# Multilateral instrument coming into force to change many tax treaties from 1 January 2019

*14 May 2018*

## *In brief*

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) will enter into force on 1 July 2018, following Slovenia depositing the fifth ratification instrument on 22 March 2018.

Earlier, the following jurisdictions deposited their instruments of ratification with the OECD: Republic of Austria, the Isle of Man, Jersey, and Poland.

The entry into force of the MLI for double tax treaty Parties (as defined) determines when its provisions come into effect for the treaties between them. Different dates potentially apply for withholding taxes, other taxes, mutual agreement procedures to resolve disputes, and the use of arbitration to resolve disputes, where territories have chosen to apply arbitration.

We expect a significant number of the current 78 signatories to ratify the MLI and lodge the instrument of ratification with the OECD in time for many provisions to be in effect from 1 January 2019. For bilateral treaties this broadly relates to:

- withholding tax events arising from 1 January 2019 where the parties have both fully ratified before 1 October 2018
- other taxes for accounting periods beginning on or after 1 January 2019 under the Austria-Slovenia, Austria-Poland and Slovenia-Poland treaties (or other treaties in the unlikely situation in which the parties fully ratify before 1 October 2018 and agree to 1 January 2019 rather than the agreed default period)
- mutual agreement procedures where the latest party to ratify does so in September 2018 (so it could be earlier than 1 January 2019 where both parties ratify before 1 September 2018), and
- arbitration cases, where both parties opt in and the latest party to ratify does so in September 2018 (so it could be earlier than 1 January 2019 where both parties ratify before 1 September 2018).

Alternative effective dates will apply to many provisions and circumstances, and careful scrutiny will be necessary of the various defaults and options.

This Tax Policy Bulletin provides an overview of when and for which provisions the MLI will enter into effect in the bilateral tax treaties of the MLI signatories. The Bulletin also covers the - largely unforseen - consequences of territories' differing reservations regarding hybrid mismatches, treaty abuse, permanent establishments and dispute resolution.

## *In detail*

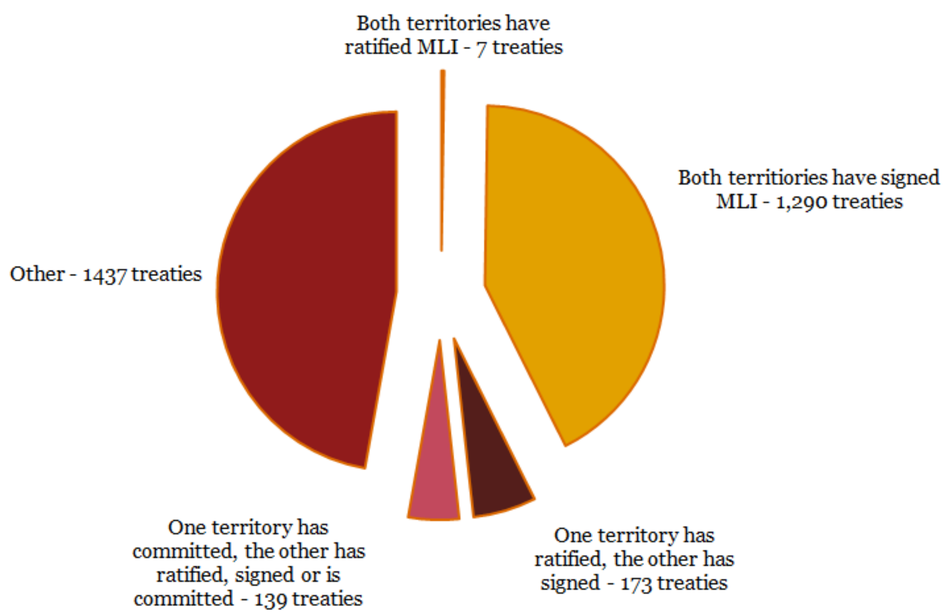
### ***Background***

The MLI covers recommendations from the base erosion and profit shifting (BEPS) project that affect double tax treaties. This applies both to various minimum standards and some additional recommendations. The MLI was developed under Action 15 and encompasses recommendations for:

- Action 2 (hybrid mismatches)
- Action 6 (treaty abuse)
- Action 7 (permanent establishments), and
- Action 14 (dispute resolution).

On 7 June 2017, 68 territories signed the MLI and a further ten have signed it since then, making 78 signatories so far. Of these, five have now obtained the status of ratification territories - Republic of Austria (22 September 2017), the Isle of Man (25 October 2017), Jersey (15 December 2017), Poland (23 January 2018) and Slovenia (22 March 2018). Six further territories have currently committed to sign.

With the aid of our MLI tracker, we have estimated the number of existing treaties involving combinations of status territories as set out in the diagram below. Some of these are not 'covered tax agreements' (CTAs) within the MLI's terms, i.e., they have not been listed by both parties for the purposes of the MLI, often because a new treaty is already being negotiated.




Source: PwC MLI Tracker

Countries that were part of the post-BEPS discussions on the MLI but have not signed the MLI include the US, Brazil, Kazakhstan and Ukraine. Of these, only Kazakhstan to date has given a firm commitment to sign the MLI. The others, along with the remainder of the 113 country BEPS Inclusive Framework, will be expected to meet the BEPS minimum standards in alternative ways (e.g., via bilateral agreement or protocol).

