The **BEPS** Monitoring Group

COMMENTS ON

UK proposed implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS)

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Tommaso Faccio and Sol Picciotto, with comments and input from Jeffery Kadet and Martin Hearson.

This submission follows the consultation event hosted by HMRC/Treasury in December 2016, and a follow-up meeting between Tommaso Faccio and Sol Picciotto of the BEPS Monitoring Group and HMRC/Treasury officials in January 2017. It sets out our view in relation to the approach the UK is proposing to adopt in relation to the implementation of the Multilateral Convention to Implement Tax Treaties Related Measures to Prevent Base Erosion and Profit Shifting.

We are very grateful for the opportunity to submit comments on the proposals of Treasury and HMRC. We understand that once Ministers have taken their decision, the necessary statutory instrument will be submitted for Parliamentary approval. We hope that this will also provide the opportunity for a wider public debate. The UK has so far not conducted a review of its tax treaty policy, especially in relation to developing countries, as some other OECD countries have done (e.g. Ireland, the Netherlands).[1] The UK Government has expressed strong support for the multilateral effort to reform international tax rules through the G20 and the OECD, of which this multilateral convention is an essential element. In our view it is important to approach the issues raised by the UK policy towards this convention in light of this global multilateral initiative.

SUMMARY

This multilateral instrument (MLI) aims to enable rapid implementation of the tax-treaty related proposals resulting from the G20/OECD project on base erosion and profit shifting (BEPS), by amending the bilateral tax treaties of participating jurisdictions. Although we

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[1] In 2012 G20 leaders made a number of commitments in relation to tax aspects of domestic resource mobilisation by developing countries. These included to conduct a 'spill over' analysis of the impact of any changes in their domestic tax systems on those of developing countries. In 2016 a follow-up report to the G20 from the Platform for Collaboration on Tax pointed out that in relation to this commitment there had been 'Important progress (notably Ireland and Netherlands), but more to be done'.

have advocated a more coherent and comprehensive approach to the problem, we support the overarching aim of the provisions in the MLI to reduce the exploitation of gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate taxation being paid. The MLI provides the easiest method of ensuring that this occurs quickly and coherently. If countries cherry-pick among the provisions of the MLI, its effectiveness would be greatly reduced, and instead of moving towards a simpler and more uniform structure of anti-abuse provisions in tax treaties, the MLI would add a new layer of complexity and potential confusion.

We would expect the UK, having been in the forefront in initiating the BEPS project and having played a major part in formulation of the proposals, to be in the lead in implementation of the outcomes. We are therefore surprised and concerned that it is proposed that the UK should adopt a selective approach to implementation. The intention apparently is to rely on general anti-abuse principles and unilateral measures, notably the Diverted Profits Tax, instead of implementing the more targeted provisions which have been agreed in the BEPS project and incorporated in the MLI.

We are especially concerned at the proposal not to adopt the provisions aiming at abuse of the taxable presence criteria provided by the permanent establishment (PE) concept. This seems based on a policy to reject attributing significant taxable profits if a MNE has an entity within the jurisdiction significantly involved in sales, even when it also has other affiliates engaged in related activities which constitute complementary functions that are part of a cohesive business operation. The approach proposed by Treasury and HMRC seems out of line with public opinion on how tax should be aligned with real economic activity, as expressed quite forcefully in several reports of the Public Accounts Committee. Treasury and HMRC policy seems to be that this should be dealt with by the diverted profits tax, which is both a unilateral and a blunt weapon. The UK rejection of the changes to the PE definition would deny them to its treaty partners, apparently aiming to offer an attractive country of residence for MNEs to carry on business outside the UK, by minimising taxation of their foreign income. However, other countries might also seek to defend their tax base with their own unilateral measures. Hence, the UK would effectively be engaging in tax competition, a beggar-thy-neighbour approach, which runs counter to the aims of the BEPS project and, we believe, to the long-term interests of the UK.

Such a partial adoption of MLI provisions, and reliance on unilateral measures and broad anti-abuse principles, would inevitably generate a higher number of conflicts. Indeed, this seems to be anticipated, by the inclusion in the MLI of a special chapter providing for mandatory binding arbitration. In our view this is putting the cart before the horse. Priority should be given to **preventing** disputes, by agreeing clear rules for allocation of profit which are easy to administer. We oppose the proposal that the UK should adopt mandatory binding arbitration, since this involves giving up UK sovereignty, which should be unacceptable in the key area of direct taxation.

For these reasons we have major concerns about the approach towards the MLI outlined so far by the UK Treasury and HMRC, which we explain further below, and hope that it can be reconsidered.

