

Significant tax treaty changes proposed in multilateral convention

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On November 24, 2016, the OECD released a multilateral convention (the [multilateral instrument or MLI](#) [PDF]) together with a detailed [Explanatory Statement](#) [PDF]. The release of the MLI follows negotiations involving more than 100 jurisdictions, including Canada. The purpose of the MLI is to allow swift implementation of a series of tax treaty measures that were contained in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. Once in effect, the MLI may have a significant impact on Canada's existing bilateral tax treaties. Effects may include the denial of certain tax treaty benefits, the reallocation of certain taxing rights, and the modification of existing dispute resolution procedures.

Procedure for implementation

The following is a summary of the steps that must be followed for the MLI to apply to a particular tax treaty between Canada and another jurisdiction:

1. Canada and the other country must first sign the MLI (either at the OECD's planned signing ceremony during the week of June 5, 2017, or at any time after December 31, 2016).
2. Canada and the other jurisdiction must then each complete its domestic procedures to ratify the MLI. In Canada, this requires parliamentary approval.
3. Once ratified, Canada and the other country must each notify the OECD (who will maintain a public record as the "depository" for the purposes of the MLI) that its domestic procedures are complete. The notification will also include certain details regarding which tax treaties or protocols are intended to be modified by the MLI, and various optional provisions in the MLI that are intended to apply (described in more detail below).
4. For each signatory, the MLI enters into force on the first day of the month that begins at least three months after the OECD receives the requisite notification (with a potential further delay if less than five jurisdictions in aggregate have provided the requisite notification).
5. The MLI will then have effect for a particular tax treaty between Canada and the other country:
 - a. for non-resident withholding taxes, on the first day of the calendar year after the MLI has entered into force in both Canada and the other country, and
 - b. for other taxes, for taxable periods beginning at least six months after the MLI has entered into force in both Canada and the other jurisdiction (or such shorter period as may be agreed by Canada and the other jurisdiction).

To illustrate this timing, if Canada and the other country each sign the MLI in June of 2017, and each notifies the OECD that its ratification procedures are complete in November of

2017, then the MLI would enter into force for each on March 1, 2018. The MLI would then have effect for non-resident withholding taxes starting on January 1, 2019, and for other taxes in taxable periods beginning on or after September 1, 2018. As a result, taxpayers should have time to determine whether the MLI will have an adverse impact and, if possible, to reorganize their affairs to mitigate any such adverse impact.

Background

In order to address BEPS in a targeted and synchronized manner, Action 15 of the 2015 BEPS Final Report proposed a multilateral instrument that could be used as an alternative to the burdensome task of renegotiating over 2,000 bilateral tax treaties to implement various treaty-based proposals recommended by the BEPS Project. (For [further detail on the BEPS Final Report](#) see [here](#)).

The MLI is not meant to replace existing tax treaties. It is rather meant to be applied alongside existing tax treaties to modify their application in a manner that implements various BEPS measures. MLI signatories must agree to adopt the various minimum standards in the BEPS Project, subject to flexibility in the MLI regarding the approach that a jurisdiction may follow.

The MLI generally allows jurisdictions to opt in or opt out of provisions in the MLI that do not reflect a BEPS minimum standard, through the use of reservations and the notification process. Where Canada reserves on a particular provision, it will not modify any of Canada's tax treaties, or will only modify listed tax treaties. Similarly, if another country reserves on a particular provision (either generally or for purposes of its tax treaty with Canada), then it will not modify that provision in Canada's tax treaty with that country.

Various compatibility clauses are included in the MLI to address situations such as which provision should govern where a provision of the MLI conflicts with a provision in an applicable bilateral tax treaty, and how to address a mismatch where different jurisdictions follow different alternative approaches to a particular provision.

The general approach to treaty interpretation applies to the MLI. This means that the MLI (as well as tax treaties in general) are to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty, in their context, and in light of the treaty's object and purpose.

Summary of principal changes to tax treaties in the MLI

1) Hybrid mismatches – BEPS Action 2

The MLI contains a set of rules that can be adopted into tax treaties to address a broad set of BEPS concerns loosely grouped together under the term “hybrid mismatch,” although some of them do not involve hybrid entities or hybrid payments or transactions.

An optional rule addresses the application of tax treaties to the income of fiscally transparent entities. Where applicable, the rule provides that income earned by an entity that is wholly or partly fiscally transparent will be considered to be income of a resident of a treaty jurisdiction only to the extent that the income is treated, for purposes of that jurisdiction, as the income of a resident of that jurisdiction. Supporting rules clarify how the new rule interacts with existing treaty provisions.

