The Legal Status of the Multilateral Instrument (incl. BEPS Reports and Recommendations): What will be the challenges?

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Adjusted after release by the OECD/G20 of the text of the Multilateral Instrument (MLI) on the 24th of November, 2016.

All references to "art" are to articles of the MLI and to "para" are to paragraphs in the Explanatory Statement to the MLI unless stated otherwise.

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Outline

- Normative framework for evaluation of the MLI.
- Challenges arising from the creation of the MLI.
- MLI design model.
- The flexibility of the MLI and its challenges.
- Tax treaty interpretation difficulties under the MLI.
- Domesticating the MLI.
- Concluding remarks.

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Normative framework for evaluation of the MLI

- **From constitutional democracy perspective:**
  - Sovereignty is connected to close political scrutiny of tax law (more so than other areas of law, as taught by history).
- **From a rule of law perspective:**
  - Tax law should be *clear law openly made*. It must be precise.
  - Tax law must be accessible law *reasonably intelligible for a*ll users (incl. their advisors).
  - Tax law is to be *disputed openly in public courts*.
  - Tax law ought to be *shorn of discretionary powers* awarded to unelected civil servants, or at least subject to *express and clear legal safeguards to protect taxpayer rights*.

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Creation of the MLI

- **Ad-hoc Group timeline:**
  - Enlargement to 99+ countries occurred only after substance of BEPS actions (except arbitration) agreed by a smaller group (OECD + G20).
  - Very short MLI negotiations limited to design implementation, except for arbitration.
  - Not a real forum for fundamental reformatting of intl. tax regime in a 99+ country wide multilateral setting.
  - Suggests: Perhaps a degree of false consensus around new standards?
  - Evidence of dissonance may be the extent of variation in opt-in / opt-out choices, or exclusion of sensitive bilateral tax treaties from the scope of the MLI.

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Creation of the MLI

- **Enlargement & composition of ad-hoc group:**
  - Includes countries with e.g. one tax treaty (Liberia, Cook Islands, Marshall Islands) or very few (e.g. Burkina Faso, Benin).
  - Severe capacity constraints in some of these countries.
- **No transparency (as yet) about the MLI negotiations.**
  - Will proceedings of the ad hoc group be published?
  - E.g. similar to conference proceedings leading to the conclusion of true multilateral conventions, e.g. VCLT.

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The MLI

- **The Preamble singles out ‘corporate tax’ and aggressive intl. tax planning, against the background of the BEPS project.**
- **Thus acknowledgement of the mischief and target of the MLI measures: Tax avoidance by multinational corporations.**
- **However: The MLI measures are all encompassing and affect all taxpayers and not only corporate taxes.**

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MLI design models

- **Basic choice between:**
  - A multilateral treaty that will have a legal life of its own, co-existing in perpetuity with existing bilateral tax treaties (model A); or
  - A multilateral treaty that will largely fall away once it has made selected changes to existing bilateral tax treaties (model B).

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The MLI

- **What design model/s is/are embodied in the MLI? A bit of both models A and B:**
  - Binding arbitration in tax treaty disputes: MLI provisions appear to stand on their own legal footing.

    "*a single cohesive arbitration provision*" per para 20.
  - Explanatory Statement contains substantive guidance on operation of arbitration clauses (to be replicated in OECD MTC? What about future changes?)

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The MLI

- **The rest of the MLI: modifies bilateral tax treaties by countries notifying clauses in tax treaties affected, incl. those subject to reservation (opt-in or opt-outs).**
  - BUT no process provided for in MLI to actually re-draft bilateral tax treaty clauses. Appears to envisage annotated treaty texts? Who's responsibility will that be?
  - Guidance on amendment process captured in the MLI's Explanatory Statement.
  - Guidance on substantive meaning in BEPS Action Reports and/or 2017 OECD MTC Commentary.
  - Intractable problem of legal status of OECD Model Commentaries (and changes thereto), and inconsistent use by domestic courts will continue, and become even more complex.

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The flexibility of the MLI

- **Flexibility in the MLI provisions reflected by:**
  - Option to exclude specific bilateral tax treaties entirely.
  - Opt-in and opt-out clauses (reservations).
  - Generally no asymmetric application, except for express deviations allowed by the MLI.

