

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

Background

As part of the base erosion and profit shifting (BEPS) process which was initiated in 2013, the OECD was tasked to come up with recommendations on different areas of international tax standards.¹ One of the outcomes of the process was a Multilateral Convention (MC-BEPS)² to implement changes to tax treaties. Countries around the world are now being encouraged to sign this Convention, which is also known as the Multilateral Instrument (MLI). The Convention is meant to implement the following changes to tax treaties:

- Prevent hybrid mismatches
- Prevent treaty abuse
- Strengthen Permanent Establishment definitions
- Amend dispute resolution provisions

Any country can sign up to the Convention but no country has to. There is also a long list of reservations that countries can make against individual provisions in the Convention if they do sign up to it. Countries are also free to withdraw from the Convention at any time.

¹ For full details about the BEPS project, see <http://www.oecd.org/tax/beps/> and ActionAid's assessment from 2015 https://www.actionaid.org.uk/sites/default/files/publications/beps_-_patching_up_a_broken_tax_system_0.pdf

² www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

ActionAid assessment of the Convention

While the Convention contains many potential improvements on some of the provisions that currently exist in most tax treaties, developing countries should carefully consider if it is in their interest to sign it at this stage. Much uncertainty remains about the impact of the Convention, including on its entrenching the role of the Organisation for Economic Cooperation and Development (the OECD) – an Paris based organisation consisting of 35 of the richest countries in the world - as the standard and policy setting body on international tax norms. This may not be in developing countries interest.

Developing countries should take a holistic approach to reviewing their tax treaties and determine the best course for improving the worst aspects of the worst treaties they have. Signing the Convention could be part of a strategy to improve a country's tax treaties but does not have to be. If developing countries do sign up to the Convention, we urge them to consider carefully which provisions to sign up to and which to opt out of. For example, we recommend that developing countries do not sign up to the provisions relating to dispute resolution and mandatory arbitration. Below is an assessment of the various provisions in the Convention.

Regarding **hybrid mismatches**, the provisions in the Convention aim to ensure that there is no double non-taxation – i.e. that taxable profits are actually taxed by one of the treaty partners. If implemented correctly, these would help ensure that companies don't get away with double non-taxation by using complex company structures, loopholes in legislation, or by exploiting differences in national tax legislations.

Similarly, the provisions on **permanent establishment**, which determine when a multinational company is established enough in a country for that country to tax its local profits, are an improvement on current praxis. Amongst other things, the permanent establishment provisions – if implemented rigorously – could make it harder for multinational companies to claim that they don't have a permanent establishment (i.e. taxable presence) in a country by using a third party to conclude contracts on the company's behalf in that country. Due to the expected reservations against these provisions in the Convention by wealthy, capital-exporting countries and the risk of patchy implementation, they may not be hugely effective.

The provisions on avoiding **treaty abuse** are also promising, but patchy implementation could decrease the effectiveness of these provisions. The Convention states that all tax treaties should include the following text in its introduction:

“Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).”

The Convention also contains a general anti-abuse provision, something that’s currently not included in most treaties that developing countries are party to. If avoiding taxes is “one of the principal purposes of any arrangement or transaction” then the treaty benefit should be denied (a so-called ‘principal purpose test’ PPT). The Convention also provides the option of adding a ‘Limitations on Benefit’ (LOB) provision to the principal purpose test. For example, the LOB says that treaty benefits shall not apply if the company trying to access the treaty benefit is operating as a holding company or providing group financing. The anti-abuse wording would be in improvement to most existing tax treaties.

The Convention further contains provisions on **dispute resolution and mandatory arbitration**. This provision means that if a company thinks a treaty has not been implemented properly, it has three years to tell the relevant countries, who will then work together to solve the problem. If this does not resolve the dispute, it can then go to ‘Mandatory Binding Arbitration’ (MBA). If a dispute does go to MBA, each of the two countries will appoint a panel member each, and then those two panel members will together appoint a third panel member who will also be the chair of the panel. These three panel members will then look at the evidence and come with binding recommendations.

The costs of the panel members will be paid for by the countries themselves regardless of the outcome of the arbitration. This risks becoming rather expensive for a developing country if they were to sign up to MBA. The threat of arbitration risks discouraging countries from fully using their taxing rights. The arbitration proceedings are confidential and will take place behind closed doors. None of the evidence produced will be made public. This is an ‘opt-in’ rather than an ‘opt-out’ clause. ActionAid recommends that countries refrain from opting in to this provision.

The Convention also contains a provision on **corresponding adjustments**, which requires a country to apply **arm's length pricing** to a transaction if the other treaty partner does so. The article is the same as OECD and UN model Art 9(2) and de facto imposes the OECD's transfer pricing standards on a bilateral basis. Under the Convention, countries can opt out only by applying the reservation in 17(3)(b)(ii), which means they will try to resolve such issues using the mandatory arbitration process described above.

This is a rather problematic, as in practice it could end up meaning that a country has to accept mandatory arbitration, or else they have to accept the OECD's transfer pricing standards. ActionAid therefore recommends that developing countries opt out of the corresponding adjustments clause (Art 17(1)).

ActionAid recommends developing countries:

- **Only sign up** to the The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting **after careful consideration** of which – if any – of the provisions in the Convention are beneficial to them
- **Consider not immediately signing up** to the Convention but rather wait until its impacts on the global network of treaties are known before considering signing
- **Do not opt in** to the provision regarding dispute resolution or **mandatory arbitration**
- Assess each provision in the Convention on their individual merits and consider whether it would be beneficial to include them on a **case by case basis** into tax treaties on a **bilateral basis** as treaties are negotiated or renegotiated, rather than signing up to the whole Convention

ActionAid recommends OECD countries:

- **Do not make signing the Convention a condition** to proceed with e.g. trade, investment or other agreements with developing countries
- Do not make reservations against the provisions on **hybrid mismatches**, **permanent establishment** or **treaty abuse** that render those provisions meaningless
- **Do not opt in** to the provision regarding **mandatory arbitration**