Back to basics

Interpreting double tax treaties in light of the BEPS multilateral instrument

Speed read

Some but not all double tax treaties are being amended by the Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the multilateral instrument or MLI). This article examines the application of the MLI to a given scenario, in the context of DTTs generally. Broadly, in applying a double tax treaty, one now needs to: locate the relevant treaty; check whether and when each party to the DTT ratified the MLI to establish: (i) when it comes into force; and (ii) when the provisions take effect; use the OECD online tool to establish which provisions of the MLI apply to the DTT; and apply the DTT, as amended by the MLI, to the facts. Applying these steps in practice may not be as straightforward as first appears.

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The Organisation for Economic Cooperation and Development's (OECD) project on base erosion and profit shifting (BEPS) is now much publicised. We are entering a new phase of the BEPS process where double tax treaties (DTTs) are to be amended in line with certain parts of the OECD's BEPS Action Plan, published in 2015. The instrument effecting these amendments is the Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, also known as the multilateral instrument (MLI).

The MLI as an instrument seeks to amend existing DTTs without requiring bilateral negotiations in respect of each and every DTT. Broadly, the MLI covers the following areas:

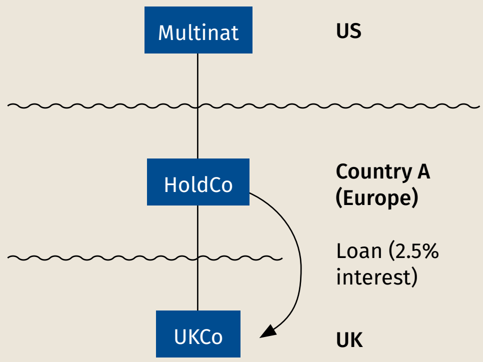
- hybrid mismatches;
- treaty abuse;
- permanent establishments; and
- dispute resolution.

There are a number of technical elements to each of these parts of the MLI, which have been very well covered in previous articles within this journal. The purpose of this article is to give practical guidance on applying the MLI to a given scenario, in the context of DTTs generally.

The scenario

Our client is a multinational group with headquarters in the US (Multinat). Multinat has an intermediate holding company (HoldCo) incorporated and resident in a European jurisdiction (Country A). HoldCo holds subsidiaries within various jurisdictions, including the UK (UKCo). Multinat chooses to fund its UK operations through a mixture of equity and debt (on which UKCo pays an arm's length rate of interest). The structure is set out in the box below.

Example structure



Multinat has relied on the EU Interest and Royalties Directive 2003/49/EC to make interest payments from UK to HoldCo free of UK withholding tax. However, Multinat is worried about the potential disapplication of the Directive as part of Brexit (having read 'The long arm of Brexit' (Ashley Greenbank and Penny Van den Brande), *Tax Journal*, 4 August 2017) and potential tax leakage within its group. As such, the question posed is how the DTT between the UK and Country A would apply to the arrangements. The UK and Country A have a DTT that is materially similar to the OECD Model DTT but provides for a 0% withholding tax rate on interest.

The client has asked for a full note to be included as part of his holiday reading, so we can start from the beginning.

The UK law position

The starting point is the position under UK domestic law. Section 874 of ITA 2007 provides the duty to deduct an amount equal to the basic rate of income tax from payments of yearly interest. Therefore, without more and absent a domestic exemption, a 20% withholding tax applies to the payment of interest by UKCo.

This may well create tax leakage for Multinat where Country A does not provide a full credit for the amount of tax withheld. HoldCo would have effectively paid tax twice (once in the UK and once in Country A) in respect of the same interest receipt. Such double taxation is, on the face of it, where one might expect a DTT to apply.

General application of DTTs

So, can we use a DTT here to override an express statutory provision? The application of international law within UK domestic law has been a high profile issue recently as a result of Brexit; and it is worth noting that DTTs do not take effect automatically within UK domestic law. Broadly, a DTT takes precedence over statutory provisions but only where it has become an Order in Council, and such Order in Council has been approved by a resolution of the House of Commons. In summary, we can look to DTTs to override domestic statute but not automatically; and changes to them will not have effect until the process noted within this paragraph is followed (in contrast to, for example, EU regulations).

