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International Tax ADVISORY ■

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Impact of the Multilateral Instrument on U.S. Taxpayers

On June 7, 2017, 68 countries signed, and eight additional countries stated their intent to sign, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (commonly referred to as the "multilateral instrument" or the "MLI"), a document created by the Organisation for Economic Co-operation and Development (OECD). Notably, the United States was not one of the 76 countries to agree to the MLI.

What Is the MLI?

The MLI is a master treaty that will allow the OECD to serve as a clearinghouse for changes to countries' treaties with one another. The MLI does not replace the expansive network of existing bilateral tax treaties, but once it is ratified by individual countries' lawmaking bodies, it will allow countries to quickly adopt recommendations from the OECD's base erosion and profit shifting project (the "BEPS project"). The OECD has said the MLI will change more than 1,000 bilateral tax treaties over the course of a couple of years as opposed to a couple of decades, which would have been the case under traditional negotiation processes.

The MLI is one of the end products of the OECD's BEPS project. Called for under Action 15 of the BEPS project, the MLI incorporates the treaty changes from four other actions: (1) Action 2, which was designed to eliminate the use of "hybrid mismatch arrangements" (where a payment creates a tax deduction in one jurisdiction without a corresponding increase in income in another or where a deduction can be claimed on both ends of a transaction); (2) Action 6, which was intended to prevent treaty shopping; (3) Action 7, which revised the definition of a permanent establishment; and (4) Action 14, which was intended to improve the process governments use to resolve their overlapping tax claims on a multinational's income. The countries that have signed the MLI must ratify the instrument through their domestic procedures. Once five countries ratify the MLI, it will go into effect.

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Why Didn't the United States Choose to Sign the MLI?

Although the United States was involved in the negotiation process for the MLI, it ultimately chose not to sign it on June 7. Henry Louie, deputy international tax counsel at the U.S. Department of Treasury, gave several reasons for why the United States decided not to sign. Louie explained that the U.S. tax treaty network is already robust enough to prevent treaty shopping and already has a low degree of exposure to base erosion and profit shifting. Louie stated that "the bulk of the multilateral instrument is consistent with U.S. tax treaty policy that the Treasury Department has followed for decades." Louie also cited the complexity of getting necessary approvals from the U.S. Department of State and from the Senate. The U.S. Department of State has to approve the treaty text negotiated by the U.S. Department of the Treasury, and Louie said that would require explaining every deviation from the U.S. model tax treaty provisions. Additionally, the U.S. Senate has to approve tax treaties negotiated by Treasury, and Louie stated that it would probably have wanted "some kind of assurance, at the very least, that all of our treaty partners share our interpretation of what the MLI has done to the bilateral treaties."

Pascal Saint-Amans, who heads the OECD's tax unit, agreed with Louie that the United States' network of tax treaties currently contains sufficient protections against base erosion and profit shifting, telling reporters ahead of the June 7 signing ceremony that even though the United States didn't sign the MLI, it already has tough anti-abuse measures in its treaties, so it's not a serious problem for the success of the MLI.

How Will This Impact U.S. Taxpayers?

Although the United States did not sign the MLI, the instrument will still impact many U.S. multinational corporations. This is because the MLI will amend many non-U.S. treaties that affect the tax consequences for foreign-to-foreign relationships within multinational groups. U.S. multinational corporations should pay particular attention to the provisions regarding the principal purpose test (PPT) and mandatory binding arbitration.

Under the PPT, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object of the provisions of the treaty. The United States embraces the "limitations on benefits" article, which is more objective than the PPT, rather than the PPT, which is more subjective. The PPT was embraced by all of the countries that signed the MLI on June 7. As a result of the PPT, U.S. companies will have to ensure that their offshore operations have a valid business purpose beyond a tax benefit; otherwise, they will risk being denied treaty benefits. In addition, the MLI could lead to a higher overall effective tax rate for multinational corporations as a result of the strong anti-avoidance measures. U.S. multinational corporations may need to restructure to try to find the most tax-optimal structure in the post-MLI landscape.

U.S. multinational corporations will also want to monitor which countries adopt the provision for mandatory binding arbitration of cross-border tax disputes, which is part of the Action 14 initiative. Cross-border tax disputes will likely become more common as more countries adopt other concepts from the BEPS project, which will cause more instances of overlapping tax claims. Treaties that include mandatory binding arbitration will provide taxpayers with more certainty and predictability on the resolution of any double taxation disputes that may arise.

Luckily, it will take some time before the MLI will be in full effect, so U.S. multinational corporations will have time to start considering the consequences the MLI may have on them and to plan for any necessary changes to their structures.

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