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

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 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 envisioned multilateral instrument.

This is a continuation of the of the article in volume II of this newsletter issued on 1

September 2017. The provisions of the Convention relating Actions 2, 6 and part of 7 were discussed in the previous volume.

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. Use of commissionaire arrangements was discussed in the previous newsletter. The other strategies as well as the provisions introduced by the Convention to combat them are discussed next.

(a) Avoidance through specific exemptions

DTTs provide that the undertaking of certain activities, which are of a preparatory or auxiliary nature, in a fixed place, shall not create a PE status. The Kenya-UK DTT for instance lists, among others, the following:

i. the use of facilities solely for the purpose of storage display or delivery of goods or merchandise belonging to the enterprise.
ii. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.
iii. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.

This provision has led to tax avoidance by entities whose core businesses corresponds to activities which are of a preparatory or auxiliary nature. To address this, the Convention contains a provision clarifying that such exceptions are only applicable where the activities are of a preparatory or auxiliary character.

MNCs have also employed a strategy under which they fragment activities of a

cohesive business operation so that all or several operations are treated as being of a preparatory or auxiliary nature, thereby minimizing the amount taxable on the operation that is deemed a PE. The Convention provides that exceptions provided by a DTT do not apply to an enterprise where the same enterprise or a closely related enterprise carries on business in the same contracting state and:

1. one of those places constitutes a PE,
2. the overall activity resulting from the combination of the activities is not of a preparatory or auxiliary nature, and
3. the business activities constitute complementary functions that are part of a cohesive business operation.

(b) Avoidance through splitting of contracts

The PE clause in many DTTs requires that for specified projects or activities, a PE status is established when a project is undertaken or activities performed in a place for a specified period. The Kenya-UK DTT for instance provides that a building site or construction or assembly project constitutes a PE if it exists for more than 6 months. To defeat such provisions, MNCs split contracts to perform work into two or more contracts to be performed by related entities, each operating in the project site for a period that is less than the period specified in the DTT. The Convention provides that where closely related enterprises have arrangements where work is split and the period during which activities are carried out by each enterprise exceeds 30 days, the separate periods shall be aggregated for purposes of determining if a PE status has been created.

The provisions on preventing artificial avoidance of PE status are not minimum standard provisions.

Action 14: Making dispute resolution more effective

It was noted that the actions undertaken to counter BEPS should not lead to uncertainty for taxpayers and to unintended double taxation. It was consequently concluded that improving dispute resolution was a core component of the work to remedy BEPS issues.

(a) Mutual Agreement Procedure

DTTs generally make provision for the competent authorities of the contracting states to resolve differences or difficulties on a mutually agreed basis–mutual agreement procedure (MAP). For instance, under the Kenya-UK DTT, a resident of a contracting state who is at the risk of suffering double taxation is empowered to present his issue to the competent authority of the state in which he is resident. The competent authority is required, where the case is justified and the state is itself not able to resolve the issue, to endeavour to resolve the issue with the other contracting state with a view to avoiding double taxation.

The Convention provides that a person who considers that the results of the actions of one or both of the contracting states will lead to taxation that is contrary to the DTT to be free to present his case to either of the contracting states. This is much broader than provisions of many DTTs which specify that a person must present his case to the competent authority of the state in which he is a national or a resident.

Further, it specifies that the case must be presented within 3 years from the first notification of the action resulting in taxation and that any agreement reached must be implemented regardless time limits imposed by the domestic laws of the contracting states. The provisions referred to in the preceding sentence are common in some DTTs but are not found in all DTTs. The provisions of the Convention are

applicable in the absence of MAP provisions or in place of MAP provisions in a DTT.

This provision on improvement of dispute resolution is a minimum standard provision.

(b) Corresponding adjustments

Where a contracting state applies transfer pricing laws and adjusts the prices charged for goods or services and consequently taxes additional profits, to avoid double taxation, the other contracting state should make corresponding adjustments in arriving at the correct taxable amount. This is often not provided for in DTTs. The Convention provides that where one state adjusts the prices for transactions, the other state is bound to make corresponding adjustments. It also provides that in making such an adjustment, the contracting state should have due regard to the other provisions of the DTT. This is a minimum standard provision.

(c) Arbitration

Contracting states may opt to adopt the arbitration procedure provided for in the Convention. The Convention provides that where a person presents a case under MAP that provides as described above and the competent authorities are unable to reach an agreement to resolve the case within two years, any unresolved issue shall be submitted to arbitration if the person requests in writing. A contracting state may reserve the right to change the 2-year period to a 3-year period.

The Convention provides for the option to adopt a provision to the effect that the contracting states shall not be bound by an arbitration decision and the decision shall not be implemented if the competent authorities of the contracting states agree on a different resolution of all unresolved matters within three calendar months after the

arbitration decision is delivered to them.

The Convention also makes provision for various other matters connected with arbitration including the confidentiality of arbitration proceedings, resolution of cases prior to the conclusion of arbitration, arbitration proceedings and costs of arbitration proceedings.

Conclusion

As at 11 July 2017, 70 jurisdictions had signed the convention, including most of the jurisdictions with which Kenya has DTTs, and 8 others had expressed the intention to sign. Mauritius, a choice jurisdiction for establishing corporate structure for African operations and with whose DTT with Kenya only awaits the final step before it can come into effect, has ratified the Convention. If Kenya signs and ratifies the Convention, the implications will be quite significant. The exact extent of the implications will, however, depend on what reservations and notifications Kenya and its partner contracting states will make.

In summary, the signing and ratification will minimize opportunities for tax avoidance and evasion. It will also minimize instances of double taxation, create greater certainty and improve dispute resolution, all to the relief of persons engaged in cross border activities. It is worthy of emphasis that this will only affect persons operating in states with which Kenya has a DTT.

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