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International tax alert

Signing of MLI to modify bilateral tax treaties

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On June 7, 2017, representatives from 68 jurisdictions, including Canada, gathered at the OECD's headquarters in Paris for the signing of the *Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting* (MLI).

The MLI is designed to implement swiftly the tax treaty-related measures arising from the G20/OECD base erosion and profit shifting (BEPS) project. "Minimum standard" changes to the functioning of existing bilateral tax

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treaties in the areas of treaty abuse, mutual agreement procedures (MAPs) and treaty preambles will be implemented through the MLI. Further, depending on the reservations and notifications made by each party, optional changes to modify tax treaties in respect of permanent establishments (PEs), transparent entities, residency tiebreakers, double tax relief, minimum shareholding periods, capital gains derived from immovable property and a jurisdiction's right to tax its own residents will be facilitated.

As at the time of signing, Canada has registered provisional reservations with respect to most provisions of the MLI, meaning that such provisions will not, pending the future narrowing or withdrawal of such reservations, apply to modify Canada's treaties. Canada has adopted those provisions setting out the BEPS minimum standards for preventing treaty abuse, as well as the provisions relating to dispute resolution.

A subgroup of 25 jurisdictions, including Canada and 16 EU member states, have opted into the mandatory binding arbitration provisions, based on the principles set out in the final report on BEPS action 14 on making dispute resolution mechanisms more effective.

Canada has indicated that it will continue to evaluate its positions with respect to the MLI provisions, and will ultimately decide to withdraw or keep its reservations at the time the MLI is ratified.

Signing jurisdictions and treaties covered

The 67 parties that, along with Canada, signed the MLI are the following:

- Andorra
- Argentina
- Armenia
- Australia
- Austria
- Belgium
- Bulgaria
- Burkina Faso
- Chile
- China
- Colombia
- Costa Rica
- Croatia
- Cyprus
- Czech Republic
- Denmark
- Egypt
- Fiji
- Finland
- France
- Gabon
- Georgia
- Germany
- Greece
- Guernsey
- Hong Kong
- Hungary
- Iceland
- India
- Indonesia
- Ireland
- Isle of Man
- Israel
- Italy
- Japan
- Jersey
- Korea
- Kuwait
- Latvia
- Liechtenstein
- Lithuania
- Luxembourg
- Malta
- Mexico
- Monaco
- Netherlands
- New Zealand
- Norway
- Pakistan
- Poland
- Portugal
- Romania
- Russia
- San Marino
- Senegal
- Serbia
- Seychelles
- Singapore
- Slovak Republic
- Slovenia
- South Africa
- Spain
- Sweden
- Switzerland
- Turkey
- United Kingdom
- Uruguay

Eight other jurisdictions have expressed their intent to sign the MLI, including Mauritius and Estonia, the only EU/EEA state remaining to sign.

The OECD, in its role as depositary, has published on its website (http://oe.cd/mli) provisional lists of the treaties intended to be subject to the scope of the MLI, along with the related reservations and notifications (MLI positions). A treaty will be modified (and considered a covered tax agreement) only if the parties to it agree. Signatories may amend their MLI positions until ratification. After ratification, signatories can choose to opt in

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with respect to optional provisions (such as arbitration) or to withdraw reservations. They cannot add reservations.

Canada has, at the time of signing, listed 75 of its existing tax conventions as covered tax agreements. Notable exceptions are Canada's treaties with Switzerland and Germany, which are in the process of being renegotiated on a bilateral basis, as well as the United States which is not expected to sign the MLI. Additionally, Canada's treaties with Barbados and Brazil, among others, remain unaffected, given that such jurisdictions have not yet signed the MLI.

Mechanism for modifying covered tax agreements

The MLI does not function in the same way as an amending protocol to a treaty. The MLI does not directly change the underlying text, but will be applied alongside the existing treaty, modifying its application.

Flexibility and transparency

In some cases, the BEPS recommendations include multiple alternative ways to address an issue and, in other cases, provide for a main provision to be supplemented with optional additional provisions. The MLI is sufficiently flexible to support all previously agreed BEPS approaches by allowing jurisdictions to select from alternative options and by filing standardized technical reservations that identify their choices.