There are some MLI provisions that MLI signatory territories are required to apply unless, again, they will meet those minimum standards in alternative ways. Some provisions are entirely optional. Other texts in the MLI provide choices of approach. Territories have deposited with the OECD their draft 'positions' in these respects and must make them final on ratification.

The range of materials published by the OECD to help interpret the MLI was described in our Tax Policy Bulletin of 13 June 2017.

***Entry into force and entry into effect***

*Entry into force*

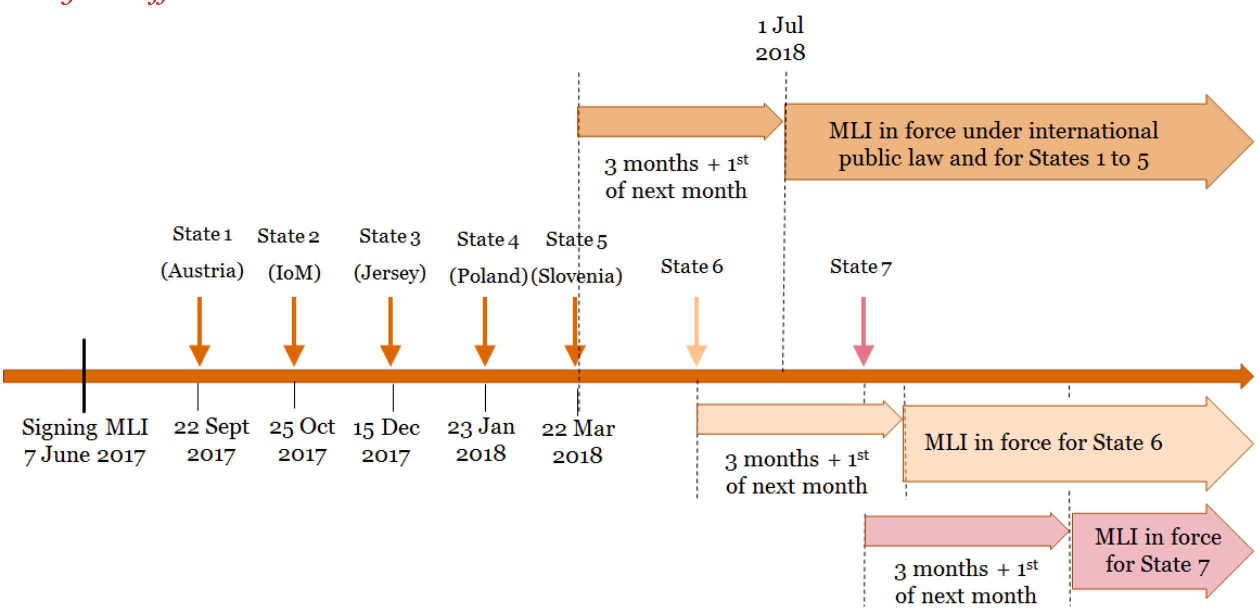
Now that five territories have ratified the MLI and deposited with the OECD their instruments of ratification together with a statement of their final positions ('ratification/ deposit'), the MLI has a date on which it will enter into force under Article 34(1) of the MLI. That date is 1 July 2018.

This date affects the potential timing for when the MLI will enter into effect in relation to a treaty to which one of those five movers is a Party. In practice it is determinative only in relation to the Austria-Slovenia, Austria-Poland and Slovenia-Poland treaties. The other four treaties involving combinations of these territories are not CTAs. The interaction of the entry into force date and timing of when provisions take effect is set out below.

The MLI will generally enter into force under Article 34(2) as regards any other territory three clear months from its ratification/ deposit by that territory.

The diagram below shows the process of entry into force for the first five ratifiers and theoretical illustrations for State 6 (say, ratification/ deposit between the date of this bulletin and 1 July 2018) and State 7 (say, ratification/ deposit after 1 July 2018).

*Entry into effect*




The effective dates from which the MLI provisions will modify the wording of a particular CTA differ according to the matter in point and options made by the Parties.

The default dates are:

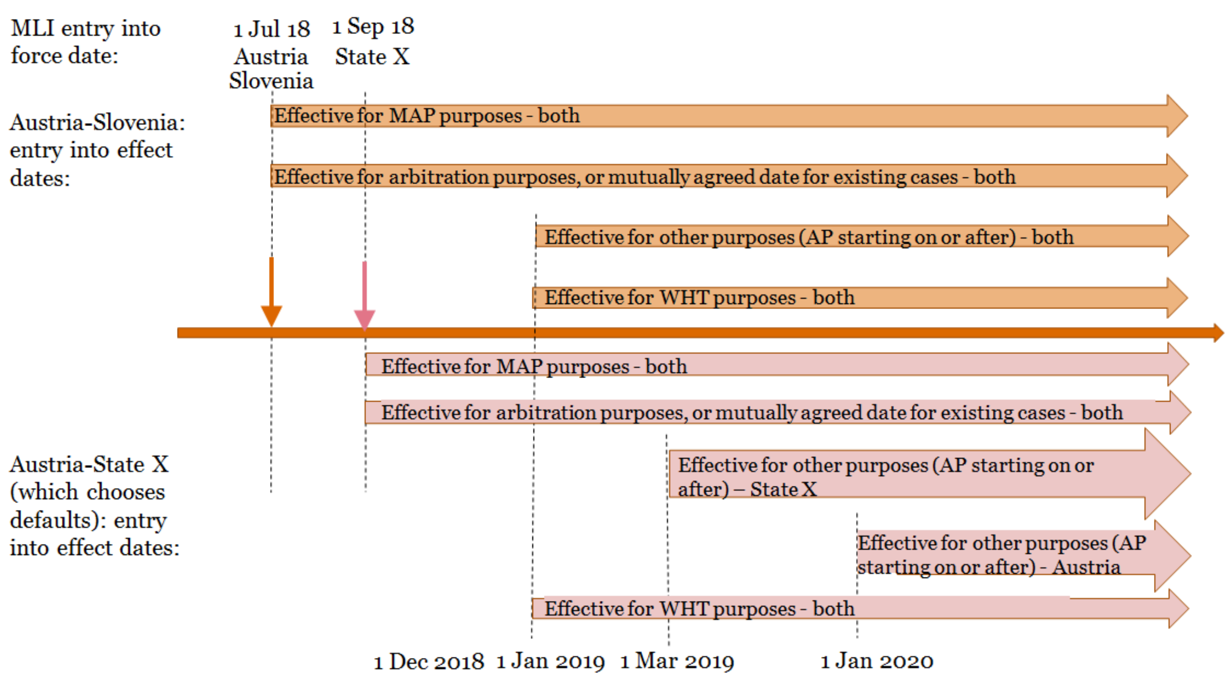
- Withholding taxes (WHT) - events from 1 January following the latest MLI entry into force date for the Parties (Article 35(1)(a))
- Other taxes - taxable/ accounting periods (APs) beginning from six months after the latest MLI entry into force date for the Parties (Article 35(1)(b))

- Mutual agreement procedures (MAP) - eligible cases presented from the latest MLI entry into force date for the Parties (Article 35(4)), and
- Arbitration - cases presented from the latest MLI entry into force date for the Parties and cases presented prior to that from the date mutually agreed by the Parties (Article 36(1)).

The main (but not only) options available to MLI territories include the right to:

- asymmetrically (i.e., for its own purposes only) have the WHT rules apply earlier, to events occurring from the latest MLI entry into force date for the Parties (Article 35(2))
- asymmetrically have the other taxes rules apply later, to APs beginning from the 1 January following six months after the latest MLI entry into force date for the Parties (Article 35(3)) - which Austria has done, as shown in the diagram below, and Jersey has also done
- symmetrically (i.e., if the parties to a CTA agree) have the other taxes rules apply sooner, to APs beginning from an agreed/ notified date after the latest MLI entry into force date for the Parties but before six months after that date (Article 35(1)(b))
- restrict the application of MAP to WHT and other taxes within scope of the MLI, rather than by reference to the time the case is presented (Article 35(6)) - which the Isle of Man and Jersey have done, and
- restrict the application of arbitration for existing cases to the extent the Parties mutually agree (Article 36(2)) - which Austria and Slovenia have done, applying that proviso to the treaty between them as well as potentially in relation to other treaties to which they are parties (but not the treaties they have with Poland, as Poland has not opted into the arbitration provisions).

The diagram below shows the process of entry into effect for the Austria-Slovenia treaty and a theoretical illustration for Austria and another territory, State X (entry into force, say, on 1 September 2018) where State X chooses default MLI start date options and opts into the arbitration provisions.



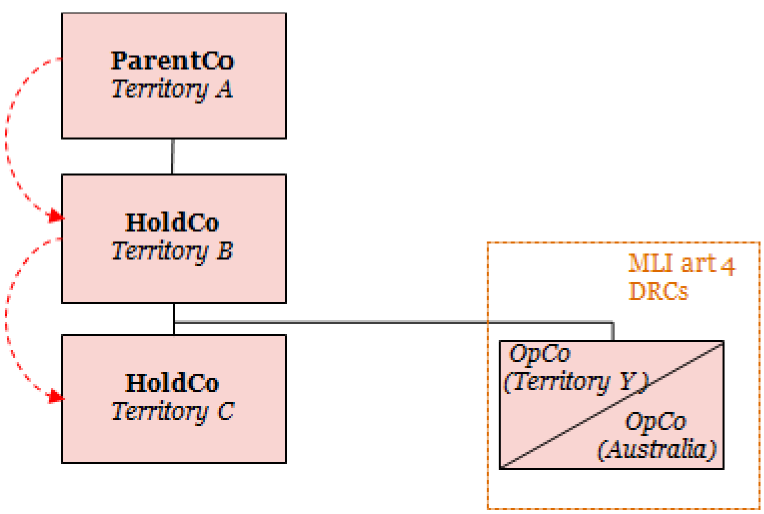

After the MLI has entered into force for a territory, a territory can add extra CTAs or relax reservations (in whole or in part) - territories may not strengthen or retract their reservations, meaning that in practice they can only move closer to the BEPS 2017 Model Tax Convention, rather than away from it. There are special provisions to deal with these situations that broadly replace the effective date for the changes to the entry into force date in the above calculations. Similarly there are adjustments if a territory later opts in to the arbitration provisions, although the other party has a period of time to accept the changes in relation to a particular CTA.