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The flexibility of the MLI

- **Opt-in and opt-out clauses by way of reservation: How will this work?**
- **Bilateral tax treaty clauses only amended by the MLI when reservations of two countries match?**
  - Expressly required in some cases (e.g. art 17 corresponding transfer pricing adjustments and art 18 arbitration), but silence in other provisions.
  - Is matching of reservations to be implied in all cases (based on reciprocity and consensus)?
  - What is the role of so-called ‘compatibility clauses’ in this?
  - Will this now trigger rounds of mini bilateral negotiations?

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The flexibility of the MLI

- **Consequences of complex system of reservations:**
  - Will establish new type of unevenness in the tax treaty landscape. This is an essential ingredient for tax arbitrage.
  - Will further encourage ‘weakest link’ approach to tax treaty planning.
  - Spill-over effect: e.g. opting out of agency PE changes -> may imply that avoidance of agency PE which was the mischief of BEPS Action 7, is acceptable for unaffected tax treaties of reserving party?
  - Sufficient capacity in developing countries to manage this complex menu of options? Spectre of large countries imposing their choices?

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The flexibility of the MLI

- **Art 28(3) of the MLI seeks to generally preclude asymmetrical application of tax treaties:**
  - One party's reservation modify provisions in a tax treaty to the same extent for the other party in its relations with the reserving party.
  - Appears to be impliedly based on reciprocity, i.e. that both party's reservations match (this is expressly required in some cases but not in all).
  - Except unless explicitly provided otherwise in the MLI.

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The flexibility of the MLI

- **Asymmetrical amendments of tax treaties expressly allowed by the MLI:**
  - Art 5 regarding double non-tax measures.
  - Art 7 regarding tax treaty abuse: Asymmetrical application of e.g. the Principle Purpose Test (PPT) alone by one party, and the PPT and the Simplified Limitation on Benefits (SLOB) clause by the other party to a particular bilateral tax treaty.

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The flexibility of the MLI

- **Selective amendment through the MLI's flexibility may affect the balance of negotiated bilateral tax treaties.**
  - Balance of a tax treaty based on particular bilateral dynamic (e.g. relative investment/trade flows, large vs. small economies).
  - Often more liberal tax treatment allowed under a tax treaty for a particular goal (e.g. favourable channel to attract FDI / promote domestic tax incentive).
  - Broad-based amendment through MLI may upset originally agreed balance and/or position of smaller economies vis-à-vis larger ones.

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Tax treaty interpretation & the MLI

Legal completeness of the MLI:

- Substantive changes to bilateral tax treaties to be catalogued through notification to Depository (OECD) by each signatory country.
- The dates of actual changes to bilateral tax treaties subject to the MLI will not coincide.
- Guidance on the substantive meaning of actual operative clauses amended by the MLI to be based on
  - The final BEPS Action reports of 2015 (and earlier drafts?).
  - A future update of the OECD Model Commentaries (not yet available).
  - Not on the MLI's own Explanatory Statement (except for arbitration).
- Seems that OECD WP1 (not ad hoc group!) responsible for completing outstanding matters e.g. agency PE profit attribution, PE in third state anti-abuse, 2017 Commentaries.

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Tax treaty interpretation & the MLI

- **Compatibility Clauses in the MLI: based on art 30(4) VCLT "Application of successive treaties relating to the same subject-matter"**

  "When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under article 59, ***the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty****."*

- **Appears to govern legal consequence of a signatory State failing to lodge a notification with the OECD as required by MLI?**

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Tax treaty interpretation & the MLI

- **What is the legal status of the Explanatory Statement to the MLI?**

"11. The text of this explanatory statement to accompany the Convention ("Explanatory Statement") was prepared by the participants in the ad hoc Group, and in the Sub-Group on Arbitration, to provide clarification of the approach taken in the Convention and how each provision is intended to affect tax agreements covered by the Convention ("Covered Tax Agreements"). It therefore reflects the agreed understanding of the negotiators with respect to the Convention. […] The members of the ad hoc group adopted this Explanatory Statement on 24 November 2016 at the same time as adopting the text of the Convention."

