The Multilateral Legal Instrument: A developing country perspective

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Abstract

Action point 15 of the BEPS program mandated developing a Multilateral Legal Instrument (MLI) to modify bilateral tax treaties. A country signing this instrument will be able to modify all treaties, where other contracting parties have also notified the same. This would allow countries to simultaneously and therefore swiftly adopt measures to tackle BEPS in a large number of treaties. Based on the country positions submitted to the OECD as on 30th August 2017, this paper makes an attempt to assess whether this instrument has succeeded in bringing about the desired changes. A unique database is constructed on the basis of these country positions. Using this database, the paper shows that the benefit of the MLI may be limited in so far as the application of the optional articles is concerned. In so far as developing countries are concerned, it is found that the gains to these countries may be limited. The adoption of the minimum standards may be the limited success achieved by the instrument.

Keywords: BEPS, tax treaties, Multilateral Legal Instrument, Foreign investment

JEL Classification Codes: H25, H26, K34

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1. Introduction

In 2013, OECD and G20 countries adopted the 15 point Action Plan to address Base Erosion and Profit Shifting (BEPS). Part of this program is Action point 15 that mandated 'Developing a Multilateral Instrument to Modify Bilateral Tax Treaties'. The purpose of this instrument is to ensure that the existing tax treaties can be updated swiftly for changes to the model convention. The fact that the instrument applies to all the covered treaties it allows for synchronised change thereby minimising gaps between the model and the actual substance of wide network of treaties.[2]

To work on the substance of the MLI an ad-hoc group was created in February 2015, approved by the OECD's Committee for Fiscal Affairs, endorsed by the G20 Finance Ministers and Central bank Governors. The group was open to participation by non-OECD countries on an "equal footing",[3] though it was clarified that this was in no way to be interpreted as a "precedent in the context of OECD procedures for participation of non-members in OECD activities".[4] Hundred countries and jurisdictions[5] joined the ad-hoc group, committed to designing this instrument. This was an unprecedented initiative where a large number of countries collaborated to contribute to the substance of the instrument. Over the two-year period through a consultative process the substance was developed, which in large part drew on the work undertaken for the remaining action point in the BEPS package. Under the BEPS program four action points have been identified as key priority measures[6] or what is referred to as minimum standards-harmful tax practices (Action 5), measures to prevent treaty abuse (Action 6), country-by-country reporting by Multinational Enterprises (Action 13) and improvement of dispute resolution (Action 14). To help countries adopt the minimum standards swiftly in their treaties, two of the treaty related minimum standards (6&14) were incorporated in the instrument and are made mandatory. Other than these, the instrument contains other Articles that pertain to different aspects of the BEPS program such as PE.

Although large number of countries participated in the process, the OECD acknowledged that for its success the instrument must allow for flexibility which is necessary so as to retain bilateral specificities as well as to maintain sovereignty.[7] Therefore flexibility[8] was incorporated through opt-out provision in non-mandatory articles and since

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[2] Page 9, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[3] Page 10 Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[4] Page 11 Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[5] http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm; Note that from here on the term country will refer to countries and jurisdictions

[6] Page 7, Background Brief on Inclusive Framework on BEPS,2017, OECD

[7] Para 16, page 19, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[8] Page 42, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

minimum standards can be met in "multiple different ways",[9] alternative measures are possible under the mandatory Articles. Thus, the instrument was designed so as to allow the countries to have their respective preferences.[10]

Though useful in meeting the minimum standards, signing the MLI is optional. The Action plan as well as the report clarified that it is not compulsory for countries to participate in developing the instrument nor it is to sign the instrument once finalised.[11] To add to this, the flexibility,[12] in terms of listing of agreements and adoption of articles, could potentially vitiate the change aspired to be achieved through the instrument.

On 7th June 2017, 68 of the 100 countries signed the MLI. With the subsequent joining of Mauritius,[13] Cameroon[14] and Nigeria[15] the number now stands at 71.[16] The instrument did not receive the response as was expected, 29 of the 100 countries that joined the ad-hoc group did not sign the MLI, which includes important treaty partners such as the USA and Brazil. To add to this, even for countries that have signed the MLI some major treaties have not been listed by one of the treaty partners, thereby leaving such treaties out of the MLI. For example, the India-Mauritius treaty has not been listed by Mauritius. This paper presents a statistical analysis of the coverage of the MLI and ascertains the economic significance of treaties that have been excluded.

The MLI or the multilateral convention to implement tax treaty related measures to prevent BEPS (from here on referred to as the Convention) will apply alongside tax treaty.[17] It consists of 6 parts, each containing articles that address a different BEPS issue. Part I deals with scope and interpretation of terms (Articles 1-2), Part II covers Hybrid Mismatches (Articles 3-5), Part III relates to treaty abuse (Articles 6-11), Part IV covers articles related to avoidance of permanent establishment (PE) status (Articles 12-15), Part V addresses dispute resolution (Articles 16-17) and lastly part VI contains articles (18-26) relating to the Mandatory Binding Arbitration (MBA). For the MLI to apply to an agreement each contracting party should notify the agreement to the depository.[18] Only where all contracting parties have notified an agreement will it be considered a Covered

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[9] Para 14, Page 3, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

[10] Page 41, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[11] Page 5 A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS, 2015

[12] Page 42, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[13] 5th July 2017

[14] 11th July 2017

[15] 17th August 2017

[16] Curacao has joined the MLI on 20th December 2017, however at the time of finalising the paper it was not a part of the instrument and therefore has not been included in the analysis. Only two agreements have been notified by the country. Therefore the analysis will not change significantly.

[17] Para 13, Page 3, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

[18] Article 2 para 1(ii)

Tax Agreement (CTA) under the Convention.[19] Further, a particular article will apply to a treaty unless the country reserves the application of the Article using the opt-out provision. Further if the country notifies[20] the provision of a treaty that is similar to the Article contained in the MLI, then the language of the MLI will replace that of the treaty, whereas where it reserves the language of the treaty will remain unchanged. Where one contracting party has notified while the other has reserved the application of a particular Article of the convention, the Article in the treaty will remain unchanged. Unlike other parts of the MLI, Part VI (MBA) is optional and where a country chooses to apply the same it must explicitly specify. As for the mandatory articles the country can choose from various alternatives. Under Article 7, pertaining to prevention of treaty abuse, the country can choose between PPT, or PPT with simplified Limitation of Benefit (LoB) or PPT as an interim measure till it bilaterally negotiates the detailed LoB supplemented by a mechanism to deal with conduit arrangements not already contained in the treaty.[21] Similarly, under Article 16 a country can apply the Mutual Agreement Procedure (MAP) as specified in Article 25 (1) through (3) of the OECD Model Convention[22] which allows a person to present his case to the competent authority (CA) of *either* of the contracting states. Alternatively, as per Article 16(5)(a) the party can opt out of applying the first sentence of Article 16(1) to its CTAs where there already exists such a provision that the case should be presented to the CA of the country of which it is resident.[23] Therefore, the Articles with the opt-out clause can be categorised as optional whereas the two related to minimum standards are mandatory. The various Articles of the MLI are summarised in Table 1.

