Application of the capital gains article of the MLI to covered tax agreements – an Australian perspective

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This article aims to analyse the legal basis and the technicality of the reservation mechanism of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI), and use examples to illustrate how they apply with respect to the capital gains article from an Australian perspective.

Article 9(1) of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) is a provision to counteract tax avoidance. Paragraph 1 specifically addresses situations in which non-real property assets are contributed to a land-rich entity shortly before the sale of shares or comparable interests (such as interests in a partnership or trust) in that entity to dilute the proportion of the value of the entity that is derived from immovable property. Article 9(1) and (2) read:

> "1. Provisions of a Covered Tax Agreement providing that gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or other rights of participation in an entity may be taxed in the other Contracting Jurisdiction provided that these shares derived more than a certain part of their value from immovable property (real property) situated in that other Contracting Jurisdiction (or provided that more than a certain part of the property of the entity consists of such immovable property (real property)):
>
> a) shall apply if the relevant value threshold is met at any time during the 365 days preceding the alienation; and
>
> b) shall apply to shares or comparable interests, such as interests in a partnership or trust (to the extent that such shares or interests are not already covered) in addition to any shares or rights already covered by the provisions.
>
> 2. The period provided in subparagraph a) of paragraph 1 shall apply in place of or in the absence of a time period for determining whether the relevant value threshold in provisions of a Covered Tax Agreement described in paragraph 1 was met."

Article 9(1) of the MLI is designed to achieve the same purpose as art 13(4) of the OECD *Model Tax Convention on Income and on Capital* (MTC) does. In accordance with the recommendation in para 129 of the action 6 final report, the 2017 version of the MTC introduces two changes with respect to art 13(4) of the 2014 version: (i) to introduce a testing period for determining whether the condition on the value threshold is met; and (ii) to expand the scope of interests covered by that paragraph to include interests comparable to shares, such as interests in a partnership or trust. The provision in art 9(1) has been divided into two subparagraphs: subparagraph a) reflects the introduction of the testing period; and subparagraph b) reflects the expansion of the interests covered.

Article 9(1) is both a substantive provision dealing with tax avoidance and a compatibility or conflict provision that modifies the provision of a covered tax agreement (CTA), using the specified wording "shall apply to". In contrast, art 9(2) is a compatibility provision that modifies the application of art 9(1) to the CTA, using the specified wording "shall apply in place of or in the absence of".

Notification to the OECD Depositary

Australia notified the OECD Depositary under art 9(7) that para 1 of art 9 shall apply in place of the previously existing provision in – or, in the absence of such a provision be added to – all its 42 CTAs on 26 September 2018, including the tax treaties with China, India, Japan, New Zealand, Singapore and other countries in the Indo-Pacific region. The tax treaties notified as per art 2(1)(a) of the MLI can be divided into three categories: (i) the treaty partner not yet signing the MLI; (ii) the treaty partner having signed the MLI but not including Australia in its list of tax treaties that it wishes to be covered under art 2(1)(a) of the MLI; and (iii) the treaty partner has signed the MLI and also included Australia in its tax treaty list under art 2(1)(a) of the MLI.

The four jurisdictions under category 1 in Table 1 are not MLI signatories. As per the action 6 final report, signing up to the MLI is not mandatory to implement the base erosion and profit shifting (BEPS) measures to the tax treaties. The four jurisdictions that have not signed up to the MLI could start bilateral renegotiation with Australia to bring the tax treaties in line with the BEPS recommendation on the avoidance of capital gains tax.[1]

Under category 2, three treaty partners have not included Australia in their respective CTA lists. The number of CTAs to be modified by the MLI provision would be increased by three to 38 if Austria, Sweden and Switzerland include Australia on their lists of CTAs later in accordance with art 29(5).

Table 1. Overview of Australia's MLI notification

Category	Status of category	Total
1. Bilateral tax agreements with parties who have not signed the MLI	The non-MLI bilateral agreements include Kiribati, the Philippines, Sri Lanka and the United States	4
2. Bilateral tax agreements not included in the CTA list by both parties	Austria, Sweden and Switzerland have not included Australia in the CTA list	3
3. Bilateral tax agreements included in the CTA list by both parties	A total of 11 CTAs are modified by the MLI provision subject to the reservations made (among them, nine of the parties to Australia's CTAs have made a full reservation, and two parties have made a partial reservation). The remaining 24 CTAs are modified by the compatibility provisions under art 9(2), or art 9(5) if they choose art 9(4), the alternative provision to art 9(1)	35
Total tax treaties notified		42

As indicated under category 3 in Table 1, nine contracting jurisdictions have made a full reservation in accordance with art 9(6)(a) for art 9(1) not to apply to the CTAs concluded with Australia, including Finland, Hungary, Korea, Malaysia, Norway, Romania, Singapore, Thailand and the United Kingdom. Two contracting jurisdictions, Belgium and China, have reserved the right under art 9(6)(b) for the 365-day period not to apply to the CTAs with Australia.

