How do the new PE rules in the MLI work?

As a result of the BEPS discussion, the OECD decided to modify its Model Tax Convention (MTC). All the bilateral treaties concluded on the basis of the old MTC are being amended through a Multilateral Instrument (MLI). The MLI entered into force on 1 July 2018 for the first signatory countries, but many countries are still ratifying it up to this date.

Applicability of the MLI

As a result of the BEPS discussion, the OECD decided to modify its Model Tax Convention (MTC). All the bilateral treaties concluded on the basis of the old MTC are being amended through a Multilateral Instrument (MLI). The MLI entered into force on 01 July 2018 for the first signatory countries, but many countries are still ratifying it up to this date.

An updated list of countries which have signed the MLI so far and dates it entered or will enter into force for each country can be found here.

With the MLI, there is now two different layers to consider in order to check the applicable law of a certain international tax case: the first layer is the bilateral treaty, and the second layer is the MLI. However, it is not that simple. There are some limits to the applicability of the MLI: it is only applicable if all the parties involved in a specific situation have ratified it and included each other in their list of “covered tax agreements” (CTAs).

This means that countries intending to ratify the MLI have to make a list of CTAs, that is, a list with their bilateral treaties that they want to be amended by the MLI. Therefore, the MLI will only affect the bilateral treaties explicitly specified by each country, provided that both parties have included each other in their CTAs (hereinafter referred to as “CTA partners”). Otherwise, the applicable law remains the existing bilateral tax treaty.

The new PE provisions included in the MLI (articles 12, 13, and 14 MLI)

The new PE rules included in the MLI relate to:

1. Commissionaire agreements (and similar strategies that include lowering the PE threshold);
2. The list of exceptions of art. 5(4) of the MTC;
3. The splitting up of contracts.

All of them are a result of the work done in BEPS Action 7 and are briefly explained below.

Article 12 MLI: the commissionaire agreements

Article 12 MLI modifies article 5(5) of the MTC, to prevent the so-called “commissionaire agreements” and the like. A commissionaire agreement is the arrangement between two companies established in different jurisdictions through which the company resident in a country (company A) sells the products/services of the other non-resident company (company B), without attributing the sale to the latter. So, the resident company (company A) acts like a disguised agent, avoiding the creation of a PE for the non-resident company (company B).

To sum up, with the amendment brought about by article 12 MLI, if the resident company (company A) acts on behalf of the non-resident company (company B), and concludes contracts transferring the ownership of products owned by the non-resident company (company B), the latter (company B) is deemed to have a PE in that State.
Furthermore, article 12 MLI also narrows down the concept of “independent agent”, making it more easy to constitute a PE. The provision determines that when a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent.

Article 13 MLI: the list of exceptions
Article 13 MLI modifies article 5(4) of the MTC, which brings a list of exceptions that do not constitute a PE. The rationale behind the exceptions is that all activities put forward in the list have a preparatory or auxiliary character, which are not considered enough to establish a significant economic presence in another jurisdiction. However, companies that have as (one of) their main business any of the activities included in the list are able to invoke the exemption and are not subject to taxation in that State. The activities of these companies are not preparatory or auxiliary, but instead constitute its main business activity and as such need to be taxed accordingly.

To avoid this loophole, article 13 MLI clarifies that the all exceptions are exclusively limited to preparatory or auxiliary activities.

Article 14: the splitting-up of contracts
The strategy of splitting-up contracts consists of circumventing the rule provided by art. 5(3) of the MTC, that establishes a 12-month threshold to create a PE (especially in building and construction sites). Companies engage in this strategy basically by limiting the period of duration of their contracts to never exceed the 12-month period. When the threshold is about to exceed, they hire another company (often a closely related company to the first hired) to provide the services.

To address this issue, article 14 MLI provides for the aggregation of periods of time during which all closely related companies carried on activities at the same place.

Reservations
It is important to highlight that, in defining the applicable rules to a given international tax case, all situations must be analysed on a case-by-case approach.

That is because each country is allowed to make reservations regarding certain provisions. This means that countries can, at their own discretion, opt out of certain rules included in the MLI. So, it’s necessary to check not only if the countries involved in a certain case have ratified the MLI, and are included in each other’s CTAs, but also if there are any reservations made by those countries regarding the relevant provisions, which would make these provisions not applicable to them. For this reason, all cases must be analysed individually.

With the exception of the reservations made by each country, the provisions inserted in the MLI are binding on every signatory state. Therefore, countries that have ratified the MLI are obliged to observe the rules therein in the relations with their CTA partners.
The Dutch reservation regarding article 12 MLI

Initially, the Netherlands did not indicate its intentions to make a reservation on article 12 of the MLI. So, it came as a surprise when the Tweede Kamer of the Dutch Parliament, in 12 February 2019, instructed the Dutch government to opt out of this provision. In 03 March 2019, the Eerste Kamer of the Dutch Parliament approved the ratification bill as recommended by the Tweede Kamer – with the reservation to article 12 MLI.

Apparently, this decision stems from the uncertainty that many legislators have been showing with respect to the lack of a sufficiently effective means of dispute resolution. Due to the absence of an international consensus regarding the definition of PE or the proper profit allocation to a PE, there is the possibility that some treaty partners strategically attempt to maximize tax revenue to the detriment of other countries. To avoid this, it is necessary that there is an effective means of dispute resolution in place.

The Netherlands argued that the reservation can be temporary, and will last until there is either enough clarity on profit allocation to agency PEs or there is an effective dispute resolution mechanism in place with sufficient other MLI parties. It stated that if adequate progress is made in this regard, the Dutch reservation can be reviewed by the end of 2020.

Anyhow, the approval of the bill by the Dutch Eerste Kamer marks the conclusion of the domestic procedure of ratification. If the Netherlands deposits the ratification bill with the OECD before 1 April 2019, the MLI will have a general entry into effect as from 1 January 2020.

Conclusion

The conclusion to be drawn is that countries in general are reluctant to fully apply the recommendations of BEPS, specially concerning the artificial avoidance of a PE status. Each jurisdiction is acting in accordance with its own legal and economic history, own culture, and own circumstances, considering their own interpretation of the recommended rules. All of these factors bring about different and individual concerns, which are being reflected in the reservations each country has made or is making.

Nevertheless, the movement to prevent base erosion and profit shifting is only moving forward and it’s unlikely to stop. States are more and more coordinated to develop an international tax policy. By accepting and ratifying the MLI, countries have taken an initial step, and exactly for this reason it is understandable that they are cautious about it.

However, it is expected that with time, jurisdictions will feel more comfortable to embrace the rules subject to reservations in their legal framework. Furthermore, with time, countries will be able to identify difficulties and make the necessary changes to the rules in order to match their reality.

Hence, it’s believed that the reservations made by those countries regarding the new PE provisions are just an indication that they are cautious about the introduction of so many new rules in their existing legal framework. At the same time, the acceptance of the MLI is also an indication that many jurisdictions need and welcome a legislative refresh in their tax systems.

Contact
For more information please contact:

Jacob Mook
Head of tax
E jacob.mook@nl.gt.com
T +31 88 676 91 11

Ana Basso
Tax advisor
E ana.basso@nl.gt.com
T +31 88 676 92 83