GENERAL REMARKS

1. A key element of the G20/OECD project on Base Erosion and Profit Shifting ("BEPS") is the Multilateral Convention to Implement Tax Treaties Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI"). The text of the MLI, as

well as an Explanatory Statement, were published by OECD on 24 November 2016. The purpose of the Multilateral Instrument is to provide a method for quickly amending existing bilateral double taxation agreements ("DTAs"), to implement those outcomes of the BEPS project which require changes to such treaties.

2. Whilst we are generally supportive of the provisions in the MLI to address tax treaty abuse by MNEs, underlying all these techniques is one basic strategy: exploitation of the fiction of separate legal personality and the 'independent entity' principle. Ending these abuses could have been achieved far more easily and with greater coherence by clearly stating as a guiding principle that MNEs should be treated in accordance with the economic reality that they operate as integrated firms. This was implicit in the mandate from the G20 to reform the system so that MNEs could be taxed 'where economic activities occur and value is created'. Instead, the MLI will introduce a plethora of anti-abuse rules for revenue administrations to apply. This will require high levels of expertise and sophistication, which are often beyond the capacity of administrations in developed let alone developing countries. This approach is also a recipe for disagreements and conflicts, which will benefit only the legions of paid tax advisers, to the detriment in particular of developing countries, which do not have the capacity to successfully monitor the schemes devised by tax practitioners and challenge them under general anti-abuse rules.

3. These problems will be exacerbated if states resort to selective application of general anti-abuse principles and unilateral measures, and do not implement the more targeted provisions which have been agreed in the BEPS project and incorporated in the MLI, notably those aiming at abuse of the taxable presence criterion provided by the permanent establishment (PE) concept. Such a partial adoption of MLI provisions would inevitably create more gaps and mismatches (or loopholes) between tax rules applied by different countries, encourage tax rule arbitrage in BEPS-motivated structures, and generate a higher number of conflicts. Indeed, this seems to be anticipated, by the inclusion in the MLI of a special chapter providing for mandatory binding arbitration. In our view this is putting the cart before the horse. Priority should be given to **preventing** disputes, by agreeing clear rules for allocation of profit which are easy to administer. For these reasons we have major concerns about the approach towards the MLI outlined so far by the UK Treasury and HMRC, which we explain further below, and hope that it can be reconsidered.

4. Some of BEPS measures are minimum standards, meaning that countries involved in the BEPS project, including the UK, have made a commitment that they must be implemented. Compliance with these commitments will be monitored by a process of peer-review through the OECD. The MLI does not permit opting out of its provisions implementing the minimum standards, except under specific conditions, essentially that the state undertakes to implement them in other ways. However, the MLI also includes provisions reflecting best practice or recommended measures, in relation to which it does permit reservations. Reservations result in the relevant provisions in the country's existing DTAs not being modified, thus denying other countries the possibility of implementing such provisions in relation to their DTAs with the country making the reservation (in this case the UK). As will be discussed in the next section, it is proposed by Treasury and HMRC that the UK should make a significant number of reservations, and hence participate only selectively in the MLI. On the other hand, it is proposed to adopt whole-heartedly the provisions for mandatory binding arbitration.

5. The overarching aim of the provisions included in the MLI is to reduce the tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate taxation being paid. The MLI provides the easiest method of ensuring that this

occurs quickly and coherently. If countries opt out of some of the MLI provisions, it may result in the continuation or even proliferation of the tax planning strategies the provisions are intended to restrict. It will also mean that instead of moving towards a simpler and more uniform structure of anti-abuse provisions in tax treaties, the MLI would add a new layer of complexity and potential confusion.

6. Comprehensive and coherent implementation of the BEPS project proposals will depend on adoption by all participating countries of both the minimum standards and the recommended best practices. We would expect the UK, having been in the forefront in initiating the BEPS project and having played a major part in formulation of the proposals, to be in the lead in implementation of the outcomes.

> **A decision to opt out of any of the MLI provisions should therefore only be made after very careful consideration, supported by strong reasons; the UK should make few reservations to the MLI.**

7. We appreciate that the procedure adopted in the MLI means that reservations can at any time be withdrawn, but new reservations cannot be added subsequently. This may encourage states to be cautious and make reservations initially which could be withdrawn later. However, making reservations, even on a provisional basis, could turn the MLI into a bilateral bargaining process, like the negotiation of bilateral DTAs, rather than part of a strong multilateral effort to block up the loopholes in the tax treaty system. The OECD is organising an event to facilitate matching of offers, by circulation of informal provisional lists of reservations.