For dual resident entities, the MLI proposes an optional tie-breaker rule pursuant to which the competent authorities would attempt to determine residency of persons other than individuals by mutual agreement having regard to the place of effective management, place of incorporation, or other relevant factors. In the absence of an agreement, treaty benefits will generally be denied. This test obviously has less certainty than the approach used in certain existing treaties based on the more objective place of incorporation test, and it puts the taxing authorities in control of settling (or not settling) cases of dual residence.

The MLI includes three optional alternative methods for applying treaty-based double taxation elimination provisions to hybrid entities. The purpose of these options is to ensure that tax treaties do not require treaty parties to facilitate double non-taxation situations. Option A provides that an exemption system will not be required to apply if an exemption is provided in the other jurisdiction (or is converted into a foreign tax credit where the other jurisdiction limits the applicable tax rate on the relevant income). Option B provides that an exemption in the jurisdiction of residence will not be required to apply on a dividend where the payment of the dividend gives rise to a deduction in the source jurisdiction. In that case, a foreign tax credit may be available in the residence jurisdiction with respect to income tax paid in the source jurisdiction. Option C provides for the use of a foreign tax credit regime.

As the MLI is focused entirely on tax treaties, the detailed recommendations in BEPS Action 2 regarding potential domestic law changes to address hybrids are not included in the MLI.

2) Treaty abuse – BEPS Action 6

Purpose of tax treaties

The MLI will amend the preamble of affected tax treaties to note an intention for tax treaties to eliminate double taxation without creating opportunities for non-taxation (or reduced taxation) through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining treaty benefits for the indirect benefit of residents of third jurisdictions). Parties may only reserve on this change if similar language is already included in a treaty preamble. This change to the preamble may be relevant in determining whether a particular transaction or arrangement results in a misuse or abuse of an applicable tax treaty for purposes of applying Canada's domestic general anti-avoidance rule.

Prevention of treaty abuse

The MLI also implements the BEPS Action 6 minimum standard by implementing a principal purpose test (PPT). Under the PPT rule, a tax treaty benefit is denied where one of the principal purposes of an arrangement or transaction is to directly or indirectly obtain the benefit, unless the granting of that benefit in the circumstances would be in accordance with the object and purpose of the relevant treaty provisions. Parties may opt out of the PPT rule only where an applicable tax treaty has a comprehensive limitation-on-benefits (LOB) rule combined with an anti-conduit rule. Although the MLI does not include a comprehensive LOB (since it generally involves country specific aspects), it does include a simplified LOB rule that could apply to supplement a PPT rule.

The LOB rule, which may apply to limit the availability of treaty benefits to an entity that is otherwise a resident of a contracting state, sets out objective conditions that are meant to ensure that there is a genuine connection or sufficient link between the entity and its residence state. Canada's treaty with the United States is the only Canadian treaty that currently has a comprehensive LOB rule. In contrast, the PPT rule is a more subjective general anti-abuse rule. Many commentators have expressed concern that the PPT rule will

result in significant uncertainty, since there may often be a dispute regarding what is a “principal purpose” and whether a particular transaction should be considered within or outside of the treaty’s object and purpose. While the OECD provided some examples in its 2015 BEPS Report, significant concerns remain.

Moreover, the OECD noted in its 2015 BEPS Report that there were many concerns with respect to how a PPT or LOB rule will apply to various collective investment vehicles, including private equity funds. This led to an OECD discussion draft in March, 2016 to which many commentators responded with continued concerns. Unfortunately, the MLI and the Explanatory Statement have not addressed these concerns, and significant issues therefore remain.

An optional provision is included in the MLI to provide some relief by allowing the competent authority to grant treaty benefits that would otherwise be denied under a PPT rule (or alternative benefits) if it is determined that such benefits would have been granted in the absence of the arrangement or transaction. However, even if this rule is followed it would generally not provide investors with the certainty that they require prior to making investments.

Dividend withholding tax

The MLI contains an optional provision to impose a holding period in order to obtain beneficial treaty rates of dividend withholding tax that apply where the dividend recipient holds more than a certain amount of the equity of the dividend-paying entity. For example, many of Canada’s tax treaties reduce dividend withholding to 5% where the beneficial owner of the dividends is a company owning at least 10% of the voting shares of the dividend payer.