The extent to which the MLI modifies an existing tax treaty depends on the MLI positions of the parties to the treaty and the corresponding application of the mechanical provisions of the MLI. The OECD has published a toolkit, including interactive flowcharts, to assist in the application of the MLI to existing tax treaties. A public online matching tool, to simulate the likely matching outcome based on MLI positions, is under development and a beta version is expected to be available by October 2017.

In general, any reservations or choices made by a country will apply to all of its covered tax agreements, but can be restricted to a subset of its covered tax agreements based on objective criteria.

Treaty abuse (minimum standard)

The treaty abuse minimum standard addresses concerns that tax treaties could be used to make treaty benefits available in unintended circumstances. The MLI includes a provision which applies to modify the preamble of covered tax agreements in order to clarify that the intent of such agreements is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. This modified preamble text is relevant from a Canadian perspective insofar as it may affect the application of the general anti-avoidance rule to transactions involving benefits obtained under covered treaties.

In addition to the modifications to the preamble of covered agreements, the MLI provides for the implementation of a substantive technical rule to prevent treaty abuse in accordance with the BEPS minimum standard. This substantive rule may take several forms: principal purpose tests (PPT) or simplified limitation on benefits (LOB) rules, supplemented with a PPT. Alternatively, the use of detailed LOB rules (supplemented by a mechanism to deal with conduit arrangements) is permitted. A multitude of outcomes can arise where the approaches differ, and asymmetric results are possible if both jurisdictions approve.

All 68 signing jurisdictions have opted to include the PPT within their covered tax agreements. The following 12 countries have chosen to opt for the supplementary LOB rules: Argentina, Armenia, Bulgaria, Chile, Colombia, India, Indonesia, Mexico, Russia, Senegal, Slovakia and Uruguay.

As Canada has adopted the PPT only, and has not opted to permit the application of the simplified LOB in any of its covered tax agreements, notwithstanding the choices of other parties to such agreements, the simplified LOB should have no application to Canada's treaties. The PPT applies to deny treaty benefits in respect of a particular transaction or arrangement where it may reasonably be concluded, having regard to all relevant facts and circumstances, that one of the principal purposes of the transaction or arrangement was to obtain the treaty benefit. The OECD has provided very limited interpretive guidance on the application of the PPT. In a domestic context, Canadian courts have historically established a very low threshold for applying similar tests. Accordingly, the widespread adoption of the PPT is likely to result in additional uncertainty as to the availability of treaty benefits for taxpayers.

Canada has indicated an intention to negotiate, over the longer term and on a bilateral basis, a detailed LOB provision that would meet the BEPS minimum standard, and which should, all else being equal, help to reduce some of the uncertainty noted above.

Permanent establishment (optional)

The PE provision in the MLI lowers the threshold at which a PE (taxable presence) will arise by:

- Broadening the scope of a dependent agent PE (capturing the use of commissionaire arrangements and other matters);
- Narrowing the exemptions for a fixed place of business PE by requiring activities to be "preparatory or auxiliary" in nature and/or by introducing an anti-fragmentation rule; and
- Countering avoidance where long-duration construction contracts are split into a series of shorter contracts.

Within the EU, only eight countries have opted for the dependent agent/commissionaire changes: Croatia, France, Lithuania, Netherlands, Romania, Slovakia, Slovenia and Spain. 14 EU member states have opted for the narrower preparatory or auxiliary provisions: Austria, Belgium, Croatia, France, Germany, Ireland, Italy, Lithuania, Luxembourg, Netherlands, Romania, Slovakia, Slovenia and Spain. 13 member states have opted for the anti-fragmentation measures: Belgium, Croatia, France, Ireland, Italy, Lithuania, Netherlands, Portugal, Romania, Slovakia, Slovenia, Spain and the UK. The splitting up of contracts anti-avoidance has only been fully adopted within the EU by France and Slovakia.

Like Canada, 11 EU member states have reserved against all of the above changes to the PE threshold: Bulgaria, Cyprus, Czech Republic, Denmark, Finland, Greece, Hungary, Latvia, Malta, Poland and Sweden.

Mandatory binding arbitration (optional)

The mandatory binding arbitration rules will apply only if both parties to a treaty opt in. Unlike in most other areas of the MLI where reservations are standardized, parties are free to determine the scope of cases that will be eligible for arbitration (subject to acceptance by the other relevant parties).