Table 1: Article of the Multilateral Convention

Article no.	Name	Mandatory or Optional
1	Scope of terms	
2	Interpretation of terms	
3	Transparent entities	Optional
4	Dual Resident Entities	Optional
5	Application of Methods for elimination of double taxation	Optional
6	Purpose of a Covered Tax Agreement	Mandatory
7	Prevention of treaty abuse	Mandatory
8	Dividend transfer transactions	Optional
9	capital gains from alienation of shares or interests of entities deriving their value principally of immovable property	Optional
10	Anti-abuse rule for permanent establishment in third s	Optional
11	Application of tax agreements to restrict a party's right to tax its own residents	Optional
12	Artificial avoidance of permanent establishment status through commissionaire arrangements	Optional
13	Artificial avoidance of permanent establishment status through specific activity exemptions	Optional

[19] Para 14, Page 3, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

[20] Or it may not make any reservation, that is the country position will not contain any notification for the said Article which means if the other contracting parry notifies it will apply to the CTA.

[21] Para 89, Page 22, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

[22] Para 193, page 48, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

[23] Para 200, page 50, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

14	Splitting up of contracts	Optional
15	Definition of a person closely related to an enterprise	Optional
16	Mutual Agreement Procedure	Mandatory
17	Corresponding Adjustments	Optional
18	Choice to apply Part VI (arbitration)	Optional
19	Mandatory Binding Arbitration	Optional
20	Appointment of arbitrators	Optional
21	Confidentiality of arbitration proceedings	Optional
22	Resolution of a case prior to the conclusion of the arbitration	Optional
23	Type of arbitration process	Optional
24	Agreement on a different resolution	Optional
25	costs of arbitration proceedings	Optional
26	Compatibility	Optional

As is evident even when countries do sign the MLI the various kinds of flexibility can limit the applicability of specific articles. Therefore the second part of the analysis ascertains articles and measures (mandatory articles) that did not gain much traction. That is, the paper asks whether countries have adopted other BEPS measures or will change with respect to these articles be brought through bilateral negotiation. Recognising that the reach of the MLI is limited by its design, the paper uses a unique database to assess the extent of change both in terms of the number of treaties covered as well as applicability of articles to the treaties that are covered.

2. MLI's reach

As mentioned in the earlier section, there are three major challenges to the success of MLI- countries not signing the MLI, fewer takers of non-mandatory Articles and the consistent application of minimum standards. In this context, the paper seeks to evaluate the extent of limitation posed by each of these on the applicability of MLI thereby marring its success.

The dataset used for the analysis has been compiled from the individual country positions reported to the OECD.[24] First, all the covered tax agreements listed by 71 countries are matched so as to find out the treaties that will be impacted by the MLI (Section 2.1). Secondly, the country position consists of Article–wise position of the country i.e. whether it will reserve the application of the Article or will apply the Article. These are used to assess the acceptance of an article in treaties as well as to verify if consistency has been achieved in the adoption of minimum standard (section 2.2).

2.1 Are significant treaty relationships covered?

2.1.1 Countries that did not sign

Prior to the signing of the convention it was expected that the existing 3000 bilateral treaties[25] will be modified. However, taking the list of agreements notified under Article 2 by 71 countries, it is found that of 2376 tax treaties listed by all countries 1119 will

[24] Last accessed on 17th July 2017 from http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf

[25] http://www.oecd.org/tax/developing-a-multilateral-instrument-to-modify-bilateral-tax-treaties-9789264219250-en.htm

be covered by the MLI since these have been listed by the countries that have joined the MLI. As is evident, only half of the listed tax agreements are actually covered and hence will be modified by the convention. This difference in listed and covered tax agreements can arise on account of countries staying out of the MLI or a signatory not listing a particular agreement. These two can be separated.

As was mentioned earlier, while the substance of the convention was developed by the members of the ad-hoc group it did not bind the participating country to sign the convention upon its finalisation. There are many countries that have not yet signed the MLI. These account for a large number of agreements listed by signatories. Figure 1 provides the number of signatories that have listed their agreement with the country that has not yet signed the MLI. Estonia, for example, has the highest number of treaties with signatories (42) that have listed their agreements, followed by Qatar, UAE and Malaysia. The fact that many of the signatories have listed their agreements with these countries indicates their interest in modifying these treaties through the MLI. However, since these countries have not yet signed the MLI, bilateral negotiations will remain the preferred means to bring about the necessary change. It is important, though, to ask why these countries have chosen to remain outside the MLI. The most noticeable absence from the MLI is that of the US, especially since Articles such as those relating to arbitration[26] in MAP are of interest to the US. However, Pascal Saint Amans is of the view that "the fact that the US did not sign the MLI is not a big issue. The US does not enter into tax treaties with tax havens and also uses a stringent limitation on benefits provision in its tax treaties, so the US probably meets the BEPS action 6 minimum standards".[27] While it is true that the US has revised its model convention in 2016[28] and it will address some of the BEPS concerns, the fact that it chooses to not sign the MLI indicates its preference to adopt measures independent of the OECD's initiative. Even though the partner countries seek to adopt the OECD suggested measures through the MLI. Another cited impediment to US' participation in multilateral instruments is that any treaty related change would have to go through a Department of State and Senate approval.[29] Similar concerns have been cited in the case of Brazil. Brazil has not signed the MLI owing to 'political' factors. According to the Brazil's tax administration the adoption of this convention could lead to lengthy discussions in the national congress, which in turn could delay the MLI from coming into effect by years.[30] Such delays are often observed even in bilateral negotiations, for example the Brazil-Russia treaty took 13 years to get the approval of the National Congress.[31]

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[26] 68 Countries Sign Super Treaty Against Corporate Tax Evasion, June 2017, Bloomberg.