In our view, therefore:

> **the UK should show willingness in these informal discussions to withdraw reservations at the request of treaty partners, especially developing countries, if a case is made that inclusion of the provision could help to stop up tax loopholes; and**
>
> **the UK should not make reservations to be used as a bargaining chip, either with its treaty partners or in the continuing discussions at the OECD on the remaining issues in the BEPS Action Plan.**

SPECIFIC COMMENTS

Proposed Reservations

8. HMRC/Treasury has recently outlined, during a public meeting on 12 December 2016, its proposed options and reservations for discussion. As an initial point, it seems that no decision has been taken as to which of the UK's bilateral tax treaties should be listed as Covered Tax Agreements which could be amended under the MLI. The UK has a very extensive network of 129 such treaties, many of them with developing countries, although it seems that only 80 of the partners to these treaties are so far participating in the MLI. It is against the spirit of the BEPS project and of the MLI to pick and choose which treaties should be modified, except for treaties which already include equivalent provisions. Some countries, especially those which have not had the capacity to follow the BEPS process carefully, may take some time to understand and evaluate the MLI. Having played a leading role in the BEPS process, the UK should be well able to decide what changes are needed to its treaties to block loopholes, and to move quickly to ensure that these changes are made to all its treaties.

> **The UK should ensure that reform is comprehensive, by listing all its treaties.**

9. We positively note that the HMRC/Treasury is proposing to implement a number of provisions in addition to the minimum standards required by the MLI.

We support the proposals for the UK to adopt MLI provisions on the following:

> article 3 (transparent entities), while reserving to exclude the exception in its paragraph 2;
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> article 4, requiring the competent authorities to decide the country of residence of an entity (failing which the entity would be denied treaty benefits);
>
> article 5 (though there is no need for the UK, since it uses the credit method, to choose one of the options) by not making a reservation preventing its treaty partners from adopting their preferred option;
>
> article 6 (new language in the treaty preamble, to include an anti-avoidance purpose), which is a minimum commitment, except for treaties which already include an equivalent provision;
>
> the principal purpose test (PPT) in article 7 para. 1, without the simplified limitation on benefits provision in paras. 8-13, and not to allow treaty partners to include the simplified limitation on benefits provision;
>
> the anti-fragmentation rule in article 13.

10. On the other hand, we note that it is proposed that the UK should make reservations and hence **opt out** of the following provisions of the MLI:

> article 8, which provides a 365 day minimum holding period requirement for entities to benefit from exemption (e.g. in the case of pension funds) or a preferential rate of dividend withholding tax that depends on the level of shareholding in the paying entity;
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> article 9, which applies article 13 of the OECD Model to indirect transfers of real property where its conditions are met at anytime in the 365 days preceding the alienation of the relevant shares or other interests;
>
> article 10, which denies treaty benefits where income is paid to a branch exempt in the residence state of the entity and taxed at a low rate in the state where the branch is located, unless the income is derived from the active conduct of a business carried on by the branch;
>
> article 12, which restricts the abuse of the permanent establishment requirements for taxable presence in relation to a dependent or independent agent of a foreign resident enterprise where the agent "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise";
>
> article 13, which restricts the abuse of the permanent establishment requirements for taxable presence using the specific activity exemptions in article 5 of the model convention, by making those exemptions subject to the test that they must be of a "preparatory or auxiliary" nature;
>
> article 14, which restricts the abuse of the permanent establishment requirements for taxable presence to avoid the time limit threshold by splitting up of contracts relating to constructions sites and similar activities.

These reservations would mean that the UK's approach to the MLI would be out of line with that of many of its treaty partners, including some OECD member states. For example, the Consultation Paper issued by Australia does not propose to make these reservations.

11. Treasury and HMRC have suggested a number of reasons to justify this approach. These include the following:

> the UK did not agree with the Action 7 recommendations for a slightly wider definition of permanent establishment (PE);
>
> it is undesirable to add the "preparatory and auxiliary" condition to the PE exceptions in article 5, since these activities should be regarded as remote from the generation of profit;
>
> extending the definition of a PE is unnecessary, as in the UK view little profit would be attributable to a dependent agent PE (DAPE), any problems should be solved by applying normal transfer pricing rules to the other associated enterprises;
>
> as regards article 10 (denial of treaty benefits to a PE in a low-tax state) the UK prefers to continue its present approach, which allows a UK-resident entity to elect exemption of a foreign PE, while ensuring there is no avoidance of UK tax through CFC rules;
>
> the widened PE definition would result in an additional administrative burden for both HMRC and taxpayers, which would be disproportionate since there would be little or no additional tax take;
>
> in any case, the UK can deal with any abuse due to avoidance of a PE through the Diverted Profit Tax (Finance Act 2015), which can apply to treaty partners under the PPT anti-abuse provision, which would be adopted.

