The Multilateral Tax Convention and Implications for Existing Tax Treaties: Volume I

Introduction

On 7 June 2017, The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the Convention) was signed by 68 states at a signing ceremony in Paris. Mauritius signed the Convention two days before the ceremony. Other signatories to the Convention include, the United Kingdom, South Africa, Germany, India, Denmark, Canada, Norway and Sweden.

The Convention is a product of the BEPS Project. The BEPS Project is an initiative of the G20 and the Organisation for Economic Co-operation and Development (OECD), undertaken to address erosion of the tax base by entities (engaged in cross border transactions) through tax planning strategies that artificially shift profits from states in which all or most of the economic activities giving rise to the profits take place, to low or no tax states in which little or no economic activity takes place. The effect of such strategies is that little or no tax at all is paid.

The BEPS Action Plan identified 15 Actions that need to be taken to deal with base erosion and profit shifting. These are: -

1. Address the tax challenges of the digital economy,
2. Neutralize the effects of hybrid mismatch arrangements,
3. Strengthen controlled foreign corporation (CFC) rules,
4. Limit base erosion via interest deductions and other financial payments,

5. Counter harmful tax practices more effectively, taking into account transparency and substance,
6. Prevent Double Tax Treaty (DTT) abuse,
7. Prevent artificial avoidance of permanent establishment (PE) status,
8. 9. and 10. Assure that transfer pricing outcomes are in line with value creation,

11. Establish methodologies to collect and analyse data on BEPS and the actions to address it,
12. Require taxpayers to disclose their aggressive tax planning arrangements,
13. Re-examine transfer pricing documentation,
14. Make dispute resolution mechanisms more effective, and
15. Develop a multilateral instrument to implement measures developed in the BEPS Project.

The objectives of implementing some of the actions are achievable only by changing domestic laws while for others both domestic laws and DTTs need to be changed. In this regard, it was concluded that full implementation of actions 2,6,7 and 14 required both domestic legislation and the existing bilateral DTTs to be amended. Considering that there are between 2,000 and 3,000 DTTs, negotiation of amendments and actual amendment would be too time consuming and so onerous a task, that it would fail and consequently, the desired objectives of making amendments would not be achieved. To address this challenge, the option of a multilateral DTT was explored. This is what Action 15 was about.

A group was established to develop the multilateral DTT. A total of 99 countries, including Kenya, participated in the discussions and on 24 November 2016 adopted both the text of the Convention and the Explanatory Statement. The Convention was opened for signature on 31 December 2016. On 7 June 2017, a ceremonial signing ceremony took place during the OECD week. Though Kenya is not one of the states that signed the Convention, we believe that having shown interest in limiting base erosion through amendments to domestic laws and having participated in the development of the Convention, it will sign and ratify the Convention in the near future.

Operation of the Convention

The Convention will modify the existing bilateral DTTs. It will not directly amend the text of DTTs but will apply together with the DTTs, by only modifying those provisions of the DTTs that require modification to achieve the desired objective of limiting base erosion and profit shifting. The rationale for not making direct amendment is that the Convention seeks to amend numerous DTTs which have varying texts and it is therefore not practical to amend all of them through a single instrument.

The Convention derives its legal authority to modify existing DTTs from Article 30 of the Vienna Convention on the Law of Treaties. The Article provides that where parties to an earlier DTT are also parties to a later DTT with respect to the same subject matter, but the earlier DTT is not terminated or suspended, the earlier DTT applies only to the extent that its provisions are not inconsistent with the provision of the later DTT. Consequently, for a DTT to be capable of being modified by the Convention, both DTT contracting states must be parties to the Convention.

Under the Convention, it is necessary for both DTT contracting states to notify the Depositary that they wish to have their DTT covered by the Convention, for the Convention to apply to that DTT. As such, if one state notifies the Depositary and the other one does not, the Convention would not apply. Contracting states can also opt out of certain provisions of the Convention. Where a provision reflects a minimum standard, contracting states may only opt out of it in exceptional circumstances, such as where there are provisions expressing the same standard in their DTT. Minimum standards are BEPS measures which it was agreed must be implemented to curb base erosion and profit shifting issues.

Provisions of the Convention on each Action Amended

Action 2: Neutralizing the effects of hybrid mismatch arrangements

Hybrid mismatch arrangements are arrangements that exploit differences in the tax treatment of hybrid entities or hybrid instruments in more than one state to achieve double non-taxation. A hybrid entity is an entity that is considered as a taxable person in one state and as a transparent entity in another. Take an example of two states, A and B, which have a DTT. A, treats a limited liability partnership (LLP) as a transparent entity and B treats the same kind of partnership as a company. The LLP is registered and does business in A. For individuals, the DTT provides for income tax to be levied on the basis of residence and for exemption of dividends from tax. The partners of the LLP are resident in B.

When the LLP earns income, A does not tax the income because it is taxable on the partners in their state of residence, which is B. B having treated the LLP as a non-transparent entity, resident in A, does not tax its income. It treats the income received from the LLP as dividends and does not tax them. In the end, the income is not taxed at all.

Under the Convention, income earned through an entity or arrangement considered transparent under the law of either contracting state will be deemed income of a resident of a contracting state only if that contracting state considers the income to be income of its resident. In the illustration above, A would not treat the income earned by the LLP as the income of persons resident in B because B does not treat the income as that of its residents. Instead, A would treat the income as income earned by its residents and tax it.

A hybrid instrument is an instrument which may be treated as debt instrument in one state and as an equity instrument in another. The different treatment in the two states can lead to double non-taxation. Take for instance state C and D. C regards preference shares as equity while D regards them as debt. A taxpayer resident in C buys preference shares in a company resident in D. D treats the dividend as interest and allows a deduction in determining the taxable income. The DTT between the two states, like many other DTTs provides for exemption from tax of dividend income derived by a resident of contracting state from the other state. C therefore exempts the dividends from tax. In effect, the dividend escapes tax completely, except where withholding tax is levied in D.

The Convention provides that where a DTT provides for exemption of dividends from tax, a contracting state should not grant the exemption where dividends qualify for a deduction in determining the taxable profits in the other contracting state. The state that would have exempted the dividend should, however, grant a credit for tax paid in the other state on the income.

Further, the Convention has the following additional provisions intended to ensure that DTT benefits are not granted in inappropriate circumstances:

1. Certain DTTs provide for avoidance of double taxation through a state exempting from tax income which is taxable in the other state. This can result in double non-taxation where both states apply the exemption rule. Under the Convention, a state should grant an exemption only to the extent that the other state has not granted a similar exemption.
2. Another instance that may result in DTT benefits being granted in inappropriate circumstances is artificial persons being resident in more that one contracting state and consequently enjoying benefits granted to residents in both states. Presently, most DTTs, being based on the OECD Model Tax Convention, use the place of effective management as a general tie breaker rule. The Convention will replace this rule with a provision requiring the competent authorities of the contracting states to determine the question by mutual agreement, having regard to all relevant factors. In the absence of such agreement, the dual resident person will not be entitled to DTT benefits except as agreed by the competent authorities. Issues of dual residence will therefore be solved on a case by case basis and DTT benefits denied where an agreement is not reached as to the residence of a person.

The provisions on hybrid mismatch arrangements are not minimum standard provisions and therefore states to the Convention can freely opt out of them.

This article will be continued in the next issue of this newsletter.

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