayer *Gleiss Lutz, Frankfurt am Main*
Floran Ponce *Lenz & Staehelin, Geneva*

Introduction

The Session Co-Chair, Raul-Angelo Papotti, introduced the subject by stating the importance of the Organisation for Economic Co-operation and Development (OECD)'s Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS), also known as the Multilateral Instrument (MLI). It has become a key instrument for many governments to incorporate the results of BEPS into their bilateral tax treaties. Measures that can be implemented through the MLI include those on treaty abuse, permanent establishment, hybrid mismatch arrangements and binding arbitration. The panel focused on practical issues that tax authorities and practitioners have faced and are currently facing.

A United States tax specialist, Co-Chari Dirk JJ Suringa, satirically explained his presence since the US is not directly involved with the MLI. First, the limitation on benefits provision is very well known to US practitioners. Further, the current US tax

reform, which will provide for lower tax rates, may lead to more double taxation situations, which raises the question as to how foreign countries will react. Also, the MLI will participate in shaping the international tax policies and will influence the expectations from treaty partners. Therefore, Suringa believes the MLI developments are very relevant to the US.

MLI overview

Stefan Mayer gave insights on the MLI's background, which is the result of intensive BEPS discussions initiated by the G20 in 2013, resulting in its signing in Paris on 7 June 2017.

Numerous BEPS actions required amendments to existing treaties[1] which would have been otherwise very burdensome. As of today, 78 states have signed the MLI and five have ratified it. Out of 3,500 treaties, 1,200 are covered. Thirty two major tax treaties signed by Germany are covered.

As Mayer explained, when applying the MLI, the first action is to check if both countries involved name each other. If so, the MLI applies. While minimum standards apply in any case, opt-in and opt-out clauses are optional provisions applying only when both jurisdictions opt-in. There are also tiebreaker rules applicable to certain provisions where countries have made specific selections.

The MLI is a multilateral international agreement, which sits alongside existing bilateral tax treaties, modifying their application: tax treaties and the MLI coexist. The MLI is not an amending protocol. Technically, the MLI as a later agreement supersedes earlier tax treaties to the extent that there is a conflict between the provisions. Treaty partners are consenting to modify their earlier tax treaties (later in time rule, Article 30(3) Vienna Convention).

The entry into effect of the MLI is six months after the date on which it enters into force. Alternatively, it is 30 days after notification to the OECD that the contracting jurisdiction has completed its domestic procedures. Germany will opt for the alternative option.

Mayer then summarised the essential content of the MLI: a minimum standard for treaty abuse (part III); an optional provision on the avoidance of permanent establishment status (part IV); an optional clause addressing hybrid mismatches (part II); a mandatory mutual agreement procedure (part V); and an optional binding arbitration rule (part VI), as well as final provisions including very important technical guidelines. He lastly mentioned that the OECD update of 2017 on the Model Convention reflects most of the provisions included in the MLI, which simplifies situations when a treaty is amended or when a new treaty is signed.

OECD update on the MLI

Sophie Chatel, representing the OECD, emphasised the challenge of amending such a wide treaty network and developing and implementing the MLI, which relates to domestic legal systems pertaining to ratification processes. Slovenia was the fifth state to ratify the MLI on 22 March 2018. As a consequence, the MLI will enter into force on 1 July 2018. It will enter into effect for the first five signatories (ie, Austria, Isle of Man, Jersey, Poland and Slovenia) in 2019. As for the projected timeline, it is anticipated that most other ratifications will take place in 2018. This timeframe is

explained by the complexity of the MLI and the diversity of domestic ratification rules among signatories.

Chatel summarised the uptake of MLI provisions by signatories. Regarding Action 6 on the prevention of treaty abuse, the principal purpose test (PPT) has been adopted by all 78 signatories, which is a great success. In addition, 12 signatories have opted for the simplified limitation of benefits (LOB) provision, and six have accepted it (ie, they consider the PPT to be sufficient, but accept LOB upon a counterpart's request). She explained that the simplified LOB is a 'super residence' clause, which applies when there is not enough substance. Under the simplified LOB, it is not sufficient to be a resident. It is also necessary to demonstrate additional connections to the state of residence. Chatel noted that while the LOB provision focuses on 'what you are', the PPT concentrates on 'what you do'. At the time of the signing, 300 tax treaties, mainly UK, US and Japan treaties, provided anti-treaty shopping rules. All agreed that an LOB provision was not sufficient and hence proposed to have a PPT clause and a simplified LOB.