[27] OECD set to release 2017 transfer pricing guidelines, clarify MLI effect on tax treaties, officials say", June 26th 2017, mnetax.com

[28] Pages 2-3, "US Treasury proposes fundamental changes to US Model Income Tax Convention", Tax Insights,2015, PwC

[29] International Tax Advisory: Impact of the Multilateral Instrument on U.S. Taxpayers, July 14th 2017, Alston and Bird LLP

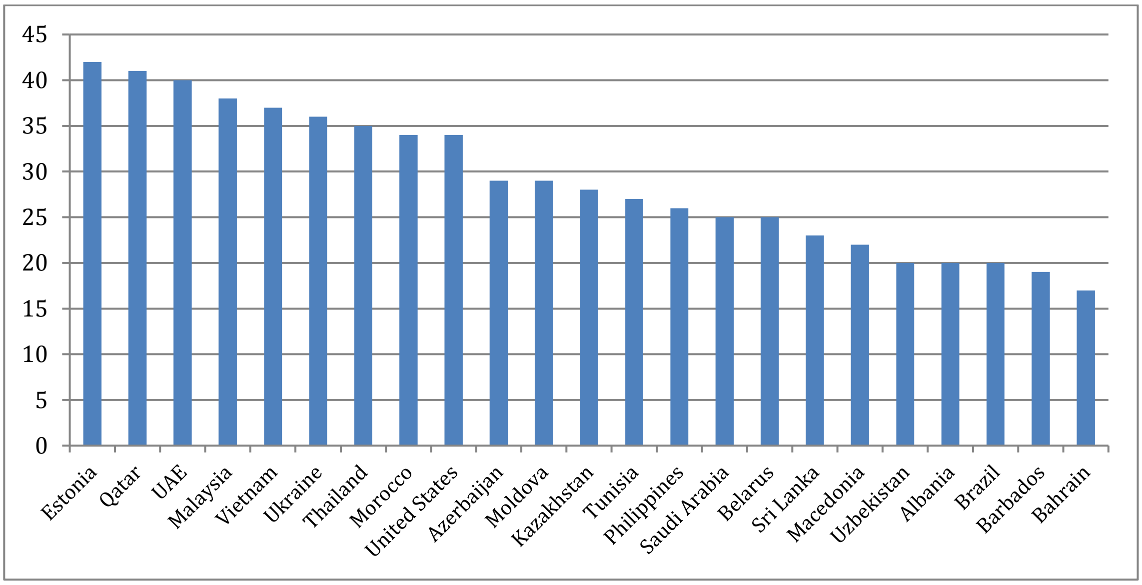
[30] "Brazil's absence from the Multilateral BEPS Convention and the new amending protocol signed between Brazil and Argentina", September 5th 2017,Kluwer International Tax Blog

[31] "Brazil's absence from the Multilateral BEPS Convention and the new amending protocol signed between Brazil and Argentina", September 5th 2017,Kluwer International Tax Blog

In addition to concerns of approval, countries such as Estonia sought to introduce a new model for LoB[32] in 2017, which will meet the minimum standard prescribed in Action point 6. Therefore, its staying out of the MLI again may be driven by its need to meet BEPS related concerns through its own revised model. On the other hand are countries such as UAE[33] and Qatar[34] that were not part of the inclusive framework at the time of signing of the MLI.

Through Figure 1, it is clear that in spite of the swift alternative to bilateral negotiations, the MLI has not yet gained enough traction. Be it for reasons such as revision of domestic model conventions or otherwise some of the major treaty partners still remain outside the purview of the MLI.

Figure 1: Number of treaties with the country notified by signatories of the MLI



Source: Estimated from country positions

2.1.2 Countries that did not list an agreement

The other reason for limited reach of the MLI is that some countries may choose not to list treaties with specific treaty partners under Article 2 of the MLI. This flexibility was introduced since it is possible that the parties may not prefer to list the agreement owing to its recent renegotiation or if negotiation is underway[35]. 141 treaties are found to have not matched since one of the contracting jurisdictions has not listed the agreement. These include some of the relatively controversial treaties such as that between India-Mauritius, therefore raising the question of the selective exclusion of treaties. Figure 2 presents the

[32] BEPS Action implementation by country, July 2017,Deloitte

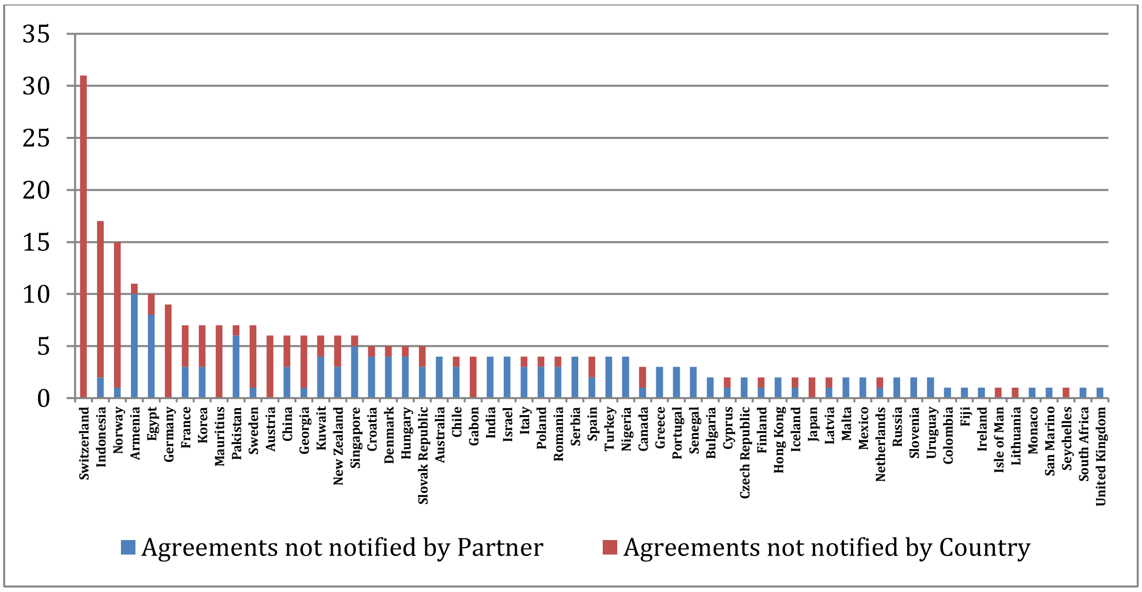
[33] Members of the inclusive framework available at https://www.oecd.org/ctp/beps/inclusive-framework-on-beps-composition.pdf

[34] Qatar joins the BEPS Inclusive Framework, Global Tax Alert, 20th November 2017, Ernst and Young

[35] Page 3, Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting, 2017

numbers for unmatched treaties, where the numbers have been further split into treaties that have not matched because the country itself has not listed the agreement or otherwise. Such bifurcation has been undertaken so as to identify countries to which the exclusion of treaties can be attributed. Interestingly, Switzerland has the highest number of treaties (31) that will not be covered by the MLI since it did not list these agreements. The same holds true for Germany and Mauritius. Indonesia and Norway follow in after Switzerland with relatively high number of treaties not covered by MLI. For these two, this is in large part due to the fact that the country did not list the agreement. On the other hand, Armenia and Egypt have large number of treaties uncovered by the Convention owing to the partner not listing the same. It is thus observed that there are a few signatories, such as Switzerland, Indonesia, Norway and Germany, which have chosen to keep out select treaties from the application of the MLI. Thus the treaties that have not matched can be attributed to these few countries.

