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

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.

The Convention is a product of the BEPS Project. The BEPS Project is an initiative of the G20 and the 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 BEPS Action Plan identified 15 Actions that need to be taken to deal with base erosion and profit shifting. The objectives of implementing some of the actions are achievable only by changing domestic laws while for others both domestic laws and double tax treaties (DTTs) need to be changed. 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 and that a multilateral instrument would be most effective in amending bilateral DTTs. The Convention is the envisaged multilateral instrument.

This is a continuation of the article in Volume I of this newsletter issued on 29 August 2017. The provisions of the Convention relating to Action 2 were discussed in the previous volume.

Action 6: Preventing DTT abuse

DTT abuse, and particularly DTT shopping, was identified by the BEPS Project as a very significant source of base erosion and profit shifting concern. DTT shopping is the application of strategies through which persons who are not residents of a State try to obtain benefits available to residents of that State pursuant to a DTT concluded by that State. This could for instance involve the establishment of a conduit entry in that State.

The Convention introduces the following minimum standard changes to deal with DTT abuse:

1. Inclusion of a statement in the preamble that the intention of the states entering into the DTT, is to eliminate double taxation without creating opportunities for reduction of taxation or non-taxation, through tax evasion or avoidance including through DTT shopping arrangements. The provision is applicable in place of or in the absence of a preamble statement on elimination of double taxation. States may reserve the right for the provision not to apply to a DTT that already contains a preamble statement that expresses the need to eliminate double taxation without creating opportunities for reduced taxation or non-taxation.
2. Inclusion of a general anti-abuse test based on the principle purpose of arrangements or transactions (''principle purpose test''). Under the Convention, a tax benefit conferred under a covered DTT will not be granted where it is reasonably concluded, having regard to all facts and circumstances, that obtaining the benefit was one of the principal purposes for which a transaction or arrangement was effected. Nevertheless, where it is determined that granting the benefit would be in accordance with the object and purpose of the DTT, the benefit will be granted. States may reserve the right for this rule not to apply where they already have a principle purpose test rule or where they intend to develop and adopt a detailed limitation of benefits rule (LOB) and a principle purpose test or rules to address conduit

structures. In the case of the latter reason, the states are required to endeavor to reach a solution which meets the minimum standard.

3. The Convention also contains a simplified LOB rule that may be adopted to supplement the principle purpose test rule. This is not a minimum standard rule. The rule applies only where both contracting states have chosen to apply it. Under the rule, a resident of a contracting state is not entitled to a benefit provided in the DTT unless the person is a qualified person.

A qualified person is:

(a) An individual,

(b) The contracting state or a political subdivision, agency or instrumentality thereof,

(c) A company or other entity whose principal class of shares are traded in a recognized stock exchange,

(d) An artificial person that is:

1. An agreed non-profit organization in each contracting state,
2. A recognized pension fund or other retirement funds.

(e) An artificial person in whom at least 50% of the shares are held by persons who are resident and qualified under (a) to (d) above, in at least half of the 12-month period that includes the time when the benefit would otherwise be accorded.

Take for instance individuals resident in state J who intend to do business in Kenya through a company and is aware that state J does not have a DTT with Kenya. State J however has a DTT with state M. State M also has a DTT with Kenya. The two DTTs provide for exemption of dividends from tax if they are paid to residents of a contracting state. M has very low rates of tax. The individuals establish a wholly owned company in state M which owns a Kenyan company so that when the Kenyan company pays dividends, they are exempt from Kenyan tax. When they are received in state M they are subject to a small rate of tax. When the company in M pays dividends to the residents of J, they are exempt from M's tax. The individuals are able to save considerable amounts in taxes.

With the LOB rule, the company incorporated in state M would not qualify for the DTT exemption because it would fall foul of (e). The individuals are not resident as required by that provision. There are exceptions to the rule, under which a person who is not considered a qualified person may enjoy DTT benefits.

There are additional provisions in the Convention, most of which do not express minimum standards, intended to prevent treaty abuse.

Action 7: Artificial avoidance of PE status

DTTs generally provide for the business profits of a foreign enterprise to be taxed in a state only where the enterprise has a permanent establishment (PE) in that state. Multinational corporations (MNCs) employ certain strategies to avoid being deemed to have a PE in a state. These strategies as well as the provisions introduced by the Convention to combat them are as discussed below:

Avoidance through Commissionaire arrangements

MNCs may have commissionaire arrangements with subsidiaries instead of having distributorship arrangements. The effect of a commissionaire arrangement is that the profits taxable in a state are less than would be taxable in a distributorship arrangement, yet the functions performed in that state are substantially the same for both arrangements. Older treaties do not contain provisions that would prevent artificial avoidance of PE through commissionaire arrangements.

Article 5 (5) of the Kenya-United Kingdom DTT for instance provides as follows:-

''A person acting in a Contracting State on behalf of an enterprise of the other Contracting State - other than an agent of an independent status to whom the provisions of paragraph (7)

of this article apply-shall be deemed to be a permanent establishment in the first mentioned State if:

(a) he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise;

(b) he maintains in that former State a stock of goods or merchandise belonging to the enterprise from which he regularly fulfills orders on behalf of that enterprise.''

A UK entity operating in Kenya through a subsidiary may avoid being deemed to have a PE in Kenya by having an arrangement under which the Kenyan subsidiary source for clients, negotiates deals with such clients and does everything necessary for customers to agree to make a purchase including the conclusion of contracts on behalf of the parent. These contracts must be approved by the parent company. In reality, the approval is a formality, the parent approves all contracts submitted by the subsidiary. The subsidiary only provides services to the parent. It earns a commission for the services.

Since the contracts concluded by the Kenyan subsidiary are not binding on the parent company, the subsidiary cannot be said to have authority to conclude contracts on behalf of its parent. The parent is therefore not deemed to have a PE in Kenya. Consequently, only the subsidiary is taxable in Kenya, on the amount earned as a commission for performing the services it performs for the parent. The net profit under the arrangement is much lower than would be if the subsidiary was acting as a distributor. Consequently, less tax than would be payable is paid in Kenya. This practice has been found to be prevalent in OECD countries.

To deal with Commissionaire arrangements, the Convention provides that despite the definition of a PE by a DTT, where a person acts in a contracting state as an agent of an enterprise and in so doing habitually concludes contracts that are routinely concluded without material modification by the enterprise, the enterprise is deemed to have a PE in that state in respect of the activities undertaken on its behalf. This does not apply where these activities would not cause a PE to be deemed to exist if they were exercised by the enterprise itself through a fixed place of business.

The provision in the Convention will ensure that an entity will be deemed to have a PE not only when its dependent agent has and habitually exercises authority to conclude contracts but also when the agent plays the principal role leading to the conclusion of contracts, such as in the scenario described above.

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

For more information on this, please write to Mr. Emmanuel Laalia at ELaalia@vivaafricallp.com or write to us at info@vivaafricallp.com