As for Action 14, all 78 signatories bring the mutual agreement procedure (MAP) up to standard. While 53 states accepted MAP submissions to both contracting states, 25 will implement a bilateral notification or consultation process. Concerning arbitration, 28 signatories have opted therefor, of which 21 have preferred the 'baseball' rule, where both parties are to make their best offer, over the hearing style. Chatel welcomed this choice, as experience shows that sometimes both positions are so close that the dispute naturally resolves without the need of further proceedings. She hopes that more signatories will opt for arbitration in the future, when positive experience will be shared.

The matching results on the provisional MLI positions widely differ. While the new preamble (Article 6) and the PPT (Article 7) reach 100 per cent, the matching on the PPT plus simplified LOB is of three per cent only. Chatel explains that the latter is not a minimum standard and is more complicated than the PPT because it already exists in treaties. She also stressed that the MLI process went fast, and that some signatories needed more time to agree on some proposed rules, even before broaching the complexity of integrating new concepts into current definitions. The matching rate on permanent establishment provisions (Articles 12, 13 and 14) varies between 17 and 33 per cent. Yet Chatel anticipates that these new rules will be implemented in policies, as there were few reservations to the new provisions on permanent establishments in the new OECD Model Convention. More generally, she reminded the audience that when a signatory lifts a reservation, there is no way back. This obviously favours a prudent approach, where countries will gradually adapt.

The OECD has a clear objective of ensuring clarity. Hence it has developed an MLI application toolkit, including a database and training and public materials, which is available on its website and designed to help professionals and governments understand and apply the MLI. Given the complex legal nature of the MLI and the numerous separate documents involved, it may prove difficult to assess how a double tax treaty is impacted by the MLI. Whereas the correct reflection of the legal situation lies on separate documents, some countries may offer synthesised texts (ie, references to the MLI in double tax treaties) or consolidation texts. However one must keep in mind that the MLI is neither an amending protocol nor a static instrument. It will continue to evolve over time and will live side by side with double tax treaties.

A focus on the minimum standard provisions of the MLI

Nadine Gelli resumed the discussion with an overview of the minimum standard provisions. Under Article 6, tax treaties' preamble texts shall be modified so to specify that their purpose is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. She indicated that all treaty provisions will be interpreted in line with the revised preamble text. It is a clarification, rather than a new rule of interpretation. Yet Gelli believes that this should not have a large impact on the way treaties will be interpreted as it results from a natural evolution and that the preamble restores an original intention.

Preventing treaty abuse under the MLI can be achieved by three alternate means, it being specified that the MLI does not offer a detailed LOB provision: (1) PPT only; (2) PPT and simplified or detailed LOB provision; or (3) detailed LOB provision supplemented by anti-conduit rules. Most signatories (60) chose the first option, while a few (12) have chosen the second option and zero the third. For instance, the new double tax treaty between France and Luxembourg already includes a PPT provision.

Under the principal purpose test (Article 7), treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction, unless it is established that granting that benefit would be in accordance with the object and purpose of the treaty provision. Gelli highlighted that the text refers to 'one of the principal' purposes, rather than the 'sole' or 'dominant' purpose. It also requires an objective analysis. One shall thus assess whether it is reasonable to conclude that one should be entitled to treaty benefits. This is unlikely when an arrangement is inextricably linked to a core commercial activity. She added that the Court of Justice of the European Union (CJEU), in the *Eqiom* case of September 2017, held that French rules providing for fraud and abuse presumption where dividends are paid to a EU parent company located outside France if the latter is controlled directly or indirectly by shareholders in third states are not permissible under the EU Parent-Subsidiary Directive. The CJEU stressed the necessity of an individual examination of the whole operation in order to determine whether an operation pursues an objective of fraud and abuse.

