

NovioTax The Multilateral Instrument – Explanation document

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Considering the increasing number of countries that ratify and implement the Multilateral Instrument (hereafter: MLI) and the changes that the MLI will bring in the field of international taxation, we have itemized the most important changes from a Dutch tax perspective. With a glance one can easily find out for each jurisdiction what changes can be expected from a Dutch tax perspective, simply by looking at the interactive world map. Since the information provided on a selected jurisdiction has to be summarized, the summarized information necessitates an explanation. Hence, this document serves as a background and an explanation to the interactive world map.

Hereafter the MLI provisions of the Netherlands are discussed and the interactive map itself is explained.

MLI & Map explanation

The MLI provides for different types of flexibility. Jurisdictions can choose amongst alternative provisions in certain MLI articles. Jurisdictions can also choose to apply optional provisions, and, in certain cases, jurisdictions may choose to reserve the right not to apply MLI provisions. In other words, jurisdictions can (for many articles) completely opt out through a ‘reservation’ of the MLI provision. The Netherlands’ government has adopted a relatively large set of MLI provisions, as compared to other Signatories.

Provisions of the MLI only have an effect on bilateral tax treaties when both jurisdictions have opted for that provision (i.e. when a ‘match’ occurs). Hence, the interactive world map only shows the MLI provisions that are opted by both jurisdictions, and thus, constitute a change to the existing bilateral tax treaty between The Netherlands and that jurisdiction. For example, when performing a ‘mouse-over’ on Russia, the following information will be shown:

Russia | Covered Tax Agreement

Implementation date 1-1-2020 (for WHT)

Hybrid mismatches: Art. 3 & 4 MLI

Anti-abuse articles: Art. 7(1) MLI (PPT)

PE articles: Art. 13(2), 14 & 15 MLI

The information provided above depicts that Russia is a MLI signatory, and that both the Netherlands and Russia have put the tax agreement under the scope of the MLI. By doing so, the implementation date is also known.¹ For taxes withheld at source (WHT) the implementation date is January 1st, 2020. In this case, the changes that will commence relate to all three main subjects. The hybrid mismatch articles that will change the existing tax agreement are art. 3 and 4 MLI. As for the anti-abuse articles, art. 7 paragraph 1 MLI will come into effect. In conclusion, art. 13 paragraph 2, 14 and 15 MLI will make changes to the PE definition in the Netherlands – Russia DTAA.

In case, for example, that hybrid mismatches would present: ‘would not apply’, this would mean that for that jurisdiction, no MLI article in respect of hybrid mismatches would modify the existing tax treaty between the Netherlands and Russia.

In the following paragraphs, the MLI articles according to their main topics will be discussed. Please note that not all of the minimum standards / standard provisions that come along with the MLI are discussed in this note, but merely the ones that on the one hand are opted in by the Netherlands (and thus can only then can become a matched provision) and on the other hand that we believe are relevant from a Dutch tax perspective.

¹ The implementation date is known since both jurisdictions have ratified the MLI. In cases where only one, or none, of the jurisdictions have ratified the MLI, the implementation date remains unknown.

Hybrid mismatches

Article 3 to 5 of the MLI concern the treatment of hybrid mismatches. The provisions reflect BEPS Actions 2 and 6. The provisions aim to amend covered tax agreements to prevent double taxation as well as double non-taxation. The articles share a significant common goal with the EU Anti-Tax Avoidance Directive 2 (hereafter: ATAD2). ATAD2 however amends domestic tax systems, and the MLI modifies bilateral tax treaties. The Netherlands has opted for art. 3, 4 and 5(2) of the MLI. Hereafter the articles are briefly discussed.