Figure 2: Number of Tax Treaties that did not match owing to the country or Partner



Source: Computed from country positions

Further, it is interesting to note that among the countries that have fewer matched agreements are also countries that have listed only a select few treaties to be covered by the MLI. Mauritius with 43 treaties in force[36] and Switzerland that has at present signed 117 treaties,[37] of which only 50 have adopted the OECD standards,[38] the two listed 23 and 14 tax treaties respectively. The number of treaties listed by these countries and the number of uncovered tax agreements reinforce the sense that countries may be less willing to

[36] List of Double Tax agreements, Mauritius Revenue authority, Mauritius Revenue Authority, http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements

[37] Tax information exchange agreements and tax treaties

[38] https://www.sif.admin.ch/sif/en/home/themen/internationale-steuerpolitik/doppelbesteuerung-und-amtshilfe.html (This link was last accessed on 15th September and is no longer available)

adopt the multilateral approach. Keeping the agreements outside the scope of the Convention means that where the minimum standards have not yet been met these will be incorporated through bilateral negotiation.

Not only is it important to assess the number of treaties that have not matched, but it is also important to assess if these treaties are between pairs of countries that have significant economic ties. One way to ascertain this is to measure the stock of bilateral investment. It is expected that the incomes that arise from such investment can give rise to BEPS related concerns. For this purpose, for all treaties that have not matched, the bilateral foreign direct investment stock with the treaty partner, inward as well as outward, is taken for the year 2015.[39] Taking the investment stock it is observed that some of treaties are between countries that account for a large stock of foreign investment in the partner country. To illustrate Table 2 presents the stock of investment where the share is more than 10 per cent for one of the countries.

Table 2: Share in inward and outward investment stock for treaty partners

Country that notified			Country that did not notify		
Country Name	**Share in Inward Investment**	**Share in Outward Investment**	**Country Name**	**Share in Inward Investment**	**Share in Outward Investment**
Netherlands		0.1	**Croatia**	22.92	31.05
Singapore	2.01	3.4	**Mauritius**	8.9	8.9
India	20.21	18.21	**Mauritius**	8.45	45.3
India	10.61	0.7	**Germany**	0.05	1.6
Greece	22.92	0.7	**Germany**	0.01	0.3
Hong-Kong	0.003	-	**Pakistan**	16.18	-
Pakistan	9.17	1.6	**Switzerland**	-	0.1
Poland	18.15	7.8	**Netherlands**	0.05	0.5
Senegal	8.44	20.6	**Mauritius**	0.02	-
Nigeria	7.98	-	**China**	1.3	-
Armenia	0.06	24.7	**Latvia**	0.38	-
Egypt	0.19	66.8	**Mauritius**	0.1	0.05
Fiji	1.56	59.97	**New-Zealand**	-	0.05
Ireland	1.64	-	**Switzerland**	0	6.4

Source: Estimated from country positions and CDIS, IMF

From Table 2 it can be seen that for some of the treaties, the investment relations that exist between countries are significant when measured either from the side of the country notifying the treaty or otherwise. For example, in the case of Egypt and Mauritius, the latter accounts for 67 per cent of the outward investment stock of the former. Similarly, Germany accounts for 22 per cent of Greece's inward investment. It may be of interest to delve into the cause for such exclusion, which may be beyond renegotiation. There is no clear pattern in the numbers to suggest that countries that are less dependent on investment tend to exclude the treaty from the list or vice versa. In fact, countries

[39] For some countries the numbers reported are derived and the latest data available at the time of compiling.

such as Switzerland, Indonesia and Norway are shown to have the largest number of treaties that have not matched, however the share in partner's inward and outward investment stock is miniscule. The fact that in spite of such low shares countries have chosen to keep such agreements could mean that the countries prefer to retain the power to negotiate bilaterally with countries that they consider of significance. Thus, the numbers not only exhibit the exclusion of some seemingly important treaties they also lay the ground for further research that allows one to decipher the cause for exclusion from multilateral convention. The conclusion to draw from the empirical exercise is countries may prefer to bilaterally negotiate the terms of the agreement that are tailored to the needs of the both countries rather than adopt the standard as it is.

2.1.3 Developing vs. Developed countries

The multilateral instrument was to provide developing countries the opportunity to benefit from the BEPS Project. The OECD report states that for "developing countries, the practical problems that are encountered in trying to address BEPS from within the bilateral tax treaty system alone are even more relevant than for developed countries. Developing countries find it more difficult than other countries both to conclude double tax treaties, and to interest other countries in tax treaty (re)negotiation, and their tax treaty negotiation expertise is often more limited than in the governments of developed economies. A multilateral instrument therefore offers the best opportunity to ensure that developing countries reap the benefits of multilateral efforts to tackle BEPS".[40] In this context it is important to ask whether the developing countries[41] have gained from the MLI. Therefore, an analysis similar to that carried out in the previous section is undertaken for developed and developing countries among the signatories.

Firstly, the benefit of the MLI to the developing countries is expected to be significant if a large number of treaties are covered by the instrument. In this regard, the percentage of treaties covered by MLI for developing and developed countries is calculated. It is observed that the proportion of treaties covered by the MLI does not differ between developing and developed countries.[42] Even though no difference is observed in terms of the total number of treaties covered by the MLI there is a difference in the stock of inward investment associated with these treaties. On an average the share of inward investment accounted by countries that matched for developed countries was 62.7 whereas that for developing countries was 48.5 per cent.[43]

Alternatively, the share in investment of countries for which the treaties did not match are presented in Figure 3 and 4. Figure 3 presents the inward investment stock associated with treaties that did not match for each country. Note that some of developing

[40] Page 18 Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report

[41] The countries are divided into developing and developed based on UN classification(2014)

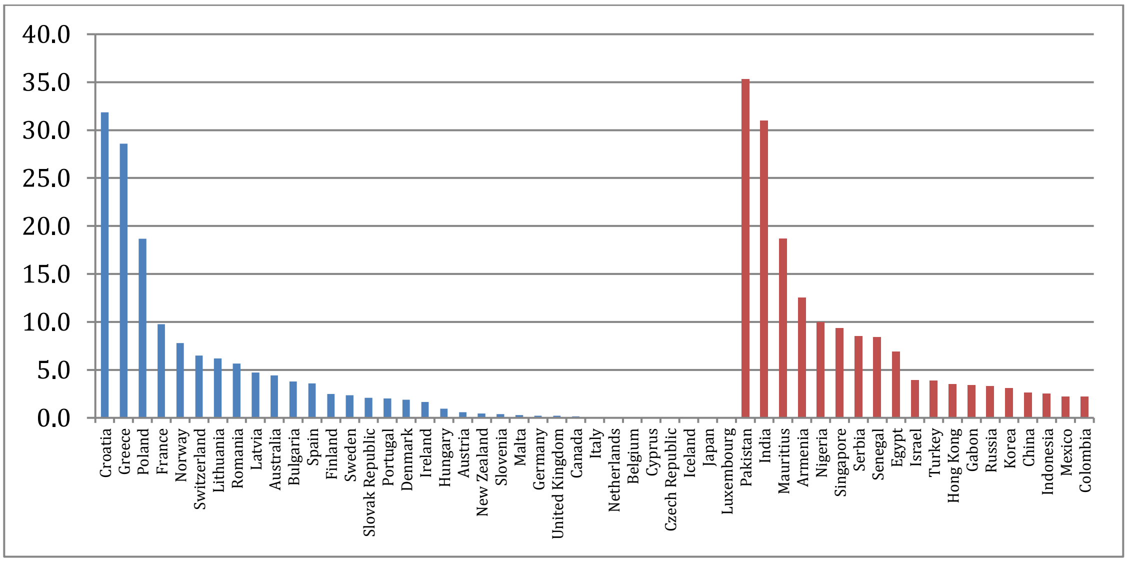
[42] Note that there are 35 developed countries and 36 developing countries therefore the sample is divided approximately equally between the two categories.