***Hybrid mismatches***

BEPS Action 2 recommended best practices (not minimum standards) for the matters briefly set out below that could be partly addressed by the MLI. Reference is made to the relevant article of the MLI and the equivalent article(s) of the OECD Model Tax Convention (MTC). The ability for a territory to opt-out (reserve) or make a relevant choice is also summarised.

| MLI | Model article | Comments | Optionality |
|---|---|---|---|
| Art 3 – Transparent entities | 1<br><br>23A/23B | Denies benefits where there is no taxation of income due to transparency<br><br>Limits double tax relief | Can reserve either or both |
| Art 4 – Dual resident entities | 4 | Replaces effective management tie-breaker with competent authority agreement | Can reserve outright or in specific circumstances |
| Art 5 – Application of methods for elimination of double taxation | 23A | Addresses non-taxation arising from including the exemption method where income is not taxed in the source state in certain circumstances, by requiring a tax credit to be given for tax imposed in the other territory instead | Can reserve outright or in specific circumstances |

*To illustrate one of these by reference to a hypothetical example, consider the impact of MLI Article 4 (Dual resident entities) on the structure below involving Australian entities dual resident also in another Territory Y (or other Territories). Australia is chosen here only because of the need to illustrate the position in relation to a given territory and one whose residence rules could interact with those of other territories in ways that give rise to dual residence situations.*




*Using our MLI Tracker, we identify 15 Australian treaties in which MLI Art. 4 does not apply and 16 treaties in which the text of Paragraph 1 of Art. 4 applies with a different last sentence. Consider one, say Malta, from the displayed non-applicable list and another, say the UK, from the applicable list. Australia's draft positions lodged with the OECD notify both treaties as CTAs and, as required by MLI Art. 4(4), notify that Article 4(5) in the Malta treaty and Article 4(4) in the UK treaty - similar to Article 4 in the OECD Model - contain an existing dual residence tie-breaker (as described in the compatibility clause in MLI Art.4(2)), which it does not exclude by reservation from application of this MLI article.*

- *However, while Malta's draft positions notify the Australia treaty as a CTA they reserve entirely against the application of this MLI article in relation to any of Malta's CTAs.*
- *On the other hand, the UK's draft positions notify the Australia treaty as a CTA and equally notify Article 4(4) of the Australia treaty as containing an existing dual residence tie-breaker which it does not exclude by reservation.*

*One difference between Australia's draft positions and the UK's draft positions is the reference in the former to replacement in the new tie-breaker of the final sentence. That substitution applies to deny any relief or exemption where the Competent Authorities cannot agree on the taxpayer's residence (the default would otherwise have been to allow for the possibility of the Competent Authorities providing a measure of relief or exemption). That applies irrespective of the UK being silent on the matter.*

*So, the positions are summarised in our MLI Tracker in relation to MLI Art.4 as:*

- *Australia-Malta treaty: No changes to existing treaty*
- *Australia-UK treaty: "Art. 4(4) of existing treaty is replaced by Art. 4(1) of the MLI (with last sentence of Art. 4(1) replaced by text described in Art. 4(3)(e) of the MLI)".*

***Treaty abuse***

### *Breadth of treaty abuse recommendations in MLI*

BEPS Action 6 set out to address what it referred to as situations in which "Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues". It recommended new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions (but offer a certain degree of flexibility regarding how to do so). These cover not only treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, but also the more underlying purpose of treaties and some specific transactions or structures. Before looking at the Principal Purpose Test (PPT) and Limitation on Benefits (LoB) tests - including the simplified LOB, or S-LOB, and detailed LOB - the table below provides a brief summary of the various MLI Articles targeted at treaty abuse:

| **MLI** | **Model article** | **Comments** | **Optionality** |
|---|---|---|---|
| Art 6 – Purpose of a tax treaty | Preamble | Clarifies that tax treaties are not intended to create opportunities for double non-taxation through evasion or avoidance | BEPS minimum standard, but can reserve if existing equivalent wording |
| Art 7 – Prevention of treaty abuse | N/A | Provides an anti-avoidance rule or PPT, optional additional S-LOB test (and suggests territories indicate if they intend to move toward a detailed LOB test) | BEPS minimum standard, but some optionality (see further below) |
| Art 8 – Dividend transfer transactions | 10 | Adds a minimum holding period of 365 days to any ownership tests in dividend WHT articles | Can reserve outright or where existing minimum holding period |
| Art 9 – Capital gains from alienation of shares deriving value principally from immovable property | 13 | Introduces a 365 day period for testing whether an entity was directly or indirectly land-rich (i.e. apply test continuously throughout the year) | Can reserve outright or in specific circumstances |

| | | | |
|---|---|---|---|
| Art 10 – Anti-abuse where low taxed PE in third territory | N/A | Discretionary denial of treaty benefits where income earned by exempt branch taxed at <60% of Head Office tax rate | Can reserve outright or in specific circumstances |
| Art 11 – Application of treaties to restrict a territory's right to tax its own residents | N/A | Inserts a 'savings clause' confirming that a treaty does not restrict a territory's right to tax its own residents, other than in specified circumstances (e.g. corresponding adjustments) | Can reserve outright or where existing provisions |