In what follows, this article will compare the MLI position of Australia with some of her treaty partners, and will examine the interactions between the positions of the selected parties and the synthesised texts resulting from such interactions.

Interaction between the operative provision and the compatibility provision

The compatibility provision under art 9(2) (or art 9(5)) modifies in specified languages the application of art 9(1) (or art 9(4)) of the MLI to the CTA provision, subject to the reservations made. The art 9(6) reservation provides that:

"6. A Party may reserve the right:

a) for paragraph 1 not to apply to its Covered Tax Agreements;

b) for subparagraph a) of paragraph 1 not to apply to its Covered Tax Agreements;

c) for subparagraph b) of paragraph 1 not to apply to its Covered Tax Agreements;

d) for subparagraph a) of paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision of the type described in paragraph 1 that includes a period for determining whether the relevant value threshold was met;

e) for subparagraph b) of paragraph 1 not to apply to its Covered Tax Agreements that already contain a provision of the type described in paragraph 1 that applies to the alienation of interests other than shares;

f) for paragraph 4 not to apply to its Covered Tax Agreements that already contain the provisions described in paragraph 5."

The capital gains article in the CTAs that Australia concluded with Korea, Malaysia and Singapore will be excluded from modification by art 9(1) of the MLI because each of the tax treaty partners has reserved its right under art 9(6)(a) for the entire art 9(1) to not apply to all its CTAs, without making the choice to apply the alternative provision under art 9(4).

Table 2. Comparing Australia's MLI position with that of selected countries or jurisdictions[2]

	Apply art 9(1) to the CTA?	Reserve for art 9(1) not to apply to CTA?	Exclude 365-day test under art 9(1)(a) from CTA?	Exclude comparable interest under art 9(1)(b)?	Choose to apply art 9(4) to CTA?
	Main provision	Full reservation	Partial reservation	Partial reservation	Alternative provision
Australia	Yes			Yes, per art 9(6)(e)	
China	Yes		Yes, per art 9(6)(b)		
India, Japan, New Zealand	Yes				Yes, per art 9(3)
Korea, Malaysia, Singapore	No	Yes, per art 9(6)(a)			

Illustrated example – reservation under article 28(3)

As per Table 2, China deposited its instrument of ratification on 25 May 2022, and the Australia–China CTA will come into force on 1 September 2022 in accordance with art 34(2) of the MLI. As China reserves its right for a 365-day test under art 9(1)(a) not to apply to all its CTAs in accordance with art 9(6)(b), the modified text of art 13(4) of the Australia–China CTA will be modified in accordance with art 9(2) of the MLI, subject to the reservation made under art 9(6)(b) as follows:[3]

> *The following subparagraph b) of paragraph 1 of Article 9 of the MLI applies to paragraph 4 of Article 13 of this Agreement:*
>
> ARTICLE 9 OF THE MLI – CAPITAL GAINS FROM ALIENATION OF SHARES OR INTERESTS OF ENTITIES DERIVING THEIR VALUE PRINCIPALLY FROM IMMOVABLE PROPERTY
>
> Paragraph 4 of Article 13 of the Agreement [the Australia–China CTA] shall apply to shares or comparable interests, such as interests in a partnership or trust (to the extent that such shares or interests are not already covered) in addition to any shares or rights already covered by the provisions of this Agreement.

MLI's reservation and notification mechanisms

Each article of the MLI, including art 9, is designed to address a specific BEPS issue. Where a contracting party chooses to adopt or not to adopt an article (or the provision of an article), it may do so by using the reservation and the notification mechanism of the MLI, as set out in Table 3.

As noted above, the reservation made in accordance with art 28(3) imposes restriction in whole or in part on the application of the MLI provision to the CTA. Article 28(3) reads:

> "3. Unless explicitly provided otherwise in the relevant provisions of this Convention, a reservation made in accordance with paragraph 1 or 2 shall:
>
> a) modify for the reserving Party in its relations with another Party the provisions of this Convention to which the reservation relates to the extent of the reservation; and
>
> b) modify those provisions to the same extent for the other Party in its relations with the reserving Party."

Article 28(3) contains two principles regarding reservations. First, unless explicitly provided otherwise, a reservation made on a unilateral basis will not only have an effect on the CTA between the reserving party and the other contracting party, but also have an effect on all other CTAs that a contracting party has nominated in accordance with para (1)(a) of art 2 (interpretation of terms) and para 5 of art 29 (notifications) of the MLI. The main exception to this rule is that a reservation to apply the arbitration articles under Pt VI of the MLI require acceptance under art 28(2). Second, unless explicitly provided otherwise, a reservation for an article (or a provision of an article) is reciprocal in application. That is, a reservation made under art 28(3) does not work only one way. In general, a reservation shall apply symmetrically to both parties to the MLI.

Table 3. Reservation and notification rules of the MLI

A party choosing to adopt an article or the provision of an article may:	
(i) give notification for the adoption of the article (or the provision of an article); or	Article 9(7): a party gives notification to adopt the alternative provision (art 9(4)).
(i) make no reservation for the application of the article (or provision of an article) to the CTAs.	A party who has not reserved its right for art 9(1) not to apply need not do anything.
A party not choosing to adopt an article, or the provision of an article may:	
(i) do so by not giving notification for the adoption of the article (or provision of an article); or	A party can do nothing for art 9(3) that provides that a party may adopt the alternative provision of art 9(4).
(ii) reserve its right for the article (or provision of an article) not to apply to the CTAs (see note below).	Article 9(6)(a): a party reserves its right for art 9(1) not to apply. Article 9(6)(b): a party reserves its right for the 365-day test (art 9(1)(a)) not to apply. Article 9(6)(c): a party reserves its right for comparable interest (art 9(1)(b)) not to apply.

Replacement or withdrawal of reservation

As per Table 2, art 9(1) would apply to the Australia–Singapore CTA (the Australia–Korea or the Australia–Malaysia CTA) if Singapore (Korea or Malaysia) later chose to withdraw its art 9(6)(a) reservation as permitted under art 28(9). Similarly, art 9(1)(a) would apply to the Australia–China CTA if China later chose to withdraw its art 9(6)(b) reservation.

Note that Australia is not permitted to make an additional reservation under art 9(6)(a) to bring its MLI position in line with Singapore. Nor can Australia make an additional reservation pursuant to art 9(6)(b) to bring its MLI position in line with China.

In contrast, Singapore is permitted to replace its art 9(6)(a) reservation with the art 9(6)(b) reservation, which is more limited in scope.

Article 28 of the MLI only works in one direction for making changes to the scope of the reservation. The reason is that when a party withdraws a reservation or replaces it with one that is more limited in scope, it will be moving closer to the full adoption of the MLI — not away from it.

Illustrated examples – reservation under article 28(8) (the later-in-time rule)

Australia considers that under art 9(7), the following agreements contain a provision described in art 9(1). The article and paragraph number of each is listed in Table 4.

List of covered tax agreements

Table 4. Australia's MLI position as notified to the OECD Depositary on the day of ratification of instrument (extracts)[4]

Listed agreement number	Contracting jurisdictions	Provisions in the CTAs
6	China*	Article 13(4)
13	India*	Article 13(4)
17	Japan	Article 13(2)
19	Korea	Article 13(1), 13(2)(a)(iii) and (b)(iii)
20	Malaysia*	Article 13(4) of agreement 20 after the amendment by art 6 of its amending instrument (a)
24	New Zealand	Article 13(4)
31	Singapore*	Article 10A(4) of agreement 31 after the amendment by art 12 of its amending instrument (a)

* MLI contracting jurisdictions that are not OECD members are members of the OECD/G20 Inclusive Framework on BEPS.[5]

Reservation under article 28(8)

Pursuant to art 9(6)(e) of the Convention (MLI), Australia reserves the right for art 9(1)(b) not to apply to its CTAs that already contain a provision of the type described in art 9(1), which applies to the alienation of interests other than shares.[6]

Table 5. CTAs that contain provisions falling within the scope of the art 9(6)(e) reservation[6]

Listed agreement number	Contracting jurisdictions	Provisions in the CTAs
17	Japan	Article 13(2)
24	New Zealand	Article 13(4)

Application of article 9(1) subject to the later-in-time rule

Australia reserves the right for art 9(1)(b) not to apply to some of its CTAs in accordance with art 9(6)(e). Australia does this because the "share or comparable interest" provision has already been included in the CTAs that it has concluded with some of the parties to the MLI, including Japan and New Zealand (see Table 5). Paragraph 2 of art 13 (alienation of property) in the Australia–Japan CTA is compatible with art 9(1)(b) of the MLI. Put differently, art 13(2) is a compliant provision, to which the later-in-time rule in art 30(3) of the *Vienna Convention on the Law of Treaties* (VCLT) applies. Article 30(3) of the VCLT provides that:[7]

> "3) 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 [of the Convention], the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty."

Australia has not reserved the right for art 9(1)(a) not to apply under art 9(6)(d). Therefore, art 9(1)(a) will apply in the absence of a time period for determining whether the relevant value threshold in the provision of the Australia–Japan CTA described in art 9(1) is met, in accordance with art 9(2) of the MLI. The modified text of art 13(2) in the Australia–Japan CTA will be as follows:

> Income, profits, or gains derived by a resident of a Contracting State from the alienation of shares in a company or of interests in a partnership, trust or other entity may be taxed in the other Contracting State where the shares or the interests derive at least 50 per cent of their value directly or indirectly from real property referred to in Article 6 and situated in that other Contracting State. *Paragraph (1)(a) of Article 9 of the Convention [the MLI] shall apply if the relevant value threshold is met at any time during the 365 days preceding the alienation.* (emphasis added)

New Zealand is also on the list of the art 9(6)(e) reservation. The modification to the Australia–New Zealand CTA follows the same legal logic and language pattern as the Australia–Japan CTA. Malaysia has made a full reservation under art 9(6)(a).

Concluding comments

There is a distinction between reservations made under art 28(3) and those made under art 28(8). On one hand, the reservation made under art 28(3) is a full reservation, which provides that an article of the MLI (such as art 9(6)(a)) or the provision of an article of the MLI (such as art 9(6)(b) and (c)) shall not only apply to the CTA that a party to the MLI has concluded, but also to all other CTAs that the reserving party has nominated in the CTA list. The art 28(3) reservation owes its legal basis to art 21(1) of the VCLT. On the other hand, the reservation made in accordance with art 28(8) is a partial reservation that only applies to some, but not all, the CTAs, such as the reservation under art 9(6)(d), (e) and (f). The art 28(8) reservation owes its legal basis to art 30(3) of the VCLT. Where a party has made a reservation for the provisions of the MLI not to apply to a CTA in accordance with art 28(8), that CTA is a compliant agreement for which that party is not obligated to do anything. A party is obligated to modify a CTA that is not a compliant agreement upon request by a treaty partner that has made the same commitment under the OECD/G20

Inclusive Framework on BEPS, subject to reservations made in accordance with art 28(3).

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References

1 Of the four jurisdictions that have not signed up to the MLI, Sri Lanka and the United States are members of the OECD/G20 Inclusive Framework on BEPS (IF), while Kiribati and the Philippines are neither MLI nor IF members. The IF was established to ensure that interested countries and jurisdictions, including developing economies, can participate on an equal footing in the development of standards on BEPS-related issues, while reviewing and monitoring the implementation of the OECD/G20 BEPS Project.

2 OECD, *Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, 19 December 2022. Available at www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

3 *The Synthesised Text of the MLI and the Agreement Between the Government of the People's Republic of China and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect To Taxes On Income.* Available at www.chinatax.gov.cn/n810341/n810770/c1152993/5026990/files/Synthesised%20text%20of%20the%20MLI%20and%20the%20China-Australia%20DTA.pdf.

4 Available at www.oecd.org/tax/treaties/beps-mli-position-australia-instrument-deposit.pdf.

5 The Secretary-General of the OECD shall be the Depositary of the MLI and any protocols, as provided under art 39(1) of the MLI. The Depositary performs an administrative function for both OECD and non-OCED members in implementing the MLI.

6 See www.oecd.org/tax/treaties/beps-mli-position-australia-instrument-deposit.pdf.

7 United Nations, *Vienna Convention on the Law of Treaties, 1969* (VCLT), entered into force on 27 January 1980. Available at https://legal.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf. Some of Australia's treaty partners that have signed the MLI are not parties to the VCLT, including India and Singapore, which Australia has listed in the list of its CTAs. To overcome the difficulty that MLI members may face in the application of the MLI to the non-VCLT parties, the Conference of the Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting issued an opinion on 3 May 2022 adopting art 30(3) and art 21(1) of the VCLT as one of the guiding principles in the interpretation and implementation of the MLI, in accordance with art 32(2) of the MLI.