12. We do not find these reasons convincing. By reserving against these provisions, the UK would effectively prevent other Treaty Partners from introducing them in their DTAs with the UK. These MLI provisions formulate targeted anti-avoidance rules that have been agreed multilaterally. Preferring to apply the blunderbuss of the general anti-abuse PPT rule and the Diverted Profits Tax will create uncertainty for business, and conflicts with treaty partners. Denied the possibility of including the MLI provisions rejected by the UK, which embody best practice recommendations, they would need to resort to general anti-abuse provisions and unilateral measures, as the UK proposes to do. Some treaty partners, notably the US, may not accept the PPT, but may adopt even more radical approaches.[2] Others may adopt the PPT as well as their own anti-abuse measures: for example, Australia has enacted its own diverted profits tax.[3] In our view, it is important for all countries which participated in the BEPS process to adopt the measures agreed by consensus, which provide agreed methods to mitigate and reduce the tax planning strategies that exploit gaps in tax rules, as they set out clear rules which are harder to circumvent.

13. We are especially concerned by the reasoning that the wider definition of a PE is undesirable because the activities in the exceptions are remote from profit generation, and unnecessary because little profit would be attributable. The BEPS Action 7 work on

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[2] A proposal made by the Republican majority in the US Congress, now being widely canvassed with President Trump in the White House, is for a destination-based cash-flow tax, which could be highly disruptive of both international tax and international trade rules.

[3] As pointed out above, Australia apparently intends to adopt the MLI provisions against which Treasury and HMRC propose to make reservations. This means that those provisions would not apply to the Australia-UK tax treaty.

"*Prevention of Artificial Avoidance of Permanent Establishment Status"* is not yet completed, especially as regards the key issue of attribution of profits. The implication seems to be that the UK considers that this work **should not** result in rules which would allow significant profit to be attributed to MNEs which may have significant sales in the UK, as well as other supporting activities. In our view, a good case can be made for attributing significant taxable profits if a MNE has an entity within the jurisdiction significantly involved in sales, especially where it also has other affiliates engaged in related activities which constitute complementary functions that are part of a cohesive business operation. This business model is not uncommon, and can be used to minimise taxes under some interpretations of the current rules on attribution of profits to PEs. In such circumstances fears that it would create disproportionate administrative burdens to expand the PE definition are not relevant, since the MNE already has affiliates subject to tax in the jurisdiction. Action 7 of the BEPS project was intended to deal with this type of situation, which has caused widespread concern including in the UK. The approach proposed by Treasury and HMRC to both the definition of a PE and attribution of profits seems out of line with public opinion on how tax should be aligned with real economic activity. These have been expressed quite forcefully in several reports of the Public Accounts Committee.

14. Generally, these reservations seem to be based on a calculation that the UK should aim to offer an attractive country of residence for MNEs to carry on business outside the UK, by resisting the pressures for greater taxation of income at the source. This is a very traditionalist approach to international taxation, which seems to ignore the ways in which the world economy has become more integrated or globalised. This has led to strong public concerns that many powerful and highly profitable foreign MNEs that have extensive sales in the UK, in addition in many cases to other related activities, are lightly taxed here.[4] Treasury and HMRC policy seems to be that this should be dealt with by the diverted profits tax, which is both a unilateral and a blunt weapon. It also means that the UK is effectively engaging in tax competition, aiming to attract MNEs to set up global or regional headquarters here, by offering low taxation of non-UK income. The intention seems to be to compete for example with Ireland, even if this means undermining the tax base of other countries. This is essentially a beggar-thy-neighbour approach, which runs counter to the aims of the BEPS project and, we believe, to the long-term interests of the UK.

2. Dispute Resolution and Arbitration.

15. We note that the intention is for the UK to adopt all the provisions on improving dispute settlement, even those which are not part of the minimum standard, as well as opting in to Part VI on Arbitration. An improvement of the mutual agreement procedure (MAP) is clearly needed, not least due to the likelihood that the extensive changes to international tax rules resulting from the BEPS project will create divergent interpretations and hence uncertainty and potential conflicts.