## *Scope of the PPT, S-LOB and LOB*

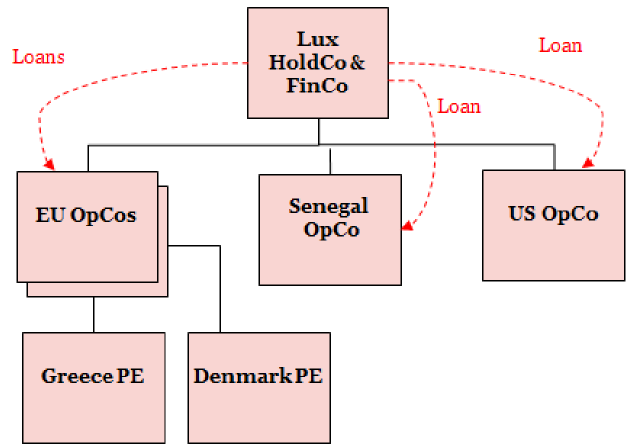
Of the treaty abuse rules, Article 7 has drawn the greatest interest. In regard to a minimum standard on anti-treaty shopping, the BEPS report recommended three options (or equivalent restrictions):

- the PPT
- the PPT with a S-LOB, or
- a detailed LOB with either an anti-conduit rule or a purpose test.

The PPT applies by default under the MLI (under Article 7(1)) and territories can reserve against it (under Article 7(15)(a)) only in certain circumstances in which they will otherwise meet the minimum standard. Where a benefit would be denied under the PPT, a territory can opt in to grant the benefit or a different benefit that would have been granted to an applicant taxpayer in the absence of the transaction or arrangement (under Article 7(4), and after consulting with the Competent Authority of the other Party to the CTA).

The current MLI signatory/ ratification territories have all chosen to apply in CTAs one of the first two options each involving the PPT, rather than reserving in favour of a detailed LOB. However, of these, Canada, Chile, Colombia, Kuwait, Mauritius, Norway, Poland, Senegal, and Seychelles have indicated an intention, in time, to adopt a detailed LOB in addition to or instead of the PPT. Further, our MLI Tracker indicates that, notwithstanding territories' overall choices, there are 15 CTAs in relation to which the PPT does not apply despite it being a minimum standard to adopt one of the three routes - a territory can reserve the right for existing treaty provisions to continue on the basis that they are already sufficiently robust (Article 7(15)(b), e.g., Germany's draft positions make this reservation and notify provisions in the treaties with China, Israel, Japan and Mauritius where it believes this is the case).

*To illustrate this by reference to a hypothetical example, consider the impact of the MLI PPT on the structure below involving a Luxembourg holding and finance company with a number of operating companies in the US and the EU, with permanent establishments (PEs) in Greece and Denmark.*




*The PPT will not have a direct impact on the US operating company since the US has not signed the MLI.*

*The PPT would not (on the basis of draft positions) have a direct impact on the Senegal operating company. Senegal has signed the MLI and generally chosen to adopt the PPT and S-LOB pending negotiation of a detailed LOB. However, it has reserved against the application of the PPT in relation to the CTA with Luxembourg on the basis that the existing treaty between them contains a sufficiently robust purpose test already. Luxembourg does not choose generally to apply the S-LOB, nor does it apply additional options to allow the S-LOB symmetrically or asymmetrically in these mismatched cases - so the S-LOB does not apply at all to the Luxembourg-Senegal CTA.*

*Within the EU, the Luxembourg-Estonia treaty is not yet relevant as Estonia is only committed to signing the MLI and has not yet done so, while Luxembourg does not have a treaty with Cyprus.*

*As regards the EU operating companies, our MLI Tracker also shows that Luxembourg's CTAs with 8 EU Member States include the additional discretionary element when a taxpayer fails the PPT while the other 17 Member States apply the PPT without it. Of the EU Member States, Luxembourg only notifies its treaty with the UK as having an existing purpose test in Article X(3)(d), which will then be replaced by the PPT; in other cases, the PPT (and discretionary benefits) provisions supersede the CTA's provisions, though the wording strictly states "to the extent that those provisions are incompatible with the existing text" (under Article 7(17)(a)). Further, Bulgaria and Slovakia have chosen to apply the S-LOB, but as noted above, since Luxembourg does not choose the S-LOB nor apply additional options to allow the S-LOB symmetrically or asymmetrically in these mismatched cases, the S-LOB does not apply to the CTAs Luxembourg has with those Member States.*

*However, for the PEs, Denmark's draft positions show that while it doesn't want to apply the S-LOB generally, where a Party with which it has a CTA chooses to apply the S-LOB, Denmark will also apply it for purposes of that CTA (under Article 7(7)(a)) - so if the head office of the Denmark PE is in Bulgaria or Slovakia, the CTAs it has with those Member States would apply the S-LOB as well as the PPT. On the other hand, Greece's draft positions show that it opts in to allow a Party with which it has a CTA to apply the S-LOB asymmetrically - only to its own residents (under Article 7(7)(b)) - so if the head office of the Greek PE were to be in Bulgaria or Slovakia, those Member States would apply the S-LOB to their residents under the CTAs with Greece, while Greece would not apply it to its residents.*

### *Nature of the PPT*

In more detail, the MLI denies a benefit under a CTA if:

- notwithstanding any provisions of the CTA
- it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes
- of any arrangement or transaction that resulted directly or indirectly in that benefit
- unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the CTA.