[43] On the other hand, taking the share of countries in outward stock, reveals that for the agreements that have matched under the MLI the proportion of investment is 51 per cent on an average for developed countries whereas it is 58 per cent for the developing countries.

and developed countries have comparable levels of inward investment stock for treaties that have not matched.

In Figure 4, it is observed that the bilateral stock of outward investment associated with treaties that are not covered by the MLI is comparatively large for developing countries. From the present analysis it can be seen that though the number of treaties that matched do not differ across the two groups of countries, for some countries major investment partners have been excluded from the list. For example, in the case of Egypt the numbers of treaties that do not match are 10 and these countries account for close to 90 per cent of total outward investment stock, accounted by two countries,- Mauritius and Georgia. Similarly, the number of treaties that did not match for say Croatia and Mauritius is five and three respectively but the share of inward investment with these countries was over a third of total stock.

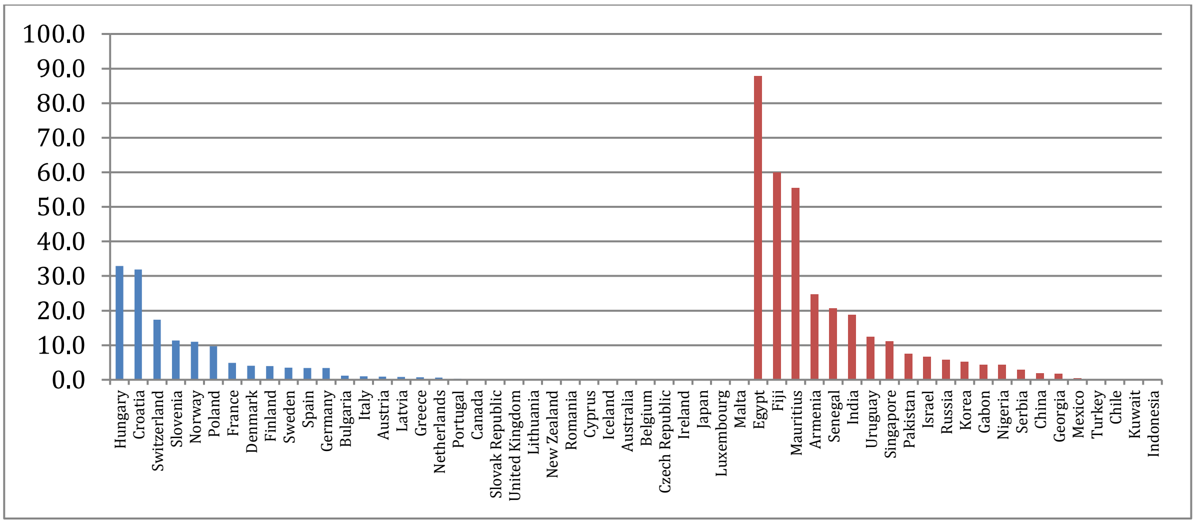
Figure 3: Share of inward investment stock with countries that did not match under MLI



Source: Coordinated Direct Investment Statistics, IMF and Country positions submitted to OECD, Note blue represent developing countries and red indicate developing countries

In this context it may be pertinent to ask if the developed countries on an average tend to be the ones that exclude the agreement from the list as opposed to developing countries. For the treaties that have not matched, it is observed that of those with developing countries it is more developed countries (53) that tended to not list the agreement (Table 3). In fact, 66 per cent of the agreements that did not match were because a developed country did not notify the same.

Figure 4: Share of outward investment stock with countries that did not match under MLI



Source: Coordinated Direct Investment Statistics, IMF and Country positions submitted to OECD, Note blue represent developing countries and red indicate developing countries

Table 3: Number of unmatched treaties by type of country

		Country that Notified the Agreement	
		Developing Countries	*Developed Countries*
Country that did not notify	*Developing countries*	28	20
	Developed countries	53	40

There is a simple takeaway from this exercise that while developing countries have similar proportions of treaties covered by the MLI, the treaties that have not matched account for a large share of investment stock. Further, a higher proportion of developed countries tend to exclude treaties with developing countries from the list of CTAs.

2.2 The applicability of articles

The MLI can also be evaluated with respect to the applicability of Articles of the MLI to large number of treaties. Firstly, there are non-mandatory Articles, which if adopted can lead to swift incorporation of anti-BEPS measures in a large number of treaties. Therefore the first section asks whether the MLI has had a significant impact in this respect. Secondly, there are mandatory articles from which the signatories cannot opt-out and must choose one of the many measures available. In this regard, the paper evaluates if consistency has been achieved in the application of these measures to treaties.

2.2.1 Optional Articles

The optional Articles, as were mentioned in section 2, are those which contain an opt-out provision which allows the country to reserve the application of the article in its entirety. Though optional, these articles reflect the preference of a particular country to incorporate such measures in their treaties. In this context, it can be seen if the MLI has been able to bring about a significant change to treaties or if the application of these articles has been reserved. Leaving aside the mandatory articles (7 and 16) as well as the section on MBA, it is observed that the 13 optional articles have had fewer takers. That is, for most of these articles, more than 30 countries have reserved the application.[44] Among these, 6 articles have had more than forty of the seventy-one countries that have reserved their application. These include Article 11 (Application of Tax Agreements to restrict a Party's Right to Tax its own resident), Article 10 (Anti-Abuse Rule for PE situated in third s), Article 3 (Transparent entities), Article 4 (Dual Resident Entities), Article 12 (Artificial avoidance of permanent establishment status through commissionaire arrangements) and Article 14 (Splitting up of contracts). In this context, again one can ask if these articles are expected to benefit the developing countries and whether fewer developed countries have adopted the ones relevant to developing countries. Further, the share of developed countries that have opted out of these articles is estimated. Article 3 relating to transparent entities, is not regarded as "high priority"[45] by developing countries thus as expected higher percentage of developing countries that have opted out of the article in its entirety (see Table 4). On the other hand, Articles[46] 4, 10, 11, 12 and 14 are articles that have lower proportion of developing countries that have opted out. Articles 12 relating to PE status of MNE and 14 on splitting up of contracts have been recognised to be of significance to the developing countries. There is a view that "A PE challenge, if successful, may bring more revenue to the source country than transfer-pricing audits of domestic subsidiaries of a group."[47] The fact that the PE can be critical in identifying the true extent of and expanding tax base for developing countries, the fact that there were fewer developed countries that opted out of the said Articles in its entirety is telling of the lack of willingness to take on this particular BEPS reform through the Convention.

