

Analysis on the Application of Articles 7(6) and 7(7) of the Multilateral Instrument to the Covered Tax Agreements

1. Introduction

Article 7 – Prevention of Treaty Abuse – of the Multilateral Instrument (the MLI) contains three opt-in provisions. Two of them, Article 7(6) and 7(7), relate to the adoption of the simplified limitation of benefit rules by the contracting jurisdictions when granting tax benefits to the taxpayer, in addition to the default principal purpose test provision. The texts of paragraphs 6 and 7 of Article 7 are reproduced below:

6. A Party may also choose to apply the provisions contained in paragraphs 8 through 13 (hereinafter referred to as the “Simplified Limitation on Benefits Provision”) to its Covered Tax Agreements by making the notification described in subparagraph c) of paragraph 17 (Article 7(17)(c)). The Simplified Limitation on Benefits Provision shall apply with respect to a Covered Tax Agreement *only where* all Contracting Jurisdictions have chosen to apply it.

7. In cases where some but not all of the Contracting Jurisdictions to a Covered Tax Agreement choose to apply the Simplified Limitation on Benefits Provision pursuant to paragraph 6, then, notwithstanding the provisions of that paragraph, the Simplified Limitation on Benefits Provision shall apply with respect to the granting of benefits under the Covered Tax Agreement:

a) *by all Contracting Jurisdictions*, if all of the Contracting Jurisdictions that do not choose pursuant to paragraph 6 to apply the Simplified Limitation on Benefits Provision agree to such application by choosing to apply this subparagraph and notifying the Depository accordingly; or

b) *only by the Contracting Jurisdictions that choose to apply the Simplified Limitation on Benefits Provision*, if all of the Contracting Jurisdictions that do not choose pursuant to paragraph 6 to apply the Simplified Limitation on Benefits Provision agree to such application by choosing to apply this subparagraph and notifying the Depositary accordingly.

2. Option and Game-tree Structure

In negotiating a tax treaty, both parties can discuss and cover every topic and insert it in the agreement or protocol. A multilateral instrument differs from a bilateral treaty in that parties (the contracting jurisdictions) to the MLI, including those that will become parties but they are unknown at the time of negotiating the MLI, can choose the opt-in and opt-out provisions that best fit individual circumstances. In addition, the options and its game-tree type of structure in the MLI provide both certainty and great flexibility for the parties to the MLI with different levels of commitment to the BEPS minimum standards. Furthermore, it can achieve the purposes of amending the more than 3,000 covered tax agreements (the CTAs) in a swift and synchronized manner. Since the MLI came into force on 1 July 2018, 22 out of 89 contracting jurisdictions have submitted the Instrument of Ratification. That accounts for more than one fourth of the total number of contracting jurisdictions. The following section is an in-depth study of the game-tree structure.

2.1. Simplified Limitation-of-Benefit (SLOB) options under Articles 7(6) and 7(7)

The author of this article uses a game tree structure with perfect information to explain the relations between Articles (6) and 7(7), and the results from the choice of alternatives by the contracting jurisdictions. The game tree has four decision nodes in which each of the contracting jurisdictions (players) knows

that he can make a choice from the available alternatives and what comes next from each of those alternatives.

The game tree starts with the SLOB option under Article 7(6) as the initial node, which contains three possible outcomes:

- (1) First, if all other parties adopt the SLOB option and notify the Depository of the choices, then article 7(6) shall apply, and the game comes to an end.
- (2) Second, if all other parties do not adopt the SLOB option, then article 7(6) shall not apply and that ends the game.
- (3) Third, in the situation that some of the parties adopt the SLOB option and some of them do not, the game proceeds to a second decision node:
 - a) The parties not adopting the SLOB option when granting the tax benefit agree to adopt the SLOB option, pursuant to articles 7(7)(a) or (7)(b). The SLOB provision shall apply either symmetrically or asymmetrically. It is important to note that the game does not end here. Here is a third decision node in the application of article 7(7)(a) or (7)(b) to the CTAs.
 - A. If the CTA already contains a provision that is compatible to the SLOB provision, the compatibility clause does not apply. The party may reserve its right for article 7(7)(a) or (b) not to apply to the CTA, pursuant to Article 7(15)(c). That brings the proceedings to the terminal node of the game-tree.
 - B. If the CTA does not contain a compatible provision, the compatibility clause shall apply. Then, one has to check whether notification is given and also given properly in order that Article 7(7)(a) or (b) shall have legal force. The terminal node will come as follows:
 - If notification is matched, Article 7(7)(a) or (b) shall apply in place of or in the absence of the CTA provision, pursuant to Article 7(14).
 - If it is not, Article 7(7)(a) or (b) shall supersede the CTA provisions to the extent that the CTA

provisions are incompatible with the SLOB provision; or

- b) The parties not adopting the SLOB provision do not agree to adopt articles 7(7(a) or 7(7)(b). In this case, the game tree does not end here. A party that adopts the SLOB option proceeds to the terminal node:
 - A. Opt out of the entire article 7, subject to certain condition being satisfied, pursuant to Article 7(16); or
 - B. It does not make reservation under Article 7(16). If it does not, that will not satisfy the requirement “where all the contracting jurisdictions have chosen to apply it”. In that case, the SLOB provision under Article 7(6) shall not apply due to an asymmetry in the option choice.

2.2. Comparison with Arbitration processes under Article 23

The arbitration process under Article 23 is another example of using the game-tree structure in the MLI. Article 23 also contains a game-tree structure.

The initial node is the “final offer” approach under article 23(1), which is the default option of the arbitration process with respect to any unresolved issues of a case under the mutual agreement procedure. If party A chooses the final offer approach, then party B may accept it, or reject it. The game tree proceeds to the beginning of a second decision node.

If Party B accepts the final offer approach, then the game tree ends here. If party B does not accept the final offer approach, it may reserve its right for (opt-out of) the final offer approach not to apply to its CTAs. Concurrently or simultaneously, the independent opinion approach in article 23(2) shall automatically apply to the arbitration proceeding.

In that case, the MLI provision provides for a third decision node. Party A, who adopts the final offer approach, has two choices (the terminal node):

- it accepts the independent opinion approach that party B has chosen; or
- it can reserve its right not to apply with respect to its CTA with party B who has made a reservation for the final offer approach.

Paragraph 3 of Article 23 continues “[...] in such a case, the competent authorities of the contracting jurisdictions of each such covered tax agreement shall endeavour to reach agreement on the type of arbitration process that shall apply with respect to that CTA. Until such an agreement is reached, Article 19 (Mandatory Binding Arbitration) shall not apply with respect to a CTA.

China Tax & Investment Consultants Ltd

www.china-tax.net

2019-07-24