16. To this end we particularly support the provision in article 16(3) of the MLI for competent authorities to 'consult together and try to resolve all difficulties and doubts arising as to the interpretation or application of the convention'. We hope that this procedure for 'interpretive mutual agreements' will be widely adopted and much greater use made of it, as a means of reducing uncertainty. We expect the UK to adopt the Best Practice recommendation 2 in the report on BEPS Action 14 (p. 29) to 'have appropriate procedures in place to publish' agreements reached under this procedure 'that affect the application of a treaty to all

[4] See the reports of the Public Accounts Committee, most recently Corporate Tax Settlements (dealing with Google), 25th report of session 2015-6, HC 788.

taxpayers or to a category of taxpayers'. However, we regret that this Best Practice recommendation limits such publication by (i) excluding specific taxpayer MAP cases, (ii) restricting publication to agreements which 'provide guidance that would be useful to prevent future disputes', and (ii) requiring both tax authorities to 'agree that such publication is consistent with principles of sound tax administration'. In our view there should be a strong presumption that such interpretations should be published. Indeed, it seems inconsistent with the principles of tax administration for them to be kept secret, and for tax authorities to have the power to decide for themselves whether and when they should be published. Regrettably, HMRC has never published any information about its tax treaty disputes, the only data available are for the aggregate number of MAP claims which have been reported to the OECD, and for aggregate number of claims under the EU Arbitration Convention reported to the European Commission.

17. As stated in our General Comments (para. 3 above), priority should be given to preventing conflicts, by agreeing clear rules for allocations of profit which are easy to administer. Where disagreements arise, they should be resolved in a principled manner, and the reasons and criteria should be published. Instead, what is proposed is arbitration held in total secrecy, so that not even the existence or the nature of the issue would be known beyond the participants and their advisers. Indeed, Part VI of the MLI adopts as the default form 'baseball' or 'short-form' arbitration. This procedure specifically prohibits the arbitrators from formulating reasons for their decision, but requires them only to choose between the 'last best offer' tabled by the parties. Not only is the decision kept secret, it may not be referred to in later disputes. Under this approach, arbitration will always remain ad hoc.

18. In our view, the introduction of mandatory binding arbitration will further undermine public confidence in international tax rules. It is entirely inappropriate to seek to resolve international tax conflicts in an administrative process held behind closed doors, such as the MAP. The attempt to coerce tax authorities to abandon their own judgments and interpretations by compelling them to reach agreement through the threat of mandatory binding arbitration is even more inappropriate. MNEs have the same remedies open to them as do all taxpayers in relation to a disputed tax assessment, of referring the issue to domestic tribunals and courts. Indeed, they have the special advantage that tax treaty provisions are generally automatically applied in domestic law, creating a special legal regime for cross-border business on which they can rely. This direct effect is especially strong in the UK, as the Taxation (International and Other Provisions) Act (TIOPA) 2010 under s.6 gives effect to tax treaties 'despite anything in any enactment'. This means that tax treaty rights prevail over UK tax law, even if enacted subsequently.

19. The provisions of the MLI in effect give the MNE taxpayer a right to choose between pursuing a remedy in domestic courts and through the MAP. This even allows the taxpayer to suspend a legal claim while the MAP proceeds, and if dissatisfied by the MAP outcome, to reject it and proceed with the legal claim. Under mandatory binding arbitration, HMRC would not have such a choice. It would be obliged to proceed with a claim validly made by a taxpayer under the MAP, including to a binding arbitration. This would be so, even if HMRC considers that the claim

(i) might not be upheld by a UK tribunal or court;

(ii) entails an interpretation of international tax rules which is not in the interests of the UK.

20. This entails a substantial cession of UK sovereignty. It could be argued that this is not new, since the UK has already accepted such an obligation under the EU Transfer Pricing Arbitration Convention,[5] and under some bilateral treaties.

21. However, the arbitration provisions in the MLI go beyond those of the EU Transfer Pricing Arbitration Convention. Under the EU Convention (article 7.3), the obligation to refer a claim to arbitration does not apply if domestic law does not permit administrative authorities to override the decision of a court or tribunal, unless the taxpayer has withdrawn any legal claim. It also provides (article 8) that a claim need not be referred to arbitration if a final court decision has been given which entails a serious penalty. The MLI does permit a state to make a reservation that it would not be obliged to refer to arbitration an issue which has already been decided by a court or tribunal (MLI article 19.12). However, we understand that Treasury and HMRC propose that the UK should not avail itself of this reservation.

22. The UK joined the EU Arbitration Convention by virtue of its membership of the European Communities. The UK has now decided, at least in principle, that this membership should cease. A major motivation for this decision is rejection of the substantial cession of UK sovereignty entailed in membership of the EU. It therefore seems anomalous that the UK should in parallel agree to extend this cession of sovereignty in a matter as central as direct taxation, in relation to any country in the world.

[5] Convention on the elimination of double taxation in connection with the adjustment of the profits of associated enterprises 90/463/EEC, Official Journal of the European Communities L225/10 of 20/08/90/