The MLI provision would impose the additional requirement that the ownership condition be satisfied throughout a 365-day period that includes the day of the payment of the dividends.

Capital gains on real property interests

The MLI also contains an optional provision that would expand a country’s right to tax the capital gain realized on shares (or similar interests) that derive their value principally from real property in the country. Under Canada’s current tax treaties, this right generally exists where the value test is met at the time the gain is realized.

The MLI provision would expand this right so that it would apply where the value threshold is met at any time during a 365-day period preceding the sale. In addition, the rule would be extended from shares of a corporation to also include, as in many of Canada’s existing treaties, other equity interests (such as interests in partnerships or trusts).

Third country permanent establishment rule

The MLI contains an optional rule that denies treaty benefits when payments are made to a low-taxed permanent establishment (PE) in a third jurisdiction (i.e., a country that is not a party to the particular treaty being modified by the MLI). Specifically, treaty benefits will not apply to an item of income derived from a source state by an enterprise resident in its treaty partner, State R, where:

- State R treats the income as attributable to a PE of the enterprise situated in a third jurisdiction, State X,

- the profits attributable to that PE are exempt from tax in State R, and
- the State X tax on those profits is less than 60% of the State R tax that would be imposed on that item of income if the PE were situated in State R.

The above treaty benefits-denial rule will not apply if the relevant item of income is derived in connection with, or is incidental to, the active conduct of a business carried on through the PE. That active business exception does not apply, however, in the case of certain specified investment-related activities.

Taxing own country residents

The BEPS Project confirmed the principle that tax treaties should not generally limit a jurisdiction's right to tax its own residents, as expressed in "saving clauses" contained in many treaties. The MLI provides for an optional saving clause that reflects the changes to the OECD model tax convention proposed by the BEPS Project.

3) Avoidance of PE status – BEPS Action 7

Consistent with Action 7, the MLI contains rules to prevent the artificial avoidance of a PE in a source state by a resident of a contracting state. The new rules go beyond preventing tax avoidance and significantly expand the scope of the PE concept. The MLI contains three sets of PE rules:

Agency PE and commissionaire

The MLI contains a provision relating to agents contracting on behalf of an enterprise. Under current tax treaties, an enterprise will generally have a PE in a source state if there is an employee or agent (other than an independent agent acting in the ordinary course of business) in the source state who acts on behalf of the enterprise and has, and habitually exercises, an authority to conclude contracts in the name of the enterprise (Agency PE).

The MLI makes two main changes to the Agency PE rules. First, significantly lowering the PE threshold, an Agency PE will arise if a person acts in the source state on behalf of the non-resident enterprise and habitually plays a "principal role" leading to the conclusion of contracts that are "routinely concluded" without material modification, and the contracts are in the name of the enterprise, are for the transfer of property of the enterprise (or for the right to use property of the enterprise), or are for the provision of services by the enterprise. Second, although an exception applies where the person is an independent agent acting in the ordinary course of its business, the independent agent exception will not apply if the agent acts "exclusively or almost exclusively" on behalf of one or more enterprises to which it is "closely related."

The change from the bright line "conclusion of contracts" test to the more subjective "plays a principal role" standard, and the narrowing of the independent agent exception, will lead to greater uncertainty about whether or not a PE exists as a result of contractual negotiations taking place on behalf of a non-resident in a source state.

This provision is optional, since it is not required to meet a minimum standard.

Preparatory or auxiliary exemption

Under current rules, a resident enterprise whose activities in the source state would otherwise give rise to a PE (either a fixed place of business PE or Agency PE) will be deemed not to have a PE if the activities fit within a list of activities that may be considered to only involve a modest connection to the source state (the Specific Activity Exemption). The MLI provides two very different options for modifying the Specific Activity Exemption:

- The less taxpayer-friendly option (Option A) would make it clear that, for the Specific Activity Exemption to apply, (a) each and every activity listed in the existing treaty's Specific Activity Exemption must itself be of a "preparatory or auxiliary" character, and (b) the overall activity (assessed in combination) of an enterprise must be of a preparatory or auxiliary character.
- The more taxpayer-friendly option (Option B) would make it clear that, for the Specific Activity Exemption to apply, (a) the specific activities listed in the existing treaty's Specific Activity Exemption need not be of a "preparatory or auxiliary" character (unless the existing treaty being modified by the MLI already imposes that condition), and (b) where more than one specific activity listed in the existing treaty's Specific Activity Exemption is carried on at a fixed place of business, the overall activity at the place resulting from this combination must be of a preparatory or auxiliary character.