Having shown that there are more developed countries that have opted out of some of the Articles, the statistics reported above also show that there are some developing countries that have opted out of the aforementioned Articles. It may be useful to ask which developing countries have opted out. Table 5 lists the countries Article-wise. The countries marked in red are those which have stayed out of *all* three Articles. It is striking that some of the countries are tax havens or favourable tax regimes[48] such as Guernsey, Georgia, Hong-Kong, Isle of Man, Jersey, Mauritius, Monaco San Marino, Seychelles and San Marino. Interestingly China too has opted out of all the Articles pertaining to PE (Articles 12, 13 and 14).

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[44] Except for 13 where the count is 27

[45] P art 1 of a report to G20 Development Working Group on the Impact of BEPS on Low Income Countries, July 2014

[46] Check description of article in the appendix

[47] Proposed BEPS-related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries, 2016, UN

[48] List of tax havens available at http://www.pwc.pt/en/pwcinforfisco/tax-guide/2017/tax-havens.html

Table 4: Share of developed and developing countries that have opted out of the Article

Article	Percentage of developed countries that opted-out in its entirety of total developed country signatories	Percentage of developing countries that opted –out of total developing country signatories	Number and %of countries opting-out
Article 3	65.7	69.4	67.6 (48)
Article 4	68.6	55.6	62.0 (44)
Article 10	71.4	61.1	66.2 (47)
Article 11	74.3	69.4	71.8 (51)
Article 12	71.4	50.0	60.6 (43)
Article 14	74.3	52.8	63.4 (45)

Source: Compiled from country positions

The optional part of the MLI pertaining to MBA (Part VI), is an opt-in. That is, to apply MBA to a CTA a country would have to opt-in unlike other Articles where it would have to specify reservation. The use of arbitration in tax treaties has been a controversial subject. The recent appeal for the use of arbitration is being made on the grounds of pendency of cases in MAP. It is argued that at the end of 2013 there were 4566 MAP cases pending resolution, which is 12.1 per cent higher than the number in 2006.[49] Therefore it is expected that the introduction of arbitration would help deal with the backlog of unresolved cases. The OECD Model Tax Convention already contains Article 25(5) that provides for the submission of cases unresolved through MAP to arbitration. This article is not mandatory for the non-OECD countries and is not widely adopted. The issue of arbitration in tax matters has been divisive and many developing countries strongly oppose its adoption, including China, Brazil and India.[50] While most of the developing countries have stayed out of adopting the MBA, the EU arbitration convention already applies to double taxation disputes.[51] Therefore, it is expected that articles relating to MBA will find traction among the EU countries. 25 countries have expressed their preference for MBA. Of these, 21 are developed countries. The four developing countries to opt-in for arbitration are Fiji, Mauritius, Singapore and Andorra. Even among the developed countries there are countries - Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Iceland, Lithuania, Luxembourg, Norway, Poland and Slovak Republic- that have not opted for Part VI.

In 2014, 158[52] DTAs contained an arbitration clause, which, at 5 per cent, is still make up a small fraction. With the choice indicated in MLI, there are 178 treaties where the option of MBA will be applicable based on the choice indicated by both contracting. Of these 145 were in treaties that are between developed countries. There is only one treaty, i.e. Fiji-Singapore that is an application of arbitration to a treaty between developing countries. Therefore, as far as arbitration in tax disputes is concerned, the measure evidently still evokes a mixed response, where some developed countries are in its favour. Thus its application will remain limited to a few treaties.

[49] Page 2, Markham(2015)
[50] Page 7, Piccioto (2016)
[51] Transfer pricing and arbitration convention, European Commission
[52] Page 5 , Markham(2015)

Table 5: Developing countries that opted out of Articles 4, 12 and 14

Article	List of countries
Article 4	Andorra, Burkina Faso, Chile, Gabon, Georgia, Guernsey, Hong-Kong, Isle of Man, Jersey, Korea, Kuwait, Mauritius, Monaco, Pakistan, San Marino, Senegal, Seychelles, Singapore, Turkey and Cameroon
Article 12	Andorra, Chile, China, Costa Rica, Georgia, Guernsey, Hong-Kong, Isle of Man, Jersey, Korea, Kuwait, Mauritius, Monaco, Pakistan, San Marino, Seychelles, Singapore and South Africa
Article 14	Chile, China, Costa Rica, Gabon, Georgia, Guernsey, Hong-Kong, Isle of Man, Jersey, Korea, Mauritius, Monaco, Pakistan, San Marino, Seychelles, Singapore, South Africa and Turkey.

Source: Compiled from country positions

The above analysis lays bare the divide in the preference for specific BEPS measures by countries. While the PE related Articles, specifically 12 &14, which are likely to be of interest to developing countries has fewer takers from developed countries, Articles pertaining to arbitration is shown to be preferred by developed countries. In terms of gains to developing countries from signing the MLI it is possible to see that there are a higher proportion of treaties with developing countries that are not yet covered since the developed country has not listed the same. The gains are further limited for developing countries since many developed countries have not notified the application of articles such as those relating to PE. Even among the developing countries, the favourable tax regimes have not adopted these standards, which imply that such treaties which may be of concern to developing countries may have to be negotiated bilaterally or the domestic law will have to evolve to tackle the BEPS issues. Overall there are fewer countries adopting the optional articles, thereby limiting the change that the MLI will make to existing treaties.

2.2.2 Mandatory Article (7) - Prevention of treaty abuse

Another change to tax treaties that is expected to result from the signing of the MLI is the adoption of the minimum standards. In keeping with the BEPS program, treaty abuse and dispute resolution constituted the mandatory Articles of the Convention. The only choice that the signatories can exercise is in terms of the measures listed within the Article to address the specific concern. For the purpose of analysis, Article 7 has been selected. Three alternatives are provided to countries to tackle treaty abuse:

i. Only PPT
ii. Simplified LoB along with PPT, or
iii. Detailed LoB negotiated through bilateral negotiation along with anti-conduit rule.

The application of this article to treaties is useful not just because it will introduce such an Article to treaties that do not have a similar provision but also in that it will expand the scope of its application to all incomes, wherever such change has not been introduced.