Multinat should be aware that there are occasions where the DTT priority rule can be limited. The UK's general anti-abuse rule (GAAR), for example, specifically states that the DTT priority rule takes effect subject to the GAAR, and so the benefit of a DTT may be unilaterally counteracted by HMRC where it considers that the relevant arrangements could not reasonably be regarded as a reasonable course of action. There are other treaty overrides in particular circumstances.

Applying the DTT provisions

The application of the relevant DTT to this scenario initially appears straightforward. UKCo is resident in the UK and HoldCo is resident in Country A. As such, the payment of interest arising in one country to the other country is, in this case, taxed in that other country (Country A). Under the DTT, the UK may not apply a withholding tax as long as HoldCo is the 'beneficial owner'.

The starting point for interpretation of a term within a DTT is usually article 3(2), which provides that where a term is not defined within the DTT it shall have the meaning that it has under the law of the state that is seeking to apply the DTT. As such, a term in a particular DTT does not have a single consistent meaning.

In the context of Multinat's question, the term 'beneficial ownership' is particularly relevant. If HoldCo is not the beneficial owner of the interest, there will not be relief under the DTT. On the article 3(2) principle outlined above, it might be expected that where the UK is utilising the relevant DTT, the meaning would be limited to a trustee/beneficiary concept. However, this is not how the phrase is interpreted by HMRC and the rationale for this shows the need for caution in respect of other terms within DTTs.

Essentially, HMRC follows the case of *Indofood* (*Indofood International Finance Ltd v JP Morgan Chase Bank NA London Branch* [2006] STC 1195), which applied an international fiscal meaning to the term beneficial owner, interpreted by HMRC to mean having 'the sole and unfettered right to use, enjoy or dispose of the asset in question' (see HMRC's *International Manual* at INTM332010). It is interesting to note that the relevant DTT in *Indofoods* was in fact the Mauritian/Indonesian DTT, as opposed to any DTT in respect of which the UK was a party.

The general point of interpretation that can be drawn out of this specific definition is that treaties will be interpreted in light of their purpose and object, and HMRC considers that such purpose and object is not to allow for situations considered to be an abuse of a DTT. If HoldCo was cunningly located in Country A as a special purpose vehicle, passing that interest on via a back-to-back arrangement to Multinat, chosen merely because that gave a better withholding tax result than if UKCo was paying Multinat directly, you could expect to encounter an *Indofoods* problem and DTT relief would most likely be denied.

Application of the MLI to the existing DTT

Is the UK's DTT with Country A one in respect of which the MLI applies?

The MLI applies to 'covered agreements', which are DTTs that each contracting party to the DTT have notified to the OECD. The list produced by the UK and Country A would need to be checked (these can be found on the OECD website); and, if there is a match, then the MLI applies once ratified by both countries.

Although the MLI has been signed by a number of countries, it won't enter into force in respect of any DTTs until three months after five countries have ratified it. Following this, it comes into force in respect of each country three months after its ratification. The MLI provisions will then come into *effect* from slightly later dates. For withholding purposes, it is from the beginning of the calendar year after the MLI comes into force for each of the relevant taxing jurisdictions. As such, it will need to be checked whether and when the UK and Country A have in fact ratified the MLI.

What is the status of the relevant provisions within the MLI?