There was some guidance on the nature of the PPT in the BEPS report, which has now been transposed into the OECD's 2017 updated MTC and Commentary. That suggests that it is an objective test of what it is reasonable to conclude – in light of the facts and circumstances. What was the reason or were the reasons for why the transaction took place or how it was structured? Obtaining a treaty benefit need not be the sole or dominant purpose. If an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a [treaty] benefit, the PPT is unlikely to apply. So, for example,

- where this is no substance in an intra-group finance company and no non-treaty benefit reason to locate there – the PPT is likely to apply
- where a sub-holding company is established to hold local subsidiaries for reasons including transportation, time zone, language and local business partners and it undertakes a range of activities and has the local people to do all of this – the PPT is unlikely to apply.

The PPT will need to be considered both in relation to transactions and arrangements already entered into, when the PPT did not need to be considered at the time, and prospectively in relation to future events.

The obvious absence of case law and guidance from tax authorities makes it difficult to look to previous legal interpretations. However, cases such as Starr in the US that deal with a purpose test in the context of the US-Swiss treaty may be instructive. While there is no direct read across from the test dealt with in Starr to the MLI, the comments on principal purpose and conclusions reached were considered in the context of a matrix of countries and considerations for relocation of a business. One of the considerations was treaty benefits; this was deemed to indicate a principal purpose of the transactions.

There is also likely to be a different interpretation of PPTs in relation to EU and EEA territories. More specifically, following the recent Eqiom case the CJEU has confirmed that, in applying anti-abuse rules to treaties, these rules should not infringe on the fundamental freedoms, such as Freedom of Establishment. Accordingly, where the PPT may otherwise apply, but the relevant taxpayer in another EU/EEA territory satisfies the genuine economic arrangement test derived from the Cadbury Schweppes line of cases, the PPT should not prevent treaty benefits.

Similar tests already exist in specific countries (e.g., UK law) so there will be some further experience of applying the principles either under case precedent or guidance from tax authorities, etc. It may be harder to tell how countries without any purposive tests will approach the interpretation of the PPT.

***Permanent establishments***

BEPS Project Action 7 recommended that various changes should be made to clarify and amend the 'threshold test' for activities carried out by an enterprise in another territory that would treat it as having a taxable presence (i.e., a PE) in that territory, to which profit would be attributable. The main provisions in the MLI targeted at modifying the threshold as typically applied within double tax treaties are summarised below:

| MLI | Model article | Comments | Optionality |
|---|---|---|---|
| Art 12 – Artificial PE avoidance through commissionaire and similar strategies - the dependent agent PE (DAPE) and independent agent rules | 5(5) | Clarifies rules applicable to when an agent acting in a territory for an enterprise in another territory will constitute a PE in the first territory, subject to the typical exclusion where it is an independent agent.<br>An independent agent can still be a PE if acting exclusively or almost exclusively for 'closely related' foreign resident enterprises. | Can reserve outright in relation to the Article as a whole |
| Art 13 – Artificial PE avoidance through specific activity exemptions | 5(4) | Makes exemptions either subject to overall 'preparatory or auxiliary' test or specifically not subject to such a test. Additional anti-fragmentation rule. | Can reserve outright in relation to either element or in specific circumstances |
| Art 14 – Splitting up contracts | N/A | Stop manipulation of PE time limits re building sites, etc. | Can reserve outright or in some circumstances |
| Art 15 – Definition of closely related person | N/A | Definition for Art 12-14 above by reference to common control | Can reserve outright |

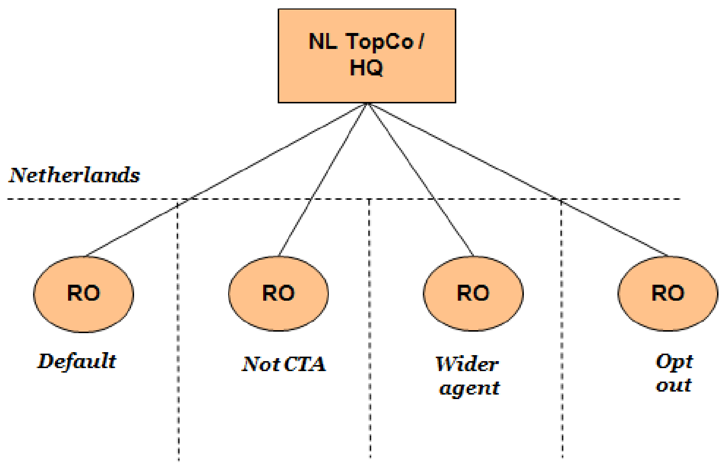
*Agency rules*

There are two separate elements in the MLI modifications to the rules dealing with agents acting on behalf of foreign enterprises - the so-called DAPE and independent agent rules.