Like in all matters, international consensus is to be drawn on matters of common interest. The Convention sought to achieve the minimum standard while allowing for flexibility. Therefore, the standard on treaty abuse too can be achieved, as per the Convention, through option of a –PPT, which is preferred by EU countries,[53] or the LOB, which for example is incorporated in the treaties by US.[54]

First, the principal purpose test in the MLI is taken from Paragraph 7 of Article X (Entitlement to Benefits) of the OECD Model Tax Convention. It reads as follows - "*Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if 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 this Convention.*" The LoB on the other hand, is based on specific tests. It is the LoB contained in Paragraphs 8 through 13 contains a simplified LOB provision, based on paragraphs 1 through 6 of Article X (Entitlement to Benefits) of the OECD Model Tax Convention.

Since each country can adopt its own preferred measure there ought to be differences. To address this concern Para 7(a) and (b) provide for the symmetric and asymmetric application of. Alternatively, as per Para 16 the contracting applying Simplified LoB to its treaties may choose to opt out of this article in its entirety, where one or more of the other contracting jurisdictions choose not to apply the LoB. Given all these combinations it is possible that consistency may be compromised at the behest of consensus.

The application of these measures is carried out through a set of reservations and notifications. The set of reservations available to a country in Para 15, provides that if a country, in its treaties, already contains a provision similar to the PPT, then Para 1 may not apply (Para 15 (b)). Secondly, if the country already has a simplified LoB in its treaties then it can reserve the right to apply the LoB in Para 14. However, if such reservations do not apply then the country must notify to the depositary all the CTAs that have a PPT along with article number of the said treaty. Similarly, if reservations are not made with respect to the CTA then a provision similar to the LoB (para14) must be notified. In case all parties notify that the simplified LoB be applied to their treaties, then the article containing the LoB will be replaced by the simplified LoB and in other cases the MLI shall supersede the provision to the extent they are incompatible.

Given that different alternatives can be applied to the treaty, it is possible the two treaty partners choose a different measure. Now suppose one country applies the LoB and PPT while the other applies only PPT how are these differences in the application of provisions with respect to a CTA to be resolved. The MLI offers two options to resolve such issues - in case one country applies the simplified LoB while the other applies the PPT, then the PPT will apply to the CTA by default. Unless the contracting party choosing the

[53] Multilateral Instrument-BEPS, EY Tax Flash, 20th April 2017

[54] An LoB provision patterned after that contained in Article 22 of the US Model Tax convention. MLI minimum standards on treaty shopping and mutual agreement procedure. LATAM countries' position, July 3rd 2017, Kluwer International Tax Blog

PPT option agrees that the LoB is applicable symmetrically or asymmetrically. The various options that are available to a country are as follows:

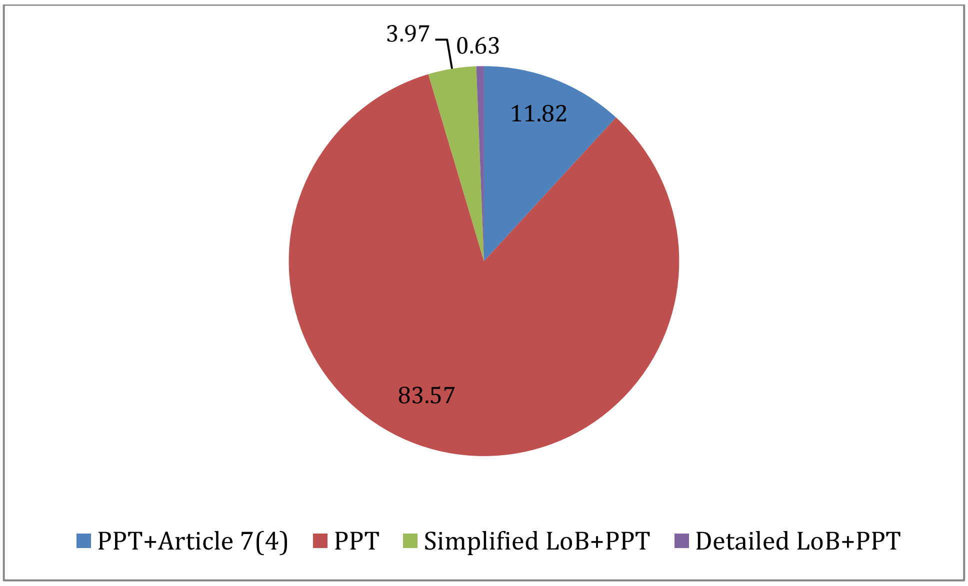
i) Reserve the application of PPT to a treaty already containing an Article to that effect-Article 7(15)(b)
ii) Notify the application of PPT to a treaty already containing an Article to that effect - Article 7(17)(a)
iii) Reserve the application of LoB to a treaty already containing an Article to that effect -Article 7(15)(c)
iv) Notify the LoB contained in the treaty to a treaty already containing an Article to that effect –Article 7(17)(c)
v) Apply PPT along with para 4[55]-Article 7 (17)(b)
vi) Apply PPT as an interim measure followed by detailed LoB negotiated bilaterally-Article 7(15) (a)

From the list of country positions it is observed that 49 countries have picked PPT either paragraph 1 alone (23 countries) or in combination with paragraph 4 (26 countries). There are only 9 countries that have opted for a detailed LoB, applying the PPT in the interim. These include Seychelles, Senegal, Norway, Poland, Mauritius, Kuwait, Chile, Colombia and Canada. The remaining have opted for some combination of simplified LoB with PPT or have opted for PPT as an interim measure till they bilaterally negotiate the detailed LoB (8 countries) which is not contained in the OECD model convention. As is expected the minimum standard has been adopted by all countries where a large number of countries have opted for the PPT. However, it may be of interest to estimate the extent of change, i.e. number of treaties that did not contain such a provision. Although 492 treaties were notified either for containing a PPT or LoB, of the matched treaties 240 contained such a provision. Although, countries can meet the minimum standards without the MLI the fact that there are 868 treaties where the MLI will introduce the new anti-abuse measure is an important achievement for the multilateral initiative. Further, as has been shown most countries have opted for the PPT and although many of them have opted to apply Para 4, to most Para 1 applies. The chart below shows the percentage share of a particular treaty abuse provision that will be adopted once the MLI is applied. As is evident in 84 per cent of the treaties PPT will apply. The introduction of the PPT therefore widens the scope of anti-abuse measures in that it applies to all incomes and does not limit the disallowance of treaty benefits to a criterion based on tests.

In sum, as far as the minimum standard relating to the anti-abuse measures, the MLI has made a significant contribution through greater consistency in the measure adopted. The PPT does not rely on tests like the LoB to deny treaty benefits and because of its broader scope of application may be more useful. While some degree of consistency seems to have been achieved, to the extent that the many countries have not yet joined the MLI and some of the treaties have been kept out of its coverage may limit such gains. Yet, the fact that many treaties could be brought on par is commendable.