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Tax treaty interpretation & the MLI

- **Binding context under art 31(2)(a) VCLT?**
  - Ad hoc members are not “parties” under the VCLT (States bound by the MLI would be). Thus negotiating States agreed the Expl Statement, and not all of them are necessarily going to be signatories of the MLI.
  - However, may be “an agreement” “made in connection with the conclusion” (in future) of the MLI by signatory States who were members of the ad hoc group.
  - Otherwise supplementary means under art 32 VCLT.
- **If the MLI Explanatory Statement is binding context: will introduce a new dichotomy in legal status of the BEPS Action Reports and OECD MTC Commentaries, which are not binding context.**

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Tax treaty interpretation & the MLI

- **Dating of bilateral tax treaties & extra-textual sources:**
  - Domestic courts often fix the use of extra-textual sources (e.g. OECD MTC Commentaries, TP Guidelines) to versions extant at the date of conclusion of a tax treaty. Tend to be based on art 32 VCLT being part of the 'circumstances of conclusion'.
  - What to do when a bilateral tax treaty will contain a clause with parts as originally agreed, and other bits as later amended by the MLI?
    - E.g. need to consult different versions of the Commentary on art. 5 OECD MTC (and BEPS Action Reports) for a PE definition partly amended by the MLI?

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Tax treaty interpretation & the MLI

- **The relation between MLI amended tax treaties and unaffected tax treaties.**
  - International treaty law recognises that the evolution of norms may over time inform the interpretation of existing treaty relations under art. 31(3)(c) VCLT (see inter-temporal rule & ICJ decision in *Gabčíkovo-Nagymaros Project* (Hungary/Slovakia) [1997] I.C.J. 7).
  - Naïve to think that interpretation of tax treaties not subject to the MLI will remain completely unaffected by MLI and more broadly BEPS inspired thinking.

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Domesticating the MLI

- **Will require unprecedented procedure for many Parliaments.**
  - No information on whether country State Law Advisors sufficiently consulted or briefed by ad-hoc group members.
  - Country practices vary, e.g. Dutch MOF provided at least two detailed briefings to upper and lower houses of Parliament, but complete dearth of updates to Parliaments in many other countries.
  - Further complicated when official language of legislature is not English or French.

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Domesticating the MLI

- **What information may be required by Parliaments in order to ratify the MLI?**
  - The same level of briefing as would be required for renegotiation of a bilateral tax treaty?
  - Otherwise risks, through uninformed ratification, the unilateral upsetting of the originally negotiated and ratified balance of a bilateral tax treaty.
  - Parliaments may require analyses of:
    - The projected impact on bilateral trade and investment flows (existing and future.
    - The impact of each opt-in / opt-out combination for MLI affected bilateral tax treaties of a country.
    - What is the timeline here? OECD seems to expect decisions by June 2017.

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Domesticating the MLI

- **Should ratification of the MLI by Parliaments be based on the *fullest information*?**
  - If yes, then incomplete aspects of MLI may hold up the ratification process.
  - E.g. may require that OECD WP1 first complete the PE profit attribution work for the (new) lower agency PE threshold.
  - Would Parliaments first need to be briefed about the 2017 updates to OECD MTC Commentaries to understand more precisely the potential consequences of MLI related substantive changes to bilateral tax treaties?
    - E.g. what is the scope of the PPT (excess discretion?) and what is the domestic assessment process and safeguards for its application, especially its relation with an existing domestic GAAR.
    - Would reliance on the BEPS Action reports be sufficient? What if the 2017 Commentary updates differ?

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Domesticating the MLI

- **The ultimate say over the MLI's legal consequences will rest with domestic courts (and perhaps arbitrators?).**
- **The domesticating process may be a source of meaning for domestic courts when they interpret MLI affected tax treaty clauses.**
  - E.g. when reference to Parliamentary history is allowed as a source to inform legal interpretation. Will be important for reservations.
  - May also possibly fall within 'supplementary means of interpretation' under art 32 VCLT (i.e. part of the 'circumstances of conclusion').
- **Suggests that a robust process of vetting the MLI by Parliaments may be desirable as it would aid legal certainty about the extent of implementation of BEPS proposals.**

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Concluding remarks

- Will Parliaments of the ad-hoc group countries assert sovereignty and closely scrutinise the domestication of the MLI?
- One may ask whether post MLI implementation tax treaties will remain accessible as reasonably intelligible law for all users? Will tax treaty interpretation become too multifaceted?
- Use of discretion in areas of dual corporate residence, general anti-avoidance (PPT) and MAP may be excessive and chip away at rule of law considerations.
- All taxpayers (not only multinationals) will be affected.

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