Gelli illustrated the application of the PPT provision with various examples proposed by the OECD. Floran Ponce reacted by saying that the examples chosen by the OECD were not based on controversial situations, but rather on circumstances where all signatories would agree on a common position, which is not helpful in practice. He then addressed unresolved issues, such as the articulation with general anti-avoidance rules (GAARs). For instance, the EU Parent-Subsidiary Directive (2015/121) and Anti Avoidance Directive (2016/1164) refer to 'valid commercial reasons which reflect economic reality'. There are also domestic anti-avoidance rules, such as in Switzerland (abuse of law doctrine). This implies a risk of practical difficulties and increased disputes. It might prove difficult to assess business reasons and tax reasons objectively. Ponce believes that this can only be subjective. He also mentioned that this may not change domestic practices. For instance, Switzerland will most likely continue interpreting the PPT in line with its current practice.

Among the challenges for the OECD, Ponce mentioned the need to provide for a consistent application of the test across jurisdictions. Countries with a detailed legislation (eg, the UK and Germany) might follow a stricter view than jurisdictions with a less detailed one (eg, France and Switzerland). Further, some jurisdictions

may adopt a stricter interpretation of the PPT than countries that have not matched an option for the LOB (eg, Indonesia and Switzerland). He then commented on a case study, indicating that treaty benefits should probably be granted by Swiss tax authorities in such a situation, given the fact that good business motives could be shown. It is, however, difficult to anticipate how this will evolve. The PPT may perhaps only add another layer of complexity, without harmonising different practices among states.

Chatel responded to the criticisms towards the OECD's work by saying that the preamble as such should play a heavy role in qualifying transactions as abusive. She added that the OECD gave much consideration to remarks and scrutinised existing domestic GAARs, as well as relevant case law. In that regard, the usufruct example commented on earlier (OECD Example B) has been inspired by a French court case, which was indeed very controversial. She thus hopes the OECD examples will prove useful. She finally added that not all countries are well equipped to fight against treaty abuse and she is therefore convinced that the MLI should be of a strong help to many.

Opt-in and opt-out clauses

As Robert Birchall noted, the MLI provides for some flexibility as to reservations and optional provisions, which is essential in order to give comfort to signatories with their domestic policies. A reservation on non-minimum standards equals an opt-out, which means that a unilateral decision can lead to a non-application for both contracting jurisdictions. Although asymmetric, such a decision hence leads to symmetry of effect. In that context, it is not possible to apply some rules to some countries, and not to others through the MLI. This flexibility yet comes at the cost of increased complexity.

As far as the UK and the Netherlands are concerned, the prevention of treaty abuse will be dealt with a PPT provision only. It is worthwhile noting that the UK has opted out of many provisions (eg, transparent entities, restriction of dividend transfer transactions, capital gains on real estate companies and the anti-abuse rule for permanent establishment in third jurisdiction), which will therefore not apply. On the other hand, as Margriet Lukkien indicated, the Netherlands have opted in on almost all provisions, believing that all other countries would do the same. The Netherlands is now considering modifying some of its choices. Birchall explained that the current selections were indeed provisional. Hence reservations and optional provision notifications are only indicative until domestic approval of MLI and deposited with the OECD. Jurisdictions can change their MLI position post-adoption, opting into optional provisions or withdrawing reservations. They cannot, however, modify their position the other way around. Hence most countries decided to keep a maximum flexibility for the future.

Interaction with existing bilateral tax treaties: application and interpretation challenges

Margriet Lukkien further discussed the MLI's effect on existing treaties and briefly presented the various compatibility clauses provided for in the MLI. She emphasised the notification requirement by states regarding existing provisions, which are modified or superseded by a particular MLI provision, and the possibility for mistakes or misunderstandings. She also pointed out that many countries are contemplating issuing consolidated MLI texts, stressing that one may not rely on such documents.

Language issues may also arise, as the MLI was drafted in two equally authentic languages: English and French. She wondered how the MLI and treaties will be read and interpreted when their languages differ.

Closing statements

Suringa concluded the session with a succinct wrap-up, observing that the panel had covered the MLI's main provisions, the structural issues presented by this method of implementing BEPS, the planning conundrums presented by an additional overlay on top of existing bilateral treaties, domestic laws and international agreements, as well as the various approaches adopted by countries allowed to pick and choose which provisions to adopt, giving rise to considerable complexity in implementation and interpretation.

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[1] Action 2: Neutralize the Effects of Hybrid Mismatches; Actions 6: Prevent Treaty Abuse; Action 7: Prevent the Artificial Avoidance of Permanent Establishment Status; Action 14: Make Dispute Resolution Mechanisms More Effective.