Under MLI Article 12(1), where an entity or agent acting in a territory for a foreign resident enterprise "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" it will constitute a PE of the enterprise in the first territory. This applies to contracts in the name of the enterprise, either for transfer of ownership/ licensing or the provision of services, and extends the existing PE rules in most double tax treaties. It is typically called the DAPE rule because there has generally been an exclusion for those acting as independent agents, so the former largely relates to an entity that is dependent (a DAPE).

The independent agent exclusion is also amended under the MLI (Article 12(2)). The interpretation of when an agent could be classed as independent of a particular enterprise has led, in the eyes of tax administrations, to countries not being entitled to tax profits when a PE should be recognised. Therefore, under the MLI, an independent agent can still be a PE if it is acting exclusively or almost exclusively for 'closely related' foreign resident enterprises.

*To illustrate this by reference to a hypothetical example, consider the MLI's impact on the structure below involving a Netherlands company with a number of representative offices (ROs). We can categorise the RO territories as those that will seek to apply the MLI default rules on agency PEs, those that will opt out, those in which the treaty is not a CTA with the Netherlands, and those where the RO may provide wider agency activities than for the TopCo/HQ.*




*Under our MLI Tracker, draft positions show signatories will almost universally choose not to apply the changes, i.e., the Parties will reserve against the changes (it is a single reservation applicable to both) in 1,015 CTAs. In only 194 CTAs will the Parties apply both provisions. However, things are more even in the Netherlands for which the provisions apply in 22 CTAs and not in 26 others (though there are a further 48 treaties which are either not CTAs or where the other territory has not signed the MLI). If the RO is in, for example,*

- *France, Russia, Japan, India or one of 18 other territories, the changes will apply*
- *UK, Canada, China, Germany, Italy or one of 21 other territories, the changes will not apply because the other territory opts out*
- *Spain, Ireland, Poland, Denmark or Belgium, the changes will not apply because the treaty is not listed as a CTA (similarly it is not a CTA where a territory like Brazil or US hasn't signed the MLI).*

*Where the RO carries out activities for entities other than the NL TopCo/ HQ, in addition to considering whether it is in one of the 22 territories where the changes apply, as above, it will be necessary to consider whether those activities are with 'closely-related entities' that prevent it being regarded as an independent agent.*

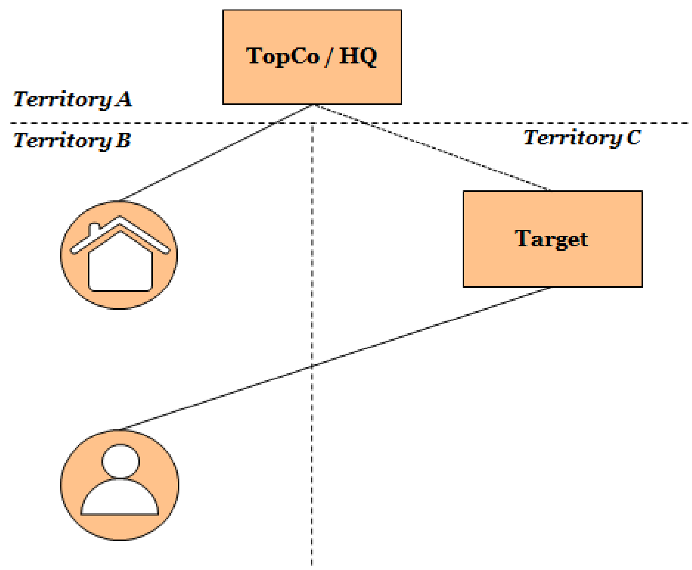
## *Specific activity exemptions*

There are two separate elements to the MLI modifications dealing with activities of a foreign-resident enterprise in a territory that will not be sufficient to cause a foreign enterprise to have a PE in that territory.

There has been a long-standing dispute as to whether the wording of existing treaties requires the activities listed (typically as per subparagraphs (a) to (d) of the OECD's MTC Article 5(4) prior to its 2017 update) to be preparatory or auxiliary - this broadly hinges on the reference to the word 'other' in a subsequent subparagraph on the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. A Party to the MLI can opt in to Option A or Option B as regards the preparatory or auxiliary nature of the activities listed in the CTA, or can choose to make neither option, thereby leaving the CTA unchanged in this regard (under Article 13(1)). Option A broadly clarifies that each of the activities listed in a CTA has to be preparatory or auxiliary, while Option B clarifies that preparatory or auxiliary only applies specifically to any activity to which the term is explicitly attached. To affect a CTA, both Parties must have chosen the same option and notified the existing provision which would be modified. If a territory does not notify either Option A or Option B, i.e., is silent on the matter, it has effectively chosen to leave the CTA unchanged and subject to existing interpretational agreements, opinions, disputes, etc.

The MLI also introduces an additional anti-fragmentation condition to the above exemption (with or without modification under Option A / Option B), potentially applicable where an enterprise or closely related enterprise also carries on activity through another fixed place of business in the same territory. If they constitute complementary functions that are part of a cohesive business operation, that other activity will prevent the exemption being applied if it is already a PE itself or the combined activities are not preparatory or auxiliary (under Article 13(4)). By default, a territory will be treated as having imposed this condition if it notifies the existence of an existing provision, either in relation to Option A / Option B above or in relation to this condition alone. As a consequence, it is possible to reserve against this paragraph (4) condition while still applying paragraph (1), or reserve against Article 13 altogether (Article 13(6), including also a reservation for CTAs that already have existing preparatory or auxiliary requirements where a territory otherwise wants to adopt the overarching rule in Option A). The anti-fragmentation condition will apply to a CTA if neither Party has reserved against it and both have notified the same existing provision.