Typically, a taxpayer can request arbitration where a case has been subject to a MAP for at least two years without resolution. Two different types of decision-making processes are facilitated by the MLI: (i) “final offer” rules, whereby each competent authority presents its own proposed resolutions and the arbitrators choose their preferred outcome; and (ii) the “independent opinion” approach, which results in a decision written by the arbitrators based on their analysis of the information provided to them.

The jurisdictions that have opted into mandatory binding arbitration are: Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK. Most, including Canada, have opted for the default option of final offer arbitration.

Canada has formulated a reservation which limits the scope of cases eligible for mandatory binding arbitration to those involving primarily factual disputes, rather than matters involving alleged instances of treaty abuse or other matters of core treaty interpretation.

Additionally, Canada has reserved the right for the existing arbitration provisions in its treaty with the UK not to be affected by the MLI.

Entry into force and into effect

Individual signatories will be required to ratify the MLI in line with their domestic constitutional arrangements. The MLI must be ratified by at least five jurisdictions before it first enters into force. Following a period of three months after the date of ratification by the fifth state, the MLI will enter into force for those first five jurisdictions at the start of the subsequent calendar month. A three-month period will apply for all other jurisdictions that subsequently ratify the MLI.

The MLI can enter into effect for a specific covered tax agreement only after the three-month period has expired for all parties to the covered tax agreement. The default timings are:

- Modified withholding tax provisions will have effect for payments made after the first day of the following calendar year; and
- Changes relating to taxes levied with respect to taxable periods will have effect for taxable periods beginning on or after a period of six calendar months has elapsed (or less if both parties agree).

Jurisdictions can unilaterally replace the term “calendar year” with “taxable period,” and vice versa (potentially leading to asymmetry). Different provisions apply for dispute resolution and cases could be eligible even where the dispute relates to a period before the MLI was in force.

The Department of Finance has estimated that the MLI will enter into force with respect to provisions in Canada’s covered tax agreements concerning withholding taxes starting in 2019, with all other provisions entering into force for taxation years commencing after June 1, 2019 (e.g., 2020 for calendar year taxpayers).

Comments

The MLI is an important milestone in global agreement on international corporate taxation. It sends a signal that countries are determined to cooperate to minimize base erosion while working to avoid economically damaging double taxation.

The participation of 68 jurisdictions in the signing ceremony is expected to result in the amendment of over 1,100 treaties in line with BEPS recommendations—about one-third of the global total. The MLI remains open to interested parties, and the OECD Secretariat hopes that 90 jurisdictions will have signed by the end of 2017.

Many countries have listed significant numbers of treaties in their provisional notification: UK (119); China (102); Belgium (98); France (88); India (93); Luxembourg (81); and Netherlands (82). Widespread adoption should help to ensure consistency in the implementation of the BEPS project, resulting in more certainty for businesses and tax authorities. The next step is for the signatories to complete their domestic ratification procedures; this will determine when the changes will have effect for each tax treaty—likely to be from 2019 onwards.

All members of the BEPS Inclusive Framework are committed to endeavouring that treaties will comply with the minimum standard requirements. The US did not participate in the signing ceremony, but does have robust LOB provisions in its existing treaties. The Inclusive Framework on BEPS will undertake a peer review and monitor whether its members' treaties satisfy the BEPS minimum standards.

The PPT will be introduced in all 1,100 treaties covered by the MLI although 12 signatories, including India and Russia, have chosen to supplement this with a simplified LOB clause.

The proposed changes in respect of PEs have not been adopted as widely. Within the EU, only France and the Netherlands will broadly adopt all of the PE changes and the UK will only adopt the anti-fragmentation rule. These provisions may require revisiting by the Inclusive Framework to increase consistency.

The effective resolution of disputes that could lead to double taxation remains an essential objective of double tax treaties and key to removing one of the barriers to international trade. The number of disputes between tax authorities globally continues to rise, and the adoption of the optional mandatory binding arbitration rules by 25 jurisdictions will be welcomed by business.

The OECD has published on its website a number of useful tools along with the provisional lists of treaties, options and reservations for each of the signatories. Businesses that currently benefit from double tax treaties between the initial signatories can now begin to analyze the impact of the changes published. Careful analysis will be needed since the information available is long and complex. The public online matching tool expected to be launched in October 2017 will be welcomed.

Although there is no requirement to do so, many governments may produce some form of consolidated treaties once the positions are finalized on ratification.

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