- **Art. 3 MLI:** Income derived by or through a transparent entity will only be considered income of a resident of a treaty jurisdiction (and thus eligible for treaty benefits) to the extent that income is treated as income of a (another) resident by that treaty jurisdiction.
- **Art. 4 MLI:** The treaty residency of a dual resident entity is determined by mutual agreement between the treaty jurisdictions. Treaty benefits are in principle withheld from the entity until such mutual agreement is reached.
- **Art. 5(2) MLI:** Provides the option to countries with respect to elimination of double taxation, specifically to disallow the exemption method for income that is exempt or subject to a reduced treaty rate in the other jurisdiction.

Treaty abuse

The MLI contains six provisions to address treaty abuse. Two of these provisions reflect the BEPS Action 6 minimum standard on treaty abuse and the four other provisions are specific anti-abuse rules that target specific avoidance strategies. The Netherlands has only opted in for the Principal Purpose Test (hereafter: PPT), and the additional discretionary relief. The PPT is a minimum standard, and thus introduced in all tax agreements that fall under the scope of the MLI.

The PPT is an effective instrument to counter arrangements such as treaty shopping arrangements that have been put into place with the main (or one of the main) driver(s) to avoid taxation. Hence, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits (i.e. a lower withholding tax rate), these benefits would be denied, unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty. Hereafter the article is briefly discussed.

- **Art. 7(1) MLI:** The PPT provides a general way to address cases of treaty abuse, including treaty-shopping situations that are not covered by more specific anti-abuse rules. Unlike the Limitation on Benefits provision, which test the subject of an arrangement, the PPT tests the object of an arrangement (i.e. a transaction or arrangement). This results into a specific test that can be subjected to any transaction or arrangement, and not just the subject behind the transaction or arrangement.
- **Art. 7(1&4) MLI:** Applies the PPT as mentioned above, and in addition applies discretionary relief under PPT.

Once the PPT is introduced to a tax treaty through the MLI, the PPT would apply to the treaty in its entirety and would address all cases of treaty abuse. Hence, we expect that the PPT will drastically change the field of international taxation, since (currently) over 1500 bilateral tax treaties will be modified and contain (at least) the PPT.

Permanent Establishments

Changes to the permanent establishment (hereafter: PE) definition develop through the work of BEPS Action 7 and included in the MLI address techniques used to inappropriately avoid the existence of a PE, including through the replacement of distributors with commissionaire arrangements, through strategies where contracts which are substantially negotiated in a state are not formally concluded in that state because they are finalized or authorised abroad, or where the person that habitually exercises a right to conclude contracts in the name of a foreign company claims to be an 'independent' agent even though it is acting exclusively or almost exclusively for closely related enterprises. These changes also address strategies based on (combinations of) specific activity exemptions of article 5(4) of the OECD Model Tax Convention, by restricting these exceptions to preparatory or auxiliary activities and by addressing the fragmentation of business activities between closely related enterprises in order to inappropriately take advantage of these exceptions.

The Netherlands has opted for art. 13(2&4), 14 and 15 MLI. Hereafter the articles are briefly discussed.

- o **Art. 13 MLI:** Stipulates that (option A) the specific activity exemption in the treaty definitions of a PE applies only to activities of an auxiliary or preparatory character or (option B) the specific activity exemption in the treaty definitions of a PE applies irrespective of whether an activity is of an auxiliary or preparatory character. The anti-fragmentation rule aggregates activities carried on by closely related enterprises for purposes of determining the existence of a PE.
 - **Par. 2:** selection for option A - specific activity exemption applies only to activities of auxiliary or preparatory character.
 - **Par. 4:** selection for the anti-fragmentation rule.
- o **Art. 14 MLI:** For the determination if a building site, or construction or installation project constitutes a PE, (i) activities carried on during one or more periods of time that, in the aggregate, exceed 30 days and (ii) connected activities carried on by closely related enterprises, are aggregated.
- o **Art. 15 MLI:** Persons are closely related if one has control of the other or both are under the control of the same person. A close relationship is deemed to exist in case a threshold of 50% of vote and value in a company is met.

The information provided in this note and in the interactive world map is based on the Matching Database provided by the OECD, per August, 2019.

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