*To illustrate this by reference to a hypothetical example, consider the MLI's impact on the structure below involving a TopCo / HQ in Territory A with a warehouse in Territory B. It acquires a target in Territory C which has sales reps in Territory B.*




*The warehouse may constitute a PE in Territory B. The nature of the exemptions set out in the treaty between Territory A and Territory B will be paramount. Our MLI Tracker shows that there are 18 CTAs where both Parties have chosen Option B to clarify that existing exclusions for warehousing will not be affected by an overarching requirement for them to be preparatory or auxiliary - those involve combinations of the following territories: Ireland, Belgium, Luxembourg, Singapore, France, Lithuania and San Marino (though Ireland-San Marino, France-San Marino and Lithuania-San Marino are not CTAs). There are 225 CTAs where both Parties have chosen Option A to clarify that existing exclusions will be dependent on the activity being preparatory or auxiliary - these include a wide range of countries including Germany, Spain, Italy, Netherlands, Austria, Russia, India, Japan. That leaves 772 CTAs where one or other Party has chosen to apply neither option (for example UK, Denmark, South Korea) or where the Parties choose different options.*

*A similar analysis may be needed in relation to Territory C and Territory B in relation to the activities of the sales reps.*

*The acquisition of Target may require an extended analysis to determine whether the anti-fragmentation rule applies to TopCo / HQ and / or Target. If the activities of the sales reps and warehouse are complementary functions that are part of a cohesive business operation - say the sales reps use the warehouse - once they become closely related, if one or the* *other is a PE of their particular entity, or the combined activities would not be preparatory or auxiliary, then they may both be PEs.*

***Dispute resolution***

BEPS Project Action 14 recommended a minimum standard for improving dispute resolution and certain best practices. Elements of both can be satisfied/ implemented by incorporating specific provisions into tax treaties. MLI Part V (Articles 16 and 17) allow territories to incorporate these provisions into CTAs, while Part VI (Articles 18-26) incorporate a standard that can be applied by those countries wishing to include it on binding arbitration to settle double taxation disputes.

The MLI articles dealing with dispute resolution are summarised in the table below:

| MLI | Model artide | Comments | Optionality |
|---|---|---|---|
| Art 16 – Mutual Agreement Procedure | 25 | Taxpayers should have a specific period (normally three years) to present a case to either authority If the authorities cannot resolve a dispute, it can be escalated to a formal procedure – irrespective of domestic time limits | BEPS minimum standard, but some optionality if meet through other methods |
| Art 17 – Corresponding adjustments | 9 | Requires downward adjustment to reflect an upward transfer pricing adjustment in the other state | Can reserve if existing rules or where commit to adjust/MAP resolution |
| Art 18-26 – Arbitration | 25 | Option to include mandatory binding arbitration | A wide range of options |

We addressed some of the key provisions in our previous Tax Policy Bulletin on this subject.

Slovenia has confirmed its final position to adopt the arbitration provisions. The draft positions for another 28 territories indicate an intention to do so: Andorra, Australia, Austria, Barbados, Belgium, Canada, Curacao, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, the Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK.

Poland was originally involved in discussions about arbitration but its final ratification documents confirm that it has decided not to commit to that at the moment. On 10 October 2017, the EU agreed a Directive on Tax Dispute Resolution mechanisms, building on the so-called EU Arbitration Convention which previously dealt with transfer pricing adjustments and attribution of profits to PEs. That Directive includes provisions similar in many respects to the MLI arbitration provisions, although there are some differences which will require Member States to consider their proposed moves carefully. Norway, a member of the European Economic Area (EEA), may be thinking of these measures in following the same path as Poland. The US was also involved but it not a signatory to the MLI.

## *The takeaway*

The MLI supplements and modifies double tax agreements (if they are CTAs) and potentially changes them in a number of ways. In such cases it will no longer be appropriate merely to read the most recent double tax treaty or protocol – you will need to see if/ how these have been changed by the MLI.

Although there are some minimum standards that all signatories have to accept, there is much optionality. There will be cases where these options are agreed by treaty partners, but a few where changes are not symmetrical. Working out the benefits under a treaty may be much more complex.

The MLI will have a fundamental impact on how taxpayers access double tax treaties, but are you ready for it? When it comes into force on 1 July 2018, it will start to impact dispute resolution under some CTAs immediately. WHTs are likely to be significantly impacted from 1 January 2019, with implication for other taxes for periods beginning shortly afterwards.

Taxpayers should assess the MLI's impact and consider whether changes to group structures, locations of people or transactional flows would be advisable.

If a particular treaty benefit is currently important, taxpayers should consider the likelihood of any potential change following the MLI coming into effect.

Tax authorities are accepting that double tax disputes need to be resolved more quickly and efficiently. In some cases binding arbitration may be an option. The changes may apply to existing or new disputes.

## *Let's talk*

For a deeper discussion of how these issues might affect your business, please call your usual PwC contact. If you don't have one or would otherwise prefer to speak to one of the people below:

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