In order to encourage countries to sign up to the MLI, there is a considerable amount of flexibility given to countries, allowing them to choose how and whether many of the provisions apply. Some of the key principles of interpretation are below:

- **Reservations:** Countries may make reservations in respect of certain provisions of the MLI so that they do not apply to that country's covered agreements. For example, under article 4 of the MLI where a company is dual resident, there is no longer a test based solely on effective management but rather a (less helpful) process where the relevant countries decide where that company is resident based on all relevant factors (and no benefits can be obtained until and unless such a decision is made). A reservation can be made in respect of this article, which the UK has not made, but if the other contracting party to the DTT has made such a reservation then this article would not apply to the DTT. Luxembourg, for instance, has made a reservation in respect of article 4 but the UK has not and so it does not apply to the UK/Luxembourg DTT.
- **Notifications:** Some parts of the MLI require express notification by a country in order to apply to its DTTs. For example, the application of the simplified limitation of benefits (SLOB) provisions may be applied by notification pursuant to article 7(6) of the MLI. The UK does not intend to make such a notification and so the SLOB would not apply to the UK's DTTs.
- **General:** In addition to the specific reservation and notification provisions, there are principles of interpretation in relation to amendments to the DTTs as follows:
  - **MLI provision applies 'in place of' the existing provision:** The relevant provision will only apply where both states make a notification in respect of there being an existing provision within the relevant DTT.
  - **MLI provision 'applies to' or 'modifies' an existing provision:** The relevant provision of the MLI will only apply to or modify an existing provision where both states make a notification in respect of there being an existing provision within the relevant DTT.
  - **MLI provision applies 'in the absence of' an existing provision:** The relevant provision of the MLI will only apply where all parties notify the absence of a particular provision.
  - **MLI provision applies 'in place of or in the**

absence of' an existing provision: The provision of the MLI will apply. Where there is an existing provision and such provision has not been notified, the MLI provision will supersede the existing provision to the extent it is incompatible.

Application of MLI provision to the particular scenario

As an example of using the rules above, we have considered for Multinat whether the principal purpose test (PPT) contained within article 7(1) of the MLI would apply to UK DTTs. Broadly, the PPT disapplies a benefit under the DTT where obtaining that benefit is one of the principal purposes of the arrangements.

Article 7(2) of the MLI states that the PPT within article 7(1) shall apply 'in place of or in the absence of' provisions within a DTT. On the interpretation principles above, it would initially appear that the PPT would therefore apply, regardless of any notifications made by either party.

However, article 7 para 15(1) of the MLI provides some optionality. Here, there is the opportunity for a specific reservation where a relevant state intends to adopt alternative provisions (a detailed limitation of benefits rule and certain other rules to reach a minimum standard) or where there are already PPT provisions within the relevant DTT. If either party reserves for the former reason, then the PPT may not apply to that DTT.

Whether the PPT applies would therefore depend on the positions adopted by the relevant countries. The OECD has a handy tool on its website (see bit.ly/2tMb9c5) that highlights which provisions would or would not apply between countries. The UK intends to publish amended DTTs and this will help, but clearly the MLI has added an additional layer of complexity.

The UK has not exercised a reservation in respect of the PPT, so the PPT will now apply to all relevant treaties (other than where a detailed SLOB is negotiated on a bilateral basis).

An analysis would then need to be carried out as to the substance of the PPT and whether it disapplies treaty benefits in this case, so you then need to look at what reservations Country A had decided to apply to PPT. If it matches the UK's position, the PPT overlays what is in the DTT and you have to look at whether the PPT causes an issue. If Country A is just a conduit, expect a problem here.

Summary of steps

In applying a DTT, one needs therefore to:

- locate the relevant treaty;
- check whether and when each party to the DTT ratified the MLI to establish: (i) when it comes into force; and (ii) when the provisions take effect;
- use the OECD online tool to establish which provisions of the MLI apply to the DTT; and
- apply the DTT, as amended by the MLI, to the facts. ■

For related reading visit www.taxjournal.com

- The long arm of Brexit (Ashley Greenbank, Penny & Van den Brande, 2.8.17)
- The BEPS multilateral convention: who loves SLOBs? (Dan Neidle & Jemma Dick, 29.6.17)
- The BEPS multilateral instrument: anti-abuse provisions (Heather Self, 26.1.17)
- The multilateral convention to implement tax treaty related measures to prevent BEPS (Sandy Bhogal & Kitty Swanson, 19.1.17)
- BEPS Action 6: preventing treaty abuse (Michael McGowan, Andrew Thomson & Emma Hardwick, 29.10.15)

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