[55] Para 4 provides that the taxpayer can request the Competent Authority of the Contracting Jurisdiction to consider facts and may prior to disallowing the treaty benefit consult the CA of the other Contracting Jurisdiction

Figure 6 Share of treaty abuse measure in matched treaties



3. Conclusion

Designing the MLI has indeed been laborious. This is expected since the interests of various countries were to be taken into consideration in the design. A country signing the MLI will not want to compromise its tax sovereignty. That is, it would prefer to retain the choice to adopt a particular anti-BEPS measure or to negotiate treaties bilaterally. The ad-hoc group was formed to include developing countries in the design of the substance. In its final form, the MLI offered flexibility to the signatories of various forms. However, this flexibility has allowed some important treaty partners as well as some major treaties to stay outside the purview of the instrument. When the treaties that did not match are analysed it is observed that a large number of the agreements are not listed by developed countries and more with developing country partners. Some countries such as Switzerland and Mauritius have in fact kept out some of their significant investment partners from the list of agreements. The exclusion of such relationships casts doubt on the willingness to address the treaty related concerns through a multilateral platform. The MLI's reach therefore in terms of countries and treaties is not as wide as was expected.

The MLI also brings to light the differences in preferences to adopt specific anti-BEPS measures. This becomes more apparent with a count of countries that opted-out of the non-mandatory Articles. Some important Articles especially pertaining to PE i.e. Articles 12 and 14 that are of greater concern to developing countries finds few takers among the developed countries. On the other hand, the application of arbitration to a limited set of countries some of which may have already introduced arbitration in their treaties corroborates the unwillingness to adopt this mechanism of dispute resolution.

The discernible benefit that the MLI can be credited to have provided is in regard of the minimum standards. The anti-abuse measure adopted by most countries proves that to some degree consistency may have been achieved with relative speed.

The MLI lays bare the divide on some of the issues as well the preference to ultimately resort to bilateral renegotiations thereby compelling us to ask if indeed there is potential for multilateralism in resolving BEPS.

Appendix

1. Article 3 relates to the transparent entities. These are partnerships or trusts that are treated as a pass through for the purpose of taxation. That is, the income is taxable in the hands of partner or the trustee in the country of residence.

2. Article 4 addresses the issue of dual residence, which is the entity claims residence of both the treaty partners to avail full treaty benefits. While there is little consensus[56] on the tie-breaker used for determining residence,[57] the OECD and UN model convention specify that the entity will be considered a resident based on the Place of Effective Management(POEM). Article 4 allows the Competent Authorities to determine by mutual agreement the contracting state of which the entity is to be deemed a resident. The tie-breaker requires Competent Authority to go beyond POEM. Given that many countries adopt their own tie-breakers or tests for determining residence, countries may choose to opt-out of this article.

3. Article 10 deals with the Anti-abuse rule for PEs situated in third s or as is referred to "triangular provision". The Article provides that treaty benefits will be denied if an item of income derived by a treaty resident and attributable to a PE in a third, is exempt from tax in the residence state and the tax in the PE is less than 60% of the tax that would be imposed in the residence state if the PE were located there. These conditions shall not apply is the income derived in the other state is "in connection with or incidental to active conduct of a business through the PE". In addition, the Article does provide the option to the CA to determine whether the treaty benefits be granted in the light of the reasons provided by the resident, which in turn satisfy the aforementioned conditions Article 11 is a saving clause[58] that gives the state a right to tax its own residents. According to this Article, the CTA shall not affect the right to tax the residents of a country except with granting benefits under specific provisions of a CTA to non-residents. The aim of this article is to "defeat interpretations claiming that some domestic rules may be contrary to treaty provisions".[59] There are just as many developing countries that have opted –out of this article as Article 3.

4. Article 12 seeks to tackle MNE operations that avoid the PE status by selling their products through an agent. The sales are registered in the name of the agent but the

[56] Page 15, Vann(1998)

[57] "Amongst the formal tests, one may highlight the place of incorporation (e.g. US) or the statutory seat or head office (e.g. Sweden). In alternative, other States have developed more substantive factors or tests such as the central management and control (e.g. UK), place of effective management (e.g. France) and place of main activity (e.g. Israel before 2003)." http://www.taxand.com/taxands-take/news/remedies-dual-residence-companies-tax-treaty-situations

[58] Page 14 Explanation and Analysis of The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MC-BEPS), BEPS Monitoring Group

[59]page 14 Explanation and Analysis of The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MC-BEPS), BEPS Monitoring Group

goods sold belong to the MNE,[60] therefore such arrangements bring down the tax liability of the MNE significantly. The article states that-

"where a person is acting in a contracting to a CTA on behalf of an enterprise and, in doing so, habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts <u>that are routinely concluded without material modification by the enterprise</u>, and these contracts are:

a) In the name of the enterprise; or

b) For the transfer of the ownership of, or for the granting of the right to use , property owned by that enterprise or that the enterprise has the right to use; or

c) For the provision of services by that enterprise,

that enterprise shall be deemed to have a PE in that contracting "(Article12 (1)).

The definition adopted in the convention is narrower, since UN sub-committee on BEPS had recommended the exclusion of the underlined sentence.[61] This article dealing with PE would be of specific interest to developing countries.

5. Lastly, Article 14 relates to the splitting up of contracts. MNEs tend to split up their activities such as construction activities in a jurisdiction so to avoid the minimum period criterion used to establish that the MNE has a PE in the said jurisdiction. While this problem can be tackled through the use of domestic-anti abuse rules or the PPT[62] the Convention provides a rule to tackle the issue. Para 1 states that-

"For the sole purpose of determining whether the period (or periods) referred to in a provision of a Covered Tax Agreement that stipulates a period (or periods) of time after which specific projects or activities shall constitute a permanent establishment has been exceeded:

a) where an enterprise of a Contracting carries on activities in the other Contracting at a place that constitutes a building site, construction project, installation project or other specific project identified in the relevant provision of the Covered Tax Agreement, or carries on supervisory or consultancy activities in connection with such a place, in the case of a provision of a Covered Tax Agreement that refers to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant provision of the Covered Tax Agreement; and

b) *where connected activities are carried on in that other Contracting at (or, where the relevant provision of the Covered Tax Agreement applies to supervisory or consultancy activities, in connection with) the same building site, construction or installation project, or other place identified in the relevant provision of the Covered*

[60] Groeneweg (2016)

[61] Page 14 BEPS Monitoring Group Report of the Subcommittee on BEPS, p.70-72

[62] Page 42 Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report

Tax Agreement during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the aggregate period of time during which the first mentioned enterprise has carried on activities at that building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement."

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