Both options provide that the Specific Activity Exemption will be satisfied where any other activity not specifically listed in an existing treaty's Specific Activity Exemption is carried on at a fixed place of business, provided that the activity is of a preparatory or auxiliary character.

These provisions are optional, since they are not required to meet a minimum standard.

For non-resident enterprises that rely on the Specific Activity Exemption to avoid PE status – for example, for their foreign storage or delivery facilities – these changes (if adopted by Canada and its treaty partners) could have a significant impact, particularly if the covered activities are central to the profit-making process of the enterprise.

Splitting-up of contracts

The MLI contains a rule aimed at the artificial segmentation of activities by related enterprises to avoid existing treaties' twelve-month (or other stipulated time) threshold (the Threshold Period) for the existence of a PE at the site of a building site or construction, installation or other specified project of a particular enterprise (a Project Site). The new rule will apply only if the particular enterprise carries on activities in a source state at a Project Site during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the Threshold Period. In that case, in order to determine whether the Threshold Period is exceeded by the particular enterprise, one has to include in the total day count any periods greater than 30 days during which any "connected activities" are carried on at the same Project Site by one or more enterprises closely related to the particular enterprise.

The above rule would also apply to modify, along similar lines, existing treaties (modelled on the UN Model Tax Convention) that apply the Threshold Period to create a PE based on the carrying on of supervisory or consultancy activities in connection with a building, construction or installation project.

This new rule will require enterprises engaged in, or consulting on, foreign building

construction or installation projects to re-examine the way they determine the PE status of such projects when “closely related enterprises” are also involved in the projects.

This provision is optional, since it is not required to meet a minimum standard.

4) Dispute resolution and arbitration – BEPS Action 14

The MLI will implement the minimum standard for resolving treaty-related disputes included in the BEPS Final Report on Action 14 by amending the mutual agreement procedures (MAP) in affected tax treaties so as to incorporate the MAP provisions of the OECD Model Tax Convention, as revised in the BEPS Final Report. These revisions are intended to improve taxpayers’ access to MAP.

More significantly, the MLI includes an optional provision for mandatory binding arbitration that was negotiated among a sub-group of 27 countries, including Canada, the United States and the United Kingdom. Jurisdictions that opt in to binding arbitration may reserve with respect to the scope of cases that will be eligible for arbitration (provided the other parties agree).

International tax disputes have taken on prominence in recent years, and their volume is expected to rise significantly as a result of the BEPS measures. This anticipated increase in the volume of cross-border controversy will no doubt place strain on an already overburdened MAP framework. While the potential availability of mandatory binding arbitration in many situations is a welcome development, it remains to be seen whether this, and full implementation of the other agreed “best practices” for MAP, will suffice to keep taxpayers out of the cross-fire as jurisdictions duel over tax dollars.

Conclusion

The MLI will allow Canada and other jurisdictions to amend their tax treaties in a streamlined manner, potentially saving years of duplicative bilateral treaty negotiations. However, the uncertainty created by the MLI’s use of a PPT general anti-abuse rule could adversely impact investment, particularly from private equity or other collective investment vehicles.

Much like the other aspects of the BEPS Project, the MLI does not attempt to determine which countries will “win” or “lose” as a result of the amendments. In particular, the MLI does not attempt to address significant differences in views between certain jurisdictions with respect to the manner in which taxing rights should be divided. Developed countries (which are predominantly capital exporters) tend to prefer allocating taxing rights to the “resident state,” generally through minimizing withholding taxes and narrowing the scope of the “permanent establishment” definition. In contrast, developing countries (which are predominantly capital importers) tend to prefer allocating taxing rights to the “source state,” generally through maintaining domestic withholding tax rates and expanding the scope of the “permanent establishment” definition. These fundamental differences in views, together with the aggressive approach that many countries are taking toward transfer pricing and related issues, will likely result in a continued increase in international tax disputes.

Moreover, the introduction of the BEPS-inspired country by country reporting will likely add fuel to the tax dispute fire, despite the OECD’s intentions for such reports to be used solely as a risk assessment tool. As a result, the arbitration provisions in the MLI will likely have significant importance going forward.

Please contact any member of our [National Tax Group](#) for further information on how the

MLI may impact you and your business.