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Dissertation

**Innovative Approach to Anti-BEPS and the Coherence of
International Tax Law**

Submitted by

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Table of Contents

1. Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight
2. A Global Treaty Override? The New OECD Multilateral Tax Instrument and Its Limits
3. China and BEPS

EVALUATING BEPS: A RECONSIDERATION OF THE BENEFITS PRINCIPLE AND PROPOSAL FOR UN OVERSIGHT

REUVEN S. AVI-YONAH*
HAIYAN XU**

The Financial Crisis of 2008 and Great Recession that followed have exacerbated income inequality within and between countries. In the aftermath of the economic turbulence, politicians have turned their attention to the twin problems of individual tax evasion and corporate tax avoidance. U.S. legislators enacted the Foreign Account Tax Compliance Act (FACTA), leading to the United States signing a series of Intergovernmental Agreements (IGAs) for the exchange of tax information. The Organization for Economic Co-operation and Development (OECD) developed the Multilateral Agreement for Administrative Assistance in Tax Matters (MAATM) and initiated the Base Erosion and Profit Shifting (BEPS) project to reduce tax evasion and tax avoidance globally. Although these efforts were well-intended, this Article argues that the tax policy response to the Financial Crisis and Great Recession has ultimately been inadequate. The problem, which is discussed in-depth in the sections that follow, is the benefits principle.

Part I of this Article introduces the primary weakness of the benefits principle: the reliance on source-based taxation for active income and residence-based taxation for passive income requires cooperation by too many jurisdictions. This section provides three case studies of individual tax evasion and corporate tax avoidance to illustrate the principle's shortcomings. Part II focuses on the individual tax evasion problem. This section analyzes the FATCA, IGA, and MAATM responses and explains why these measures are likely to fall short. Part III focuses on corporate tax avoidance. This section examines the BEPS response and its inadequacies. Part IV proposes an alternative to international tax policy based on the benefits principle. This section argues that reversing the benefits principle by taxing passive income primarily at source and active income primarily at residence will more effectively reduce individual tax evasion and corporate tax avoidance in the developed and developing world.

INTRODUCTION		186
I. ILLUSTRATING THE TAX EVASION AND TAX AVOIDANCE PROBLEMS		189
A. <i>Individual Tax Evasion—Sam Wily</i>		190
B. <i>Corporate Tax Avoidance—Apple and Caterpillar</i>		191
C. <i>Assessing the Tax Evasion and Tax Avoidance Problems</i>		194
II. FATCA, IGAs AND MAATM		195
A. <i>The Scope of the Tax Evasion Problem</i>		196
B. <i>Lack of Information</i>		198
C. <i>The Revenue Rule and Non-Assistance in the Collection of Taxes</i>		200

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- D. *Article 27 under the OECD Model of the Tax Convention on Income and Capital* 201
- E. *Article 27 – The U.S Treaties in Practice vs. the OECD Model* 202
- F. *Multilateral Conventions for Tax Collection Assistance* . . 203
- G. *The Tax Evasion Problem Reconsidered* 204
- H. *The Limits of BEPS Project in Addressing the Financial Secrecy Issue* 205
- III. THE LIMITS OF THE BEPS PROJECT 207
 - A. *New Shoes on the Old Road: an Old Approach for the New Destination* 208
 - B. *The Survival and Continuity of Notional and Illusionary Independent Entity Principle and Arm’s Length Principle* 209
 - C. *The Survival and Continuity of the Problematic Benefits Principle* 210
 - D. *Limited Inclusiveness and Multilateralism* 210
 - E. *The Limits of Action 1* 212
 - F. *The Limits of Action 2* 213
 - G. *The Limits of Action 3* 215
 - H. *The Limits of Action 4* 216
 - I. *The Limits of Action 5* 218
 - J. *The Limits of Action 6* 220
 - K. *The Limits of Action 7* 221
 - L. *The Limits of Actions 8–10* 224
 - M. *The Limits of Action 11* 227
 - N. *The Limits of Action 12* 229
 - O. *The Limits of Action 13* 230
 - P. *The Limits of Action 14* 232
 - Q. *The Limits of Action 15* 233
- IV. RECONSIDERING THE INTERNATIONAL TAX REGIME: A MULTILATERAL SOLUTION 234
- CONCLUSION 237

INTRODUCTION

The Financial Crisis of 2008 and the Great Recession that followed have raised anew the problem of how to address growing inequality within and between countries. These intra- and inter-country dimensions of inequality have widened in this century, and the Great Recession has made both problems worse. The current rise of populism in the United States and Eu-

rope and the vehement reactions to a tide of migrants from poorer to richer countries show how these two problems are intertwined.¹

Sixteen years ago, the first author examined the challenge that globalization and tax competition pose to the fiscal viability of the post-World War II welfare state.² He argued that if tax evasion by rich individuals and tax avoidance by multinational enterprises (MNEs) continues to undermine the ability of developed and developing countries to provide adequate social insurance for their citizens, a violent reaction against globalization may end the current era of open borders, just like World War I curtailed globalization a century ago. In 2016, we worry that the inadequate tax response to the Great Recession is escalating anti-globalization sentiments, embodied in the United States by the success of Bernie Sanders and Donald Trump, and in Europe by an even more virulent rejection of the European Union's open border policies.³

Following the Financial Crisis and ensuing austerity, politicians have turned their attention to the twin problems of tax evasion and tax avoidance. On the individual tax evasion front, U.S. legislators enacted the Foreign Account Tax Compliance Act (FATCA) in 2010. This law led to the signing of Intergovernmental Agreements (IGAs) between the United States and 115 other countries (and counting) for the exchange of tax information. The IGAs led the Organization for Economic Co-operation and Development (OECD) to develop Common Reporting Standards (CRS) and the Multilateral Agreement for Administrative Assistance in Tax Matters (MAATM), which has been adopted by over eighty countries (though only signed but not ratified by the United States).⁴

¹ See, e.g., Peggy Noonan, Opinion, *Trump, Sanders and the American Rebellion*, WALL ST. J. (Feb. 11, 2016), <http://on.wsj.com/1QavpWY>.

² See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

³ See Noonan, *supra* note 1; *Why is EU Struggling With Migrants and Asylum?*, BBC NEWS (Mar. 3, 2016), <http://www.bbc.com/news/world-europe-24583286>.

⁴ On FATCA, IGAs and MAATM, see generally Allison Christians, *What You Give and What You Get: Reciprocity Under a Model 1 Intergovernmental Agreement on FATCA*, 31 CAYMAN FIN. REV. 24 (2013), <http://ssrn.com/abstract=2292645>; Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why it Matters)*, 69 TAX NOTES INT'L 565 (2013), <http://ssrn.com/abstract=2280508>; Itai Grinberg, *Taxing Capital Income in Emerging Countries: Will FATCA Open the Door?*, 5 WORLD TAX J. 325 (2013), <http://ssrn.com/abstract=2256587>; Itai Grinberg, *The Battle Over Taxing Offshore Accounts*, 60 UCLA L. REV. 304 (2012), <http://ssrn.com/abstract=2497998>; J. Richard Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and its Potential Future*, 57 VILL. L. REV. 471 (2012), <http://ssrn.com/abstract=1969123>; Susan C. Morse, *Why FATCA Intergovernmental Agreements Bind the U.S. Government*, 70 TAX NOTES INT'L 245 (2013), <http://ssrn.com/abstract=2252843>; Susan C. Morse, *Ask for Help, Uncle Sam: The Future of Global Tax Reporting*, 57 VILL. L. REV. 529 (2012), <http://ssrn.com/abstract=1999101>; Reuven S. Avi-Yonah & Gil Savir, *IGAs vs. MAATM: Has Tax Bilateralism Outlived its Usefulness?* (Univ. of Mich. Pub. Law, Research Paper 384, 2014), <http://ssrn.com/abstract=2392702>; Joshua D. Blank & Ruth Mason, *Exporting FATCA* (N.Y. Univ. Law and Econ., Working Paper No. 14-05, 2014), reprinted in 142 TAX NOTES 1245 (2014), <http://ssrn.com/abstract=2389500>; Itai Grinberg, *Beyond FATCA: An Evolutionary Moment for the International Tax System* (Georgetown Law Faculty, Working Paper No. 160, 2012), http://scholarship.law.georgetown.edu/fwps_papers/160/; J. Richard

On the corporate tax avoidance front, the OECD and G20 launched the Base Erosion and Profit Shifting (BEPS) project in 2013, culminating with the release of a series of action reports in October 2015.⁵ Commenting on the project, OECD Secretary-General Angel Gurría stated:

Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis[,] and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. The measures [presented in the action reports] represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective.⁶

Is Mr. Gurría justified in his optimism? We think not. As the Article discusses in the sections that follow, the benefits principle is the problem. Under the benefits principle, active (business) income is taxed primarily at source, while passive (investment) income is taxed primarily at residence.⁷ Formed in 1923, this compromise between the claims of residence and

Harvey, Jr., *FATCA - A Report From the Front Lines* (Villanova Law Pub. Policy, Working Paper No. 2013-3001, 2012), reprinted in 136 *TAX NOTES* 713 (2012), <http://ssrn.com/abstract=2122491>.

⁵ On BEPS, see, e.g., Pascal Saint-Amans and Rafaëlle Russo, *The BEPS Package: Promise Kept*, 70 *IBFD Bulletin for International Taxation* 4 (2016); Hugh J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 *TAX NOTES INT'L* 1195 (2013); Itai Grinberg, *Breaking BEPS: The New International Tax Diplomacy*, GEO. L. J. (forthcoming), <http://ssrn.com/abstract=2652894>; Adam H. Rosenzweig, *Building a Framework for a Post-BEPS World*, 74 *TAX NOTES INT'L* 1077 (2014); Richard J. Vann, *Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporation Income Tax*, 62 *CAN. TAX J.* 433 (2014); Hugh J. Ault et. al., *Base Erosion and Profit Shifting: A Roadmap for Reform* (Bos. Coll. Law Sch., Working Paper No. 324, 2014), <http://ssrn.com/abstract=2459646>; Yariv Brauner, *What the BEPS?* (Univ. of Fla. Coll. of Law, Legal Studies Working Paper No. 15-40, 2014), <http://ssrn.com/abstract=2408034>; Dhammika Dharmapala, *Base Erosion and Profit Shifting: A Simple Conceptual Framework* (Univ. of Chi. Law Sch. Coase-Sandor Inst. for Law & Econ., Working Paper No. 703, 2015), <http://ssrn.com/abstract=2497770>; Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature* (Univ. of Chi. Law Sch., Coase-Sandor Inst. for Law & Econ., Working Paper No. 702, 2014), <http://ssrn.com/abstract=2373549>; Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a 'Fix' on Recent International Tax Policy Developments* (N.Y. Univ. Sch. of Law, Pub. Law & Legal Theory Research Paper Series, Working Paper No. 15-20, 2015), <http://ssrn.com/abstract=2605144>.

⁶ *Centre for Tax Policy and Administration, OECD Presents Outputs of OECD/G20 BEPS Project for Discussion at G20 Finance Ministers Meeting*, ORG. FOR ECON. CO-OPERATION & DEV. (Oct. 5, 2015), <http://www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm>.

⁷ On the benefits principle and its origins, see REUVEN S. AVI-YONAH, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* ch. 1 (2015); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 *TAX L. REV.* 507 (1997); Reuven S. Avi-Yonah, *The*

source countries still serves as the foundation of the international tax regime.⁸ It is embedded in over 3000 bilateral tax treaties as well as the domestic laws of the United States and most other countries. In accordance with the benefits principle, FATCA, the IGAs, and MAATM are designed to enforce residence-based taxation of passive income, while BEPS represents an attempt to improve source-based taxation of active income.⁹ Against this orthodoxy, this Article reconsiders the benefits principle and offers modifications of existing policies to develop a more effective international tax regime.

Part I introduces the primary weakness of the benefits principle: the reliance on source-based taxation for active income and residence-based taxation for active income requires cooperation by too many jurisdictions. This section provides three case studies of individual tax evasion and corporate tax avoidance to illustrate the principle's shortcomings. Part II focuses on the individual tax evasion problem. This section analyzes the FATCA, IGA, and MAATM responses and explains why these measures are likely to fall short. Part III focuses on corporate tax avoidance. This section examines the BEPS response and its inadequacies. Part IV proposes an alternative to international tax policy based on the benefits principle. This section argues that reversing the benefits principle by taxing passive income primarily at source and active income primarily at residence will effectively reduce individual tax evasion and corporate tax avoidance in the developed and developing world.

I. ILLUSTRATING THE TAX EVASION AND TAX AVOIDANCE PROBLEMS

Taxation at residence is traditionally justified because most passive income is earned by individuals whose residences are relatively easy to determine. However, tax havens provide secret avenues for the flow of funds from the residence countries to the countries in which the funds are invested. Since the relaxation of exchange controls in the 1980s, tax competition to attract funds has led source jurisdictions to abolish withholding taxes on such income. Consequently, a wealthy person can route her investment through a tax haven conduit, resulting in no taxation at source (because there are no withholding taxes) or at residence (because the residence country does not know about the investment given secrecy in the tax haven). Preventing this erosion of the tax base through the exchange of information

Structure of International Taxation: A Proposal for Simplification, 74 TEX. L. REV. 1301 (1996).

⁸ See Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, *supra* note 7.

⁹ On FATCA, IGAs and MAATM, see, e.g., Blank & Mason, *Exporting FATCA* *supra* note 4. On BEPS, see, e.g., Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, *supra* note 5.

as envisaged by the MAATM would require the cooperation of every tax haven.

Taxation at source has been justified because active income is generally earned by corporations that have no fixed residence. However, since the 1980s, tax competition has led many source jurisdictions to offer tax holidays to MNEs, while residence jurisdictions have become reluctant to tax MNEs on their global income to remain competitive without other jurisdictions. As a result, most MNEs are not taxed at source or residence. Reducing this tax avoidance would likewise require the cooperation of countries that currently compete with each other to provide tax holidays. Three recent examples illustrate the tax evasion and tax avoidance on cross border income that results from the shortcomings of the benefits principle:¹⁰

A. *Individual Tax Evasion—Sam Wyly*¹¹

Sam Wyly is a rich Texas businessman. In 2006, Forbes estimated his net worth as \$1.1 billion. He and his brother Charles made their money in computers, a steakhouse chain, and Michael's Arts and Crafts, which they bought in 1982 and sold in 2006 to a group of private equity firms, including Bain Capital, for \$6 billion. Sam is a major philanthropist: a \$10 million gift resulted in the naming of Sam Wyly Hall at the University of Michigan Ross School of Business. He is also an avid Republican. In 2004, Sam Wyly helped finance the "Swift Boat" ad campaign that scuttled John Kerry's bid for the presidency.

But Sam Wyly is now bankrupt. In 2006, a hearing of the U.S. Senate Permanent Subcommittee on Investigations (PSI) revealed that he had been evading U.S. tax laws by hiding his money in trusts in the Isle of Man, a notorious tax haven. He began by transferring stock options from his various companies to the trusts, which were managed by Isle of Man trustees. The nominal trust beneficiaries were two foreign charities, but the six Wyly children were contingent beneficiaries, and the trustees understood that at Sam's death the children would become the true beneficiaries and collect the funds.

In the meantime, the trusts were free to exercise the stock options and use the stock for investments, with the understanding that ten years down the road they would have to make annuity payments to Sam. Sam obtained an opinion from a law firm that this arrangement worked to defer taxes on the income gained from exercising the options until he began receiving annuity payments years later. But the linchpin of the legal opinion was that the offshore trusts were independent actors when, in fact, Sam exercised total con-

¹⁰ The examples in sections I.A. and I.B. appear in Reuven S. Avi-Yonah, *International Tax Evasion and Avoidance: What Can Be Done?* THE AMERICAN PROSPECT, (May 26, 2016), <http://prospect.org/article/international-tax-evasion-what-can-be-done>. The examples have been reprinted in this Article with minor editing to conform to the *Harvard Business Law Review* style requirements.

¹¹ See *supra* text accompanying note 10.

control over the trust assets, secretly using the investment profits to operate businesses and buy real estate, jewelry, and artworks in the United States. The Wyllys' secret control over their offshore funds was revealed in the PSI hearing.

In 2010, the Securities and Exchange Commission (SEC) charged Sam and Charles Wyly with securities fraud based on Sam's hidden control of the offshore trusts. In 2014, a jury found him liable. To avoid paying a \$300 million judgment, he filed for bankruptcy, which triggered a tax assessment for his failing to pay any taxes on hundreds of millions of dollars in offshore income since 1992. After a prolonged court battle, in June 2016, a federal judge in Texas ordered Wyly to pay \$1.1 billion in taxes and penalties.¹²

How many Wyllys are hiding their money from the IRS, with no PSI hearing to bring their misdeeds to light? We will probably never know. A recent estimate of the global costs of illegal tax evasion by the economist Gabriel Zucman was \$200 billion, but this is probably too low since estimates for the United States alone range from \$20 billion to \$70 billion. Every time a Swiss banker talks, many billions in U.S. tax evasion are revealed. The IRS Offshore Voluntary Disclosure Program has netted over \$6 billion and counting.

And this is only for illegal tax evasion by individual taxpayers. Because the evasion hides taxable income, it is hard to quantify with any precision.

Corporations are another story, because what they are doing is legal tax avoidance—manipulating their books to avoid taxation—and therefore the magnitudes can be better quantified. As of the end of 2015, U.S.-based MNEs had more than \$2 trillion in offshore profits in low-tax jurisdictions. This amount, which translates to about \$700 billion in U.S. taxes avoided, is mostly income that was economically earned in the United States and shifted offshore to jurisdictions like Singapore, Ireland, or Luxembourg, which have effective tax rates in the single digits.

B. Corporate Tax Avoidance—Apple and Caterpillar¹³

How do the MNEs avoid taxes? A couple of examples can suffice. Apple Inc. is the world's largest company by market capitalization. Most of its billions in profits relate to intellectual property developed at its headquarters in Cupertino, California. But for tax purposes, most of the profit is booked in its Irish subsidiaries—which we will call Apple Ireland.

Some of the profit-shifting is achieved through a “cost sharing agreement.” Cost sharing is a concept developed in IRS regulations in the 1980s, but it became more significant due to the increasing importance of intellec-

¹² Katy Stech, *Judge Hands Entrepreneur Sam Wyly a \$1.1 Billion Tax Bill*, WALL ST. J. (June 28, 2016), <http://www.wsj.com/articles/judge-hands-entrepreneur-sam-wyly-a-1-1-billion-tax-bill-1467144226>.

¹³ See *supra* text accompanying note 10.

tual property. The idea behind cost sharing is this: when a U.S.-based MNE begins a new research project (for example, a search for a drug to treat a certain disease), it can agree to share the costs of development with its offshore subsidiaries. Then, if the project is successful, the parties share the profits in the same proportions. For example, if Apple Ireland contributed 80% of the costs of developing the iPhone 6, it would get 80% of the profit. Importantly, none of the actual work is done by Apple Ireland. Apple just gives Apple Ireland the money and Apple Ireland pays it back as its contribution to the research costs.

Why would the IRS regulations permit this? Because if the research failed, then the taxpayer would lose its ability to deduct the costs sent offshore. The more of the cost sent offshore, the more deductions would be at risk. So the IRS thought there was a natural limit to taxpayer willingness to share costs with offshore affiliates.

That analysis may have been true for Big Pharma, which usually waits to enter into cost sharing with an offshore affiliate until a drug has passed its initial trials and is well on its way to a patent, and then battles the IRS over valuation issues at the time the cost-sharing agreement was executed. But the same analysis makes less sense for Apple, since it faces lower R&D risk for its new products, such as the iPhone 6, than Big Pharma companies do for their new drugs.

There is another trick involved in Apple Ireland's profitability. Another portion of its profits derive from countries where Apple sells the iPhones. Apple Ireland licenses the right to use Apple's brand and intellectual property to Apple affiliates in other countries. Those affiliates in turn pay Apple Ireland hefty royalties, which operate to shift the sales profits gained in those countries to Ireland.

Before 1997, such a scheme would not have worked, because the royalties received by Apple Ireland would have triggered a tax in the United States under so-called Subpart F, which was designed to prevent foreign corporations from taking advantage of inconsistencies between U.S. and foreign tax law. But in 1997, the Clinton administration adopted a rule called "check the box." Under "check the box," Apple Ireland can, for U.S. tax purposes, treat all of its foreign affiliates as if they did not exist as separate entities, and treat the money they paid to Apple Ireland as income earned in Ireland. The result is that, for U.S. tax purposes, there are no royalties and no U.S. tax triggered by them, because Apple Ireland treats the money as its own sales income.

The Obama administration came in promising to repeal "check the box;" this was the biggest international revenue raiser in the first Obama budget. But by its next budget in 2010, the administration recanted under pressure from the MNEs. Recently, Obama signed into law a five-year extension of a provision (first enacted by a Republican Congress as a "temporary" measure in 2006) that enshrines "check the box" in the tax law.

Finally, the PSI hearing revealed two Irish-specific tricks used by Apple. Ireland has a tax rate of 12.5 percent, far below the U.S. rate of 35 percent. But Apple did not want to pay even 12.5 percent. Its solution: for U.S. tax purposes, Apple Ireland is treated as an Irish company because it is incorporated in Ireland, so it is not taxed by the United States. But for Irish tax purposes, Apple Ireland was treated as an American company because it is “managed and controlled” from California. As a result, Apple Ireland claimed it was a tax resident nowhere. On top of that, Apple negotiated a sweetheart tax deal with Ireland for its Irish income, which resulted in its paying a tax rate of less than 2%.

These types of tricks are used by most U.S.-based MNEs. If the primary driver of value of a U.S.-based MNE is intellectual property developed in the United States, the Apple scheme can simply be replicated.

But what if the value derives from more traditional, tangible items? Some U.S.-based MNEs do pay higher taxes (e.g., car companies). But others try to avoid tax nevertheless. Caterpillar Inc. is a good example.

Caterpillar does not make a lot of money on the heavy equipment it manufactures. But it does profitably sell replacement parts. Before 1999, Caterpillar bought the parts from unrelated manufacturers and stored them at its warehouse in Morton, Illinois. When a dealer requested a part for a customer overseas, Caterpillar “sold” (but did not actually ship) the part to a Swiss subsidiary, which in turn sold the part to the unrelated dealer.

The problem, according to accounting firm PricewaterhouseCoopers (PwC), was that Caterpillar’s sale of the part to its Swiss subsidiary triggered U.S. taxes. Much better, PwC said, would be if the parts were sold by the manufacturer directly to the Swiss subsidiary, which could then sell them to the dealer. The result was that Caterpillar continued to run its parts business from the United States, but declared 85% or more of the parts profits in Switzerland.

In addition, PwC came up with a way to lower Caterpillar’s U.S. tax without requiring Caterpillar to change its operations. PwC’s solution was for the manufacturers to bill the Swiss subsidiary for the parts but continue to ship them to the Illinois warehouse, which continued to transport them to Caterpillar’s foreign customers. If the parts were shipped overseas, they were deemed to have been “owned” by the Swiss subsidiary, and PwC devised a virtual inventory to track them, even though the parts were indistinguishably commingled in the warehouse. The result was that Caterpillar continued to run its parts business from the United States, but declared 85% or more of the parts profits in Switzerland.

The IRS has now challenged this billing arrangement, which resulted in shifting some \$2.4 billion in Caterpillar profits from the United States to Switzerland. A grand jury has issued subpoenas under a criminal investigation for tax fraud.

But the disturbing fact is that the whole story would not have come to light but for a whistleblower, who alerted both PSI and the IRS. And while

Caterpillar is facing a court challenge, in most cases of corporate tax avoidance, like Apple, the IRS's hands are tied, because what Apple did may have been legal under the U.S. tax code.

C. *Assessing the Tax Evasion and Tax Avoidance Problems*

The problem with this state of affairs is that the progressive income tax cannot be maintained in the absence of taxing cross-border flows. The wealthy can more easily earn cross-border income. The result has been a worldwide shift to taxing consumption rather than income. But consumption taxes are regressive and cannot by definition reach the unconsumed income of the rich.¹⁴ Without progressive taxation, it will not be possible to maintain the public's commitment to social insurance that is globalization's main defense against growing inequality.

To preserve the income tax in the twenty-first century, multilateral solutions are needed. MAATM and BEPS are both multilateral, but they are hampered by the fact that there are too many residence jurisdictions for passive income and source jurisdictions for active income. If we reversed the benefits principle, so that passive income is taxed primarily at source and active income at residence, far fewer jurisdictions will need to cooperate.

For passive income, the number of source jurisdictions is much smaller than residence jurisdictions. Portfolio investment flows overwhelmingly to a small number of jurisdictions—the United States, the European Union, and Japan. Even Brazil, Russia, India, China, and South Africa (BRICS) mostly attract portfolio investment through mutual funds that are relatively easy to tax. Thus, if the “big three” can coordinate to reinstate a withholding tax on interest, dividends and royalties flowing from them, most of the problem of taxing passive income can be solved. Crucially, money cannot stay in tax havens and earn decent rates of return, so the cooperation of tax havens is not needed, unlike in the case of the MAATM. For active income, about 90% of MNEs are headquartered in the G20, and none of those countries have a tax rate below 20%, so if they taxed their MNEs currently on a coordinated basis and restricted the ability to move out most of the problem would be resolved.¹⁵

¹⁴ On the shift to consumption taxes, see Reuven S. Avi-Yonah, *Tax Competition*, *supra*; note 2. On the inability of consumption taxes to reach the unconsumed income of the rich, see Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 *YALE L. J.* 1391, 1407 (2002) (reviewing Joel B. Slemrod, *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (2000)); Reuven S. Avi-Yonah, *Risk, Rents and Regressivity: Why the United States Needs Both an Income Tax and a VAT*, 105 *TAX NOTES* 1651, 1653 (2004).

¹⁵ For the location of the world's 100 largest MNEs, see Liyan Chen, *The World's Largest Companies 2015*, *FORBES* (May 6, 2015), <http://www.forbes.com/sites/liyanchen/2015/05/06/the-worlds-largest-companies/#4ebf4ea14fe5> (89% are in G20 countries). For the tax rates of the G20, see HM Treasury, *Budget 2012*, H.C. 1853, at 33 (Mar. 21, 2012).

We suggest reconsidering the benefits principle in light of the reality of globalization. We should tax passive income primarily at source and active income primarily at residence. Importantly, this approach does not preclude the alternative. Once passive income is taxed at source, taxpayers may be able to credit the tax upon declaring it to their residence country. In parallel, once active income is taxed at residence, a credit can be given to source country taxes if the source country responds to the limitation of tax competition by re-imposing its tax. But the key is that the income has already been taxed, so that no double non-taxation ensues even if taxpayers do not declare the income (in the case of passive income, where the residence rate may be higher) or source countries choose not to tax in the case of active income. The sections that follow further develop this Article's reconsideration of the benefits principle.

II. FATCA, IGAs AND MAATM¹⁶

In 2010, the United States revolutionized the international taxation of individuals with the enactment of FATCA. The Act arose as a response to the UBS AG aiding and abetting tax evasion by U.S. citizens.¹⁷ FATCA imposes a 30% withholding tax on the U.S. source income of any "foreign financial institution" that has not shared information on its account holders who are U.S. citizens or residents.¹⁸ In response, foreign banks and other financial institutions strongly objected to the policy for two main reasons.

First, banks claimed that it imposed unreasonable compliance costs.¹⁹ The fundamental problem stems from the fact that the United States has since 1861 taxed its citizens living permanently overseas, and as a result, FATCA applies to many such expatriates who have no intention of hiding their income from the IRS (in fact, most of them do not owe any taxes to the United States because of the earned income exclusion of the Internal Revenue Code (IRC) section 911²⁰ and the foreign tax credit of IRC section 901²¹). This complaint could be addressed by stopping the taxation of citizens living overseas.²²

¹⁶ This section is based in part on Avi-Yonah and Gil, *IGAs vs. MAATM*, *supra* note 4.

¹⁷ See Reuven S. Avi-Yonah, *What Goes Around Comes Around: Why the US is Responsible for Capital Flight (and What it Can Do about It)*, 2–3 (U of Michigan Public Law Research Paper No. 307, 2013), <http://ssrn.com/abstract=2208553>.

¹⁸ I.R.C. § 1471 (2015).

¹⁹ See Grinberg, *The Battle over Taxing Offshore Accounts*, *supra* note 4, at 304, 336.

²⁰ I.R.C. § 911 (2015); see also Internal Revenue Service, *Foreign Earned Income Exclusion – Requirements*, I.R.S.GOV, <http://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion—Requirements> (last updated May 14, 2015).

²¹ I.R.C. § 901 (2015).

²² See Reuven S. Avi-Yonah, *The Case Against Taxing Citizens* (March 25, 2010). University of Michigan Law Sch. Empirical Legal Studies Ctr., Working Paper No. 10-009, 2010; University of Michigan Law Sch. Pub. Law & Legal Theory Working Paper Series, Working Paper No. 190, 2010), <http://ssrn.com/abstract=1578272>

The second problem with FATCA was that many foreign countries have taxpayer confidentiality laws that preclude banks from sharing account information with the IRS. Under the modern version of Article 26 of tax treaties and the Tax Information Exchange Agreements (TIEAs), such prohibitions should not bar the exchange of information, but many treaties have not been updated to reflect the new norms. Consequently, the banks argued that they faced a serious dilemma of either violating the laws of their home country or being subjected to the FATCA penalty.

The U.S. Treasury responded by negotiating a series of IGAs with the governments of various countries with which the United States has either a tax treaty or a TIEA. Under the IGAs, foreign governments are responsible for collecting the necessary information from their banks and for transmitting the information to the IRS. In return, under some IGAs, the United States has agreed to collect information on its residents who have accounts in U.S. banks and share it with the foreign governments. The difference, of course, is that the United States taxes its citizens living overseas, so it has many more taxpayers with accounts in foreign financial institutions than the foreign country is likely to have in U.S. banks.²³

It is not clear that the IGAs are permitted under FATCA because the legislation requires direct submission of the information by the Foreign Financial Institutions (FFIs) to the IRS. Nor is it clear that the Treasury has the authority to enter into IGAs under the tax treaties and TIEAs.²⁴ But the main concern about the IGAs is that they enshrine the bilateral model of tax information exchange that has dominated the twentieth century.

There are good reasons to believe this bilateral model does not work, especially when IGAs are signed with countries, such as the Cayman Islands,²⁵ that have no interest in reciprocity. The alternative is MAATM. In response to the Financial Crisis and the outrage it caused in Europe about tax evasion by the wealthy, the OECD proposed MAATM,²⁶ which provides for the automatic exchange of information and appears to overcome the problem of non-reciprocity that bedevils the tax treaties, bilateral TIEAs, and IGAs.

A. *The Scope of the Tax Evasion Problem*

Technological advances have made it easier for companies and individuals to shift income and capital among countries to reduce their global tax

²³ See Reuven S. Avi-Yonah, *The Case Against Taxing Citizens*, 58 TAX NOTES INT'L 389 (2010).

²⁴ See Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why It Matters)*, 69 TAX NOTES INT'L 565 (2013).

²⁵ For a list of TIEAs, see OECD, *Tax Information Exchange Agreements (TIEAs)*, <http://www.oecd.org/ctp/harmful/taxinformationexchangeagreementstieas.htm> (last visited Feb. 5, 2014).

²⁶ OECD, *Convention on Mutual Administrative Assistance in Tax Matters* (June 2011), <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf> [hereinafter MAATM].

amount by using tax haven jurisdictions. The OECD has recognized this phenomenon as a Harmful Tax Competition.²⁷ Although the ability of individuals to shift their capital income without being taxed is subject to substantial limitations,²⁸ capital-income shifting still exists, especially in situations where the taxpayer relies on the lack of information-sharing between different countries around the world²⁹ by not reporting her income.³⁰ In response, a significant effort has been made to force tax haven countries to share their information³¹ about foreign taxpayers who utilize the lack of information exchanges between countries, while enabling the tax havens³² to enjoy the investment of capital in their jurisdiction.

With the benefit of this information, tax researchers have been able to define the scope of the problem in terms of lost tax revenue. The Tax Justice Network, a non-profit organization, reports that the amount of equity held offshore by individuals alone was about \$11.5 trillion, with a resulting annual loss of about \$250 billion in taxes.³³ A study conducted by the Congressional Research Service indicates that tax evasion by individuals through setting up foreign corporations in tax havens and channeling the income to these foreign companies results in an estimated \$70 billion a year deficit to the U.S. Treasury.³⁴ Economist Gabriel Zucman used financial asset reporting to calculate an estimate of \$200 billion of lost income tax revenue per year worldwide,³⁵ which is significantly below other estimates, but provides a useful lower bound.

²⁷ OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), <http://www.oecd.org/tax/transparency/44430243.pdf> [hereinafter OECD, Harmful Tax Competition]. Under the OECD definition for tax havens, a country that does not share information about transactions that occurred within its jurisdiction is also a potential tax haven.

²⁸ See Reuven S. Avi-Yonah, *And Yet it Moves: A Tax Paradigm for the 21st Century* (University of Michigan Law Sch. Law & Econ. Working Papers, Working Paper No. 59, 2013), http://repository.law.umich.edu/law_econ_current/59.

²⁹ See Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A 10th Anniversary Retrospective* (University of Michigan Law Sch. Law & Econ. Working Papers Archive: 2003–2009, Working Paper No. 89, 2008), <http://law.bepress.com/umichlwps-olin/art89>.

³⁰ See JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 20 (2010), <https://www.fas.org/spp/crs/misc/R40623.pdf>.

³¹ See Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, *supra* note 29, at 4–7.

³² The OECD recognized that a country that does not provide information about its taxpayers is also a tax haven.

³³ Tax Justice Network, *Briefing Paper – The Price of Offshore* (Mar. 2005), http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf.

³⁴ GRAVELLE, *supra* note 30, at 29.

³⁵ GABRIEL ZUCMAN, *THE HIDDEN WEALTH OF NATIONS: THE SCOURGE OF TAX HAVENS* 31 (2015).

B. Lack of Information

Tax evasion has become a central concern of the major economies around the world. Accordingly, the global finance system has developed agreements for the exchange of information to increase the ability of its tax systems (both civil and criminal) to enforce its rules on sophisticated taxpayers.³⁶ In particular, the OECD has targeted countries whose lack of transparency allows them to function as tax havens.³⁷ Just before the Financial Crisis, the first author argued that the OECD has achieved significant progress in the field of information exchange.³⁸ However, lack of transparency is still a major problem globally. As long as some countries provide tax shelters, the OECD may win the battle, but lose the war.

Our assessment is based on two factors. First, in a competitive financial world, some countries will always be willing to host trillions of dollars to attract investment in their infrastructures.³⁹ Second, sophisticated internal law, such as that which exists in the British Virgin Islands (BVI), facilitates tax evasion.⁴⁰ BVI laws “require no identification of shareholders or directors, and require no financial records.”⁴¹ Thus, even if the BVI provides information about its taxpayers, it is unlikely that information will be useful.⁴² Consequently, the taxpayer has no real concerns.

With the information-exchange problem in mind, the United States started signing bilateral treaties and TIEAs with countries around the world.⁴³ The United States signed over sixty bilateral treaties,⁴⁴ which usually permit the exchange of civil and criminal information.⁴⁵ In addition, the

³⁶ See Kevin Jestin, *Mutual Legal Assistance in Tax Matters: Recent Trends and Challenge Ahead* 1 (2008) (unpublished manuscript), <http://visar.csustan.edu/aaba/Jestin2008.pdf>.

³⁷ See OECD, *Harmful Tax Competition*, *supra* note 27, at 28–29.

³⁸ See Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, *supra* note 29, at 783, 783–84.

³⁹ Dhammika Dharmapala and James R. Hines Jr., *Which Countries Become Tax Havens?* 93 J. OF PUB. ECON. 1058–1068 (2009) (stating that tax haven countries are usually quite affluent).

⁴⁰ GRAVELLE, *supra* note 30, at 21.

⁴¹ *Id.*

⁴² *Id.*

⁴³ See Chris Horton, *The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds*, 41 U. MIAMI INTER-AM. L. REV. 357, 372

⁴⁴ Avi-Yonah and Gil, *IGAs vs. MAATM*, *supra* note 4, at 5.

⁴⁵ See IRS, *Internal Revenue Manual* pt. 5 ch. 21 § 2 (Dec. 17, 2013), http://www.irs.gov/irm/part5/irm_05-021-002.html. (“The U.S. has over [sixty] bilateral tax treaties with other countries, and over [twenty] Tax Information Exchange Agreements (TIEA) in effect with various countries and jurisdictions where a bilateral tax treaty is not in place. These treaties and agreements facilitate the exchange of information, and generally allow for mutual assistance for both civil and criminal investigations. The tax treaties allow for information exchange by specific request, and in most cases, through spontaneous and automatic exchanges as well.”).

United States signed TIEAs with over twenty countries.⁴⁶ However, the effectiveness of the TIEAs agreements is in doubt.⁴⁷

Between 2006 and 2010, the United States and other countries exchanged 5111 information requests.⁴⁸ But only 894 were outgoing requests.⁴⁹ Two factors inhibited the outgoing requests. First, “most of these agreements are restricted to criminal matters, which are a minor part of the revenues involved and pose difficult issues of evidence.”⁵⁰ Second, the complexity of the information that the IRS is required to provide to get information discouraged outgoing requests.⁵¹ Generally, the IRS must provide a specific taxpayer name to retrieve any information and the reason that the taxpayer is under investigation. For example, the United States signed a TIEA with the Cayman Islands in 2004. According to the TIEA, the United States must provide very specific information to the Cayman Islands to get information about a U.S. taxpayer.⁵² As a result, the TIEA is more of a confirmatory than discovery tool.⁵³

In addition to tax treaties, in 2001, the IRS established the Qualified Intermediaries (QI) Program.⁵⁴ Under the program, a QI, such as a bank, is required to identify the payment and, in some types of investments where the beneficiary is a U.S. resident or any profit is subject to withholding,⁵⁵ the QI must notify the IRS about the transaction without disclosing the name of the taxpayer.⁵⁶ The QIs are required to withhold any tax amount and send the payment to the U.S. Treasury.⁵⁷ UBS was a QI. After its scandal,⁵⁸ the effectiveness of the QI program was questioned.⁵⁹ Although UBS was a QI, instead of discovering the identity of the beneficiary account, the bank created shell companies for its clients in the Cayman Islands to hide their identities.

⁴⁶ *Id.*

⁴⁷ See GRAVELLE, *supra* note 30, at 26.

⁴⁸ U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-730, TAX ADMINISTRATION: IRS'S INFORMATION EXCHANGES WITH OTHER COUNTRIES COULD BE IMPROVED THROUGH BETTER PERFORMANCE INFORMATION 22 (2011).

⁴⁹ *Id.*

⁵⁰ GRAVELLE, *supra* note 30, at 20.

⁵¹ See U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-730, TAX ADMINISTRATION: IRS'S INFORMATION EXCHANGES WITH OTHER COUNTRIES COULD BE IMPROVED THROUGH BETTER PERFORMANCE INFORMATION 8–10 (2011).

⁵² Agreement between the Government of the United States of America and the Government of the Cayman Islands for the Exchange of Information Relating to Taxes, U.S.-Cayman Is., Nov. 29, 2013, <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx?loc=60367d5a-48c4-4b82-8fd6-fd6e00763d5d>.

⁵³ Horton, *supra* note 43, at 373.

⁵⁴ Susan C. Morse, *Qualified Intermediary or Bust?*, 124 TAX NOTES 471 (2009).

⁵⁵ See I.R.C. § 871(a) (2014). See I.R.C. § 862(a) (2010).

⁵⁶ See Morse, *supra* note 54, at 472.

⁵⁷ Lynnley Browning, *U.S. Tax Agency to Strengthen Program to Catch Offshore Tax Evasion*, N.Y. TIMES (July 15, 2008), <http://www.nytimes.com/2008/07/15/business/worldbusiness/15iht-15tax.14499852.html>.

⁵⁸ Lynnley Browning, *U.S. Ends Inquiry of UBS Over Offshore Tax Evasion*, N.Y. TIMES (Nov. 16, 2010), <http://www.nytimes.com/2010/11/17/business/17tax.html>.

⁵⁹ See GRAVELLE, *supra* note 30, at 26.

However, there has been some progress since 2008. For example, in 2009, UBS agreed to disclose about 4450 American clients suspected of using the bank's offshore services to evade taxes.⁶⁰ But this was a small fraction of the more than 24,000 U.S. accounts held by the bank. Moreover, only a small portion of the 4450 names were prosecuted.⁶¹ In parallel, FATCA and the IRS's offshore voluntary compliance initiative have had some success. But both policies are inherently limited because they apply to only U.S. residents (including U.S. citizens) and can be avoided by putting assets in a bank that has no U.S. assets (hence avoiding FATCA penalty tax exposure) in a jurisdiction that does not comply with MAATM.

C. *The Revenue Rule and Non-Assistance in the Collection of Taxes*

As the global economy becomes more interconnected, tax collection is becoming more complex. Even if a country has determined the right to tax liabilities of its taxpayers, collection can be a difficult task. When a taxpayer lacks any assets in the country that is trying to make the collection, very limited solutions are available to that country. For example, in *India v. Taylor*,⁶² the government of India sought taxes from a company registered in the United Kingdom, but trading in India. The House of Lords held that India could not enforce its collection of taxes through a British court:

“[T]here is a well-recognized rule, which has been enforced for at least 200 years or thereabouts, under which these courts will not collect the taxes of foreign States for the benefit of the sovereigns of those foreign States; and this is one of those actions which these courts will not entertain.”⁶³

In *United States v. Harden*,⁶⁴ the United States District Court for the Southern District of California held for a deficiency of \$639,500.15 against the respondent. When the United States tried to enforce the judgment, it could not locate any of the respondent's assets in a U.S. jurisdiction. Consequently, the United States tried to enforce the judgment in a Canadian court based on a Canadian contract. However, like the House of Lords in the United Kingdom, the Supreme Court of Canada held that no Canadian court would enforce the revenue laws of another country:

⁶⁰ Lynnley Browning, *14,700 Disclosed Offshore Accounts*, N.Y. TIMES (Nov. 17, 2009), <http://www.nytimes.com/2009/11/18/business/global/18irs.html>.

⁶¹ Zach Lowe, *Six Months Later: Still a Good Deal for UBS?*, THE AMLAW DAILY (Aug. 18, 2009), <http://amlawdaily.typepad.com/amlawdaily/2009/08/six-months-later-a-good-deal-for-ubs-.html>

⁶² *Government of India, Ministry of Finance (Revenue Division) v. Taylor*, [1955] AC 491 (HL) (appeal taken from Eng.).

⁶³ *Id.*

⁶⁴ *United States of America v. Esperanza P. Harden*, [1963] S.C.R. 366 (Can.).

“[T]he argument that the claim asserted is simply for the performance of an agreement, made for good consideration, to pay a stated sum of money must also fail. We are concerned not with form but with substance, and if it can properly be said that the respondent made an agreement it was simply an agreement to pay taxes which by the laws of the foreign state she was obligated to pay.”⁶⁵

Although countries may enforce private judgments in fields like torts and contracts, when they are faced with a request to force foreign judgments in criminal, antitrust and tax law, the request will be denied.⁶⁶ The obvious result is a decrease in the ability of countries to enforce their laws even when public policy is not an issue. This phenomenon arises, in part, from one country viewing the enforcement another country’s law within its territory as “an extraterritorial intrusion.”⁶⁷ In this respect, despite the dramatic evolution of international tax practice in the last decades,⁶⁸ cooperation between countries on a voluntary basis remains limited.

D. Article 27 under the OECD Model of the Tax Convention on Income and Capital

In January 2003, the OECD added Article 27—The Assistance in The Collection of Taxes—to its Model Tax Convention on Income and Capital.⁶⁹ Article 27 outlines rules for contracting parties who wish to collaborate in collecting taxes across country boundaries. A brief review of the rules reveals a painstaking process for collaboration.

Under paragraph 1, a country will provide assistance to the other country upon a request to collect taxes within the foreign country. According to the Commentaries on the Articles of the Model Tax Convention (CAMTC), paragraph 1 is very flexible and subject to negotiation among the contracting countries based on their local laws. In addition, according to the CAMTC, the article is an elective. The collection of taxes is not limited to the type of taxes covered by Article 2 and most importantly, is also enforceable against people who are not entitled to the benefits derived from the convention.

Paragraph 4 allows a contracting country to require temporary relief before a final judgment is made against the taxpayer to safeguard future collection. The aforementioned provision combined with paragraph 6 is very

⁶⁵ *Id.*

⁶⁶ See William S. Dodge, *Breaking the Public Law Taboo*. 43 HARV. INT’L. L. J., 161 (2002).

⁶⁷ Alan R. Johnson, Lawrence Nirenstein & Stephen E. Wells, *Reciprocal Enforcement of Tax Claims Through Tax Treaties*, 33 TAX LAWYER 469, 470 (1980).

⁶⁸ See Reuven S. Avi-Yonah, *International Tax as International Law* (U. Mich. L. Sch. Law & Econ., Research Paper No. 7, 2004) (for the evaluation and the impact of the international law on the practice).

⁶⁹ See OECD, Articles of the Model Convention with Respect to Taxes on Income and on Capital, art. 27 (Jan. 28, 2003), <http://www.oecd.org/tax/treaties/1914467.pdf>.

interesting. According to paragraph 6, the “validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.”⁷⁰ An interesting question is whether paragraph 6 should also apply when temporary relief is provided (e.g. seizure), and whether the foreign court has the right to determine whether the request is reasonable on the strength of the evidence. A review of the CAMTC supports the hypothesis that any judicial proceeding will take place in the country that asks for assistance in the collection of taxes.

E. Article 27 – The U.S Treaties in Practice vs. the OECD Model

The MAATM convention operates at the international level, similar to other multilateral conventions, such as the Geneva Convention. Another traditional way to address tax issues between countries is through bilateral conventions. Although the U.S model tax convention of 2006 lacks any reference to assistance in the collection of taxes, the United States has signed treaties that include provisions relating to assistance in collection of taxes in a foreign country.⁷¹ These provisions appear in two forms: general enforcement and limited enforcement.⁷²

General enforcement provisions outline general mutual assistance in the collection of taxes within a foreign country. This provision appears in treaties with Canada, Denmark, France, the Netherlands, and Sweden.⁷³ A review of paragraph 1 of Article 27 of the convention between the United States and Sweden⁷⁴ reveals that the assistance applies to any type of tax that is covered by Article 2. Paragraphs 2 and 3 of Article 27 stipulate that when a country files⁷⁵ a tax claim against a person’s assets in another country, the latter country will enforce the claim as if the liability were in its jurisdiction. Paragraph 4 states that “the assistance provided by the article shall not be accorded with respect to the citizens, companies, or other entities of the state to which the application is made, except when the enforcement is against a person who enjoyed the convention although he was not entitled to.”⁷⁶ The application of Article 27 varies from treaty to treaty. For example, under the tax convention between the United States and Canada⁷⁷ is not applicable

⁷⁰ *Id.* at art. 27, ¶ 6.

⁷¹ IRS, *Internal Revenue Manual*, *supra* note 45, at pt. 5 ch. 21 § 2.

⁷² See Johnson et al., *supra* note 67, at 472–473.

⁷³ IRS, *Internal Revenue Manual*, *supra* note 45, at pt. 5 ch. 21 § 2.

⁷⁴ Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 27, Swed.-U.S., Sept. 1, 1994, S. TREATY DOC. NO. 103-29.

⁷⁵ See IRM 5.21.7.4, Mutual Collection Assistance Requests (MCAR) (Nov. 13, 2015) (outlining the procedure for filing a claim).

⁷⁶ *Id.*

⁷⁷ Tax Convention, art. 27, Canada-U.S. Sept. 26, 1980, as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997, https://www.fin.gc.ca/treaties-conventions/USA_-eng.asp.

against a Canadian citizen if, at the date of the tax deficiency, the taxpayer was a citizen of the Canada. Under this provision, the United States would have won the case of *United States v. Harden*.

Why does the United States vary its application of Article 27? The answer is hidden in the late 1960s, when a broad collection of provisions was deleted from the U.S model.⁷⁸ Three hypotheses can explain the withdrawal of the provisions: (1) the IRS performed very limited collection abroad under the treaties that included “general enforcement” provisions;⁷⁹ (2) during the years following World War II, countries were more sensitive to measures that could be expressed as a foothold in their territory;⁸⁰ and (3) there was a development of independent agreements that are more limited. As a result, the United States entered a collection provision only when a convention was renegotiated and assistance of tax collection provisions was included.⁸¹

Limited enforcement provisions outline assistance in collection of taxes where a person or entity enjoys the benefits provided by the treaty, even though they are not entitled. Consequently, the application of the provision is narrow and limited to very specific situations.⁸² For example, a limited enforcement paragraph can be found under the U.S.-Iceland convention:

Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto.⁸³

A similar approach can be found under the treaties with Luxemburg (1996), Germany (1989), Austria (1996), and the United Kingdom (2001).⁸⁴

F. Multilateral Conventions for Tax Collection Assistance

Due to a historic problem of tax collection by countries within a foreign country, jurisdiction countries have begun to sign mutual agreements. The first agreement appeared in 1950 as a multilateral convention among Belgium, the Netherlands, and Luxembourg (the Benelux⁸⁵ countries) for tax

⁷⁸ THE NEW US-BELGIUM DOUBLE TAX TREATY: A BELGIAN AND EU PERSPECTIVE 558 (Anne Van de Vijver, et al. eds., 2009).

⁷⁹ *Id.*

⁸⁰ See Grinberg, *The Battle Over Taxing Offshore Accounts*, *supra* note 4, at 314.

⁸¹ Johnson et al., *supra* note 67 at 469–70.

⁸² *Id.* at 475–76.

⁸³ Tax Convention, art. 25, Ice.-U.S., Oct. 23, 2007, S. TREATY DOC. NO. 110-17.

⁸⁴ See THE NEW US-BELGIUM DOUBLE TAX TREATY: A BELGIAN AND EU PERSPECTIVE, *supra* note 78, at 558.

⁸⁵ A collective name for Belgium, the Netherlands, and Luxembourg, especially with reference to their economic union.

collection assistance.⁸⁶ Under the convention, the Benelux countries agreed to enforce the collection of tax in their territory for the foreign country. In 1972, the Nordic convention was signed with similar principles.⁸⁷ Following the success of the Nordic convention, the OECD started to draft a new convention in 1988 to reverse the lack of cooperation between OECD countries in collecting taxes.⁸⁸ At first, only a few countries signed the convention.⁸⁹ Two decades later, the OECD opened the convention on MAATM⁹⁰ for signature. In the first two years, about fifty countries signed the MAATM convention. By 2016, the convention had over eighty signatories.

The MAATM convention is designed to create a global network that deals with tax evasion cases.⁹¹ The model of the MAATM convention is based on a combination of tax exchange provisions and administrative assistance in the collection of taxes. Under the model, countries that have signed the convention enjoy “cross-border tax co-operation including exchange of information, multilateral simultaneous tax examinations, service of documents, and cross-border assistance in tax collection, while imposing extensive safeguards to protect the confidentiality of the information exchanged.”⁹² One advantage of the convention is the flexibility that it offers to countries by reserving the right to provide no information or assistance in the collection of taxes.⁹³ A country can exclude the collection of taxes in its jurisdiction either at the time of signing, ratification, or a later date.⁹⁴ For example, Poland withdrew its reservations concerning assistance in tax collection when it joined the European Union.⁹⁵

G. *The Tax Evasion Problem Reconsidered*

The current state of affairs is as follows: the United States has FATCA and a set of bilateral IGAs, but FATCA has loopholes (most obviously, using a bank with no U.S. source income exposure). The IGAs have come under

⁸⁶ Jestin, *supra* note 36 at 3.

⁸⁷ *Id.* at 3–4.

⁸⁸ *Id.* at 4.

⁸⁹ OECD, *Background brief: The Convention on Mutual Administrative Assistance in Tax Matters and New Protocol*, (June 5, 2012), <http://www.oecd.org/ctp/exchange-of-tax-information/backgroundbrieftheconventiononmutualadministrativeassistanceintaxmattersandnewprotocol.htm> [hereinafter OECD, MAATM Background].

⁹⁰ See MAATM, *supra* note 26; see also OECD, *Convention on Mutual Administrative Assistance in Tax Matters*, (Feb. 2016), <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm>.

⁹¹ See generally Grinberg, *Breaking BEPS: The New International Tax Diplomacy*, *supra* note 5.

⁹² OECD MAATM Background, *supra* note 89; OECD, *Updated Multilateral Tax Convention now Open to All Countries* (Nov. 2012), <http://www.oecd.org/ctp/exchange-of-tax-information/updatedmultilateraltaxconventionnowopentoallcountries.htm>.

⁹³ MAATM, *supra* note 26, at art. 30.

⁹⁴ OECD, MAATM’s flyer (June 5, 2013), http://www.oecd.org/ctp/exchange-of-tax-information/ENG_Convention_Flyer.pdf.

⁹⁵ *Id.*; see also MAATM, *supra* note 26, at art. 30.

legal challenge in Canada and depend on actual government cooperation to be fully implemented. The Obama Administration won in court on the validity of regulations requiring U.S. banks to collect information on payments of interest eligible for the portfolio interest exemption,⁹⁶ but in the absence of knowledge about the true beneficial owners, it is not clear that this information will be of any use even if exchanged under the IGAs. Moreover, foreign governments that have signed IGAs can, in many cases, be expected to behave like they do under the older TIEAs: namely, pretend to cooperate, but not do so in practice.

The OECD has Article 27, but this has not been implemented in most treaties, and the United States has generally not included it in its treaties or its model. Nor is it clear that courts are willing to overturn the revenue rule, despite the United States Supreme Court's *Pasquantino* decision.⁹⁷ In addition, the problem with MAATM is two-fold: the United States has not ratified the convention so that it may become a huge tax haven for the rest of the world and even a small non-cooperating jurisdiction may be able to derail it.

H. The Limits of BEPS Project in Addressing the Financial Secrecy Issue

One of the missions of BEPS project is to ensure transparency, while promoting increased certainty and predictability. Action 5 focuses on the transparency of harmful tax practices in intellectual property (IP) regimes. Action 12 requires taxpayers to disclose their aggressive tax planning arrangements. Action 13 reexamines transfer pricing documentation. Despite these reports, the issue of financial secrecy has not received enough attention in the BEPS project. Bilateral and multilateral actions are needed to address the financial secrecy issue.

Since 2009, the Global Forum on Transparency and Exchange of Information for Tax Purpose has been the main international body working on the implementation of the international standards on tax transparency. The Forum currently has 130 members and fifteen international organizations participating as observers. The OECD explains:

There are two internationally agreed standards on exchange of information for tax purposes: Exchange of Information on Request (EOIR); Automatic Exchange of Information Portal (AEOI). All member jurisdictions have committed to implementing the international standard on EOIR. More than [ninety] countries and jurisdictions have committed to implementing the new standard on

⁹⁶ See *Florida Bankers Ass'n v. U.S. Dept. of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015).

⁹⁷ See, e.g., *European Community v. RJR Nabisco, Inc.*, 424 F.3d 175 (2nd Cir. 2005) (limiting the scope of *Pasquantino v. United States*, 544 U.S. 349 (2005)).

AEOI. Work is currently underway to implement this Standard, with the first exchanges occurring on a very ambitious timeline of 2017 and 2018.

The global standard for automatic exchange of financial account information was approved by the OECD Council on July 15, 2014. Under the standard:

[Jurisdictions] obtain financial information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

Although AEOI will facilitate the discovery of some tax evasion, there is a long way to go to eliminate the information asymmetry created or exacerbated by domestic financial secrecy regimes and practices. For instance, as Switzerland is “the old grand-daddy of tax havens” the surprising demise of Switzerland’s legendary banking secrecy regime was not easy to achieve. As observed by political economy professor Patrick Emmenegger:

Switzerland is structurally dependent on the economic welfare of its largest banks, and Swiss banks are again structurally dependent on access to the [U.S.] financial market. This advantage along with the [UBS scandal enabled the United States to compel] Switzerland to make a series of bilateral concessions on the banking secrecy. In [the] spring [of] 2012, Switzerland accepted group requests for client files by the [United States] in cases of administrative assistance. In December 2012, Switzerland had agreed in principle with the [United States] on how to implement FATCA. These Swiss concessions to the [United States] once again fueled multilateral efforts by demonstrating the continued need to act on banking secrecy and by providing a focal point for collective action.

The successful unilateral action by the United States against Swiss banks not only rooted out the barrier for the U.S. Department of Justice and the IRS to acquire the files of American taxpayers from the Swiss banks, but also paved the way for collective action to overcome Switzerland’s resistance to international tax cooperation. Switzerland adopted the Standard for Automatic Exchange of Financial Account Information in 2014.

But, the unanswered question is, if the United States withdraws its pressure on the next successor of Switzerland, what will be the effective strategy to make the multilateral actions sustainable and viable? Emmenegger believes the international community likely will have to wait for the next “demonstration effect” before new substantial improvements are possible.

Although we appreciate his concern about the challenge for the viability of multilateral actions, we do not believe the international community's only choice is to wait for the demonstration effect of another legal battle between a powerful residence country and another tax haven.

The modernization of international tax governance, including the global efforts in fighting against BEPS should neither count on the luck associated with the tax evasion scandal nor on any single white knight among the victim countries. Instead, the sustainable multilateral actions should be built upon the rule of law, including but not confined to rational core values, coherent institutional arrangements, and effective methodologies for achieving voluntary practices on the part of the governments, financial institutions, and taxpayers.

Public shaming of wrongdoing countries and financial institutions has been an effective solution to ensure the compliance of international tax law because of reputational concerns. To improve the credibility of the blacklist, the peer review process of AEOI group should be impartial, transparent, and inclusive. Each blacklisted country should have the opportunity to be heard and to explain before the final decision is made by the AEOI group.

In addition to the banking secrecy, other financial secrecy regimes, including anonymous trusts and foundations and shell companies held by nominal shareholders for anonymous shareholders, need to be regulated from the perspective of international tax law. Examined from the domestic law, either in the form of statutes or decided cases, the private relationships in the structure of anonymous trusts and foundations and shell companies are legal. However, the sole purpose of such legal structures is to avoid taxation created by tax law. While recognizing the validity of the private legal relationship based on anonymous structures, we urge the international community to restrict the abuse of anonymous structures for illegal BEPS purposes. All nominal owners of the taxable properties for the beneficiary owners should be obligated to report the information to the local tax authority, which shares such information with the tax authority in other jurisdictions. Of course, the confidentiality of such information should be well protected from being abused by irrelevant individuals or institutions.

III. THE LIMITS OF THE BEPS PROJECT

On October 5, 2015, two years after announcing the Action Plan, the OECD and G20 released the final BEPS package of thirteen reports, which cover fifteen actions. The BEPS package represents the first substantial renovation of international tax standards in almost a century. Its mission is to align the location of taxable profits with the location of economic activities and value creation. Some generally accepted principles of international tax law, including the single tax principle, the benefit principle, the anti-discrimination principle, and the transparency principle are incorporated in the reports. Despite considerable progress, there are many shortcomings with the

BEPS project due to the short two-year framework. Hence, the BEPS project is not the final destination of international tax law reform. Rather, it is the first step toward the modernization of global tax governance in the long run.

A. New Shoes on the Old Road: an Old Approach for the New Destination

The primary problem with the BEPS project is that although the new destination has been defined, new principles and new rules have not been established. Instead, the old principles have been strengthened by a patch up of current rules. The core principle of international tax law is the single tax principle, which requires eradication of double taxation and double non-taxation. Unfortunately, governments and MNEs have focused on fighting double taxation at the expense of double non-taxation. As a result of this singular focus, the main theme of traditional international tax law has been the eradication of double taxation. Accordingly, the mission of the BEPS project is to prevent and eliminate the double non-taxation. As the G20 leaders note, “profits [should be] taxed where economic activities occur and where value is created.” In this respect, the new direction of international tax law reform in the BEPS project is to safeguard the single tax principle.

It is well known that the rickety international tax regime, including rules and underlying principles, is one of the primary root causes of BEPS opportunities. As a result, the new direction demands revolutionary changes to current approaches. The ideal roadmap for the BEPS project is supposed to replace the old principles with a new principle, and to redesign the rules based on the requirement of the new principle. Unfortunately, many old principles of international tax law have been preserved in the final BEPS package. This approach has substantially compromised the value of the new principle, and made the legal reform of international tax look more like the patch-up of existing rules and principles.

As a result of the patch-up, complete renovation of current international tax law has not happened and genuine new rules guided by the new principle have not been formulated. Instead, the patch-up work has produced complex, discretionary, uncertain, costly, and contradictory rules. It remains difficult to translate all the new rules into the reality. Moreover, even if the BEPS project is implemented as outlined, it remains possible new BEPS opportunities to arise or arbitrariness by tax authorities to compromise the implementation’s effectiveness. The BEPS project is also silent on the basic concepts of residence and source, and where profit should be considered to be earned. Without the support of new principles for new rules, it remains very challenging to achieve the new destination of aligning the taxation of MNE profits with economic activity.

B. The Survival and Continuity of Notional and Illusionary Independent Entity Principle and Arm's Length Principle

The traditional international tax law is designed and interpreted based on the assumption that the various constituent entities or members of MNE groups are independent of each other and conduct transactions with each other at arm's length. While criticizing the independent entity theory as a fundamental flaw of the existing rules, the BEPS Monitoring Group, an active tax advocate group, identified a new but implied approach in the G20 mandate to treat the MNE group as a single firm, and ensure that its tax base is attributed according to its real activities in each country. This approach means that the new destination of taxing MNEs where economic activities occur and value is created is unlikely to be achieved, without treating the MNE group as a single firm.

We support the single unitary entity principle. The G20 mandate could be interpreted as both a new direction and a new guiding philosophy, which requires all the BEPS actions should serve the purpose of taxing MNEs where economic activities occur and value is created in the most efficient manner. Unfortunately, the BEPS project did not make the implied principle explicit. Instead, it continued to emphasize the independent entity principle, while attempting to counteract its harmful consequences. Virtually all of the new rules of the BEPS package are still built on the notional principle of independent entity.

The orthodoxy of independent entity taxation has two basic assumptions. First, the members of the MNE group are regarded as equal, separate, and independent legal entities. Second, the contracts between the related parties in the MNE group are freely negotiated at arm's length, and the terms of the contract are fair and reasonable dealings. However, these assumptions do not really exist in commercial reality.

The primary commercial reality is that the MNE group operates more like a single, unitary entity or enterprise rather than separate independent entities or enterprises. This cohesion is made possible by the controlling power of the parent corporation. As traditional international tax law stubbornly insists on the old concept of independent entity, MNEs have been encouraged to incorporate dozens and even hundreds of affiliates all over the world to undertake aggressive BEPS schemes. Because of the controlling power of the parent corporation, it is unlikely to find a real arm's length transaction in the reality. In fact, the related party contracts within the corporate group are always concluded without genuinely free, competitive, and transparent bargaining and negotiations.

If the BEPS project is designed on the principle of single unitary entity, the BEPS countermeasure will be much more simple and effective, as inter-group transactions will be disregarded, and the profit or tax base will be attributed to its real activities which generate the profit and create the value in the jurisdictions. Unfortunately, many actions of the BEPS project, in-

cluding but not confined to Action 2 on hybrid mismatches, Action 7 on permanent establishment, and Actions 8–10 on transferring pricing, rely on the legal fictions of independent entity and arm's length transactions.

C. The Survival and Continuity of the Problematic Benefits Principle

The OECD declared that the goal of BEPS package is “to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms. Once the measures are implemented, many schemes facilitating double non-taxation will be curtailed.” One of the root causes is traditional benefit principle, which has guided the allocation of global profits in the past decades, and has created many BEPS opportunities. Unfortunately, the BEPS project failed to replace the benefit principle. Instead, the BEPS package maintains residence jurisdictions for passive income and source jurisdictions for active income.

BEPS concerns will be more effectively addressed if passive income is primarily taxed at source and active income is primarily taxed at residence. This new philosophy will help build a win-win framework international tax governance that will benefit developed countries and developing countries. Moreover, the conflicts between the domestic demand for tax revenue and domestic policy to attract foreign direct investment will be better balanced, and the MNEs and domestic firms will be offered a level playing field.

D. Limited Inclusiveness and Multilateralism

Global challenges need global solutions. BEPS, as a global concern, is made possible by uncoordinated tax rules at domestic and international levels. Accordingly, the global solutions need to be based on inclusive and multilateral global governance. This approach means that all countries should be offered equal opportunities to shape the outcome of the global solutions. Although the OECD and G20 have made great efforts in organizing many non-member countries and non-governmental organizations to participate in the development of the BEPS package, the inclusiveness and multilateralism of the BEPS project is limited.

Major OECD countries dominated the formulation of the BEPS package, which reflects compromise between developed countries. For instance, weak measures on controlled foreign companies (CFCs), interest deductibility, and innovation box schemes are favored particularly by the United Kingdom. Although over sixty countries were directly involved in the process of the BEPS project, they account for less than one-third of the 193 United Nations (UN) members. As MNEs have their taxable presence around the globe, including the non-participating countries, the effectiveness of the BEPS project is very limited. The tax competitions between participating and non-participating countries will continue. The race to the bottom and the unilateral actions taken by any jurisdiction could hurt all countries.

Although some developing countries were consulted for the BEPS project, their core proposals were not necessarily accepted by the BEPS package. As observed by independent commentators, “some key OECD countries opposed and succeeded in blocking the institutional reform proposal from developing countries at the [Third] International Conference on Financing for Development.” Less influential participating countries and more than 120 non-participating countries might be hurt due to the effect of negative spill-over arising from the implementation of the BEPS project. These countries are weak not only because of their limited influence in the renovation of the current rules, but also because of their limited experience and resources to enforce the BEPS actions.

The process of public debate and consulting was relatively insufficient. The BEPS Monitoring Group complains that they have been vastly outnumbered by the army of paid tax advisers and representatives of multinational enterprises. Although stakeholder interest, including invaluable interactions with business and civil society, saw more than 12,000 pages of comments received on the twenty-three discussion drafts published and discussed at eleven public consultations, it is unknown to what extent these valuable proposals have been adopted by the BEPS package. More importantly, detailed reasons for rejecting different proposals have not been published.

Given the impossibility of guaranteeing that countries and stakeholders really had equal opportunities to influence and shape the BEPS package, the OECD and G20 are not the truly global platform needed for comprehensive reform of international tax law. To transform the current BEPS project into truly global, coherent, coordinated, and inclusive actions, the UN should undertake the leadership in the next stage of international tax law reform.

The third paragraph of Article 1 of the Charter of the UN recognizes that the third purpose of the UN is to achieve international cooperation in solving international problems of an economic, social, cultural, or humanitarian character. The fourth paragraph of Article 1 of the Charter of the UN recognizes its fourth purpose is to “be a cent[er] for harmonizing the actions of nations in the attainment of these common ends.” We believe that the UN will be more qualified, impartial, transparent, credible, and influential than the OECD and G20 in rewriting and renovating the international tax rules including the BEPS countermeasures. All UN members have the right to be heard and represented in the process of international tax law reform.

We urge that the UN Convention of Anti-BEPS should be made as the cornerstone of the global response to BEPS in a more coherent, inclusive and multilateral manner. Compared with the partial multilateral approach of OECD and G20, the global BEPS actions launched by the UN will better address the BEPS concerns and restore the integrity of international tax principles of single tax, neutrality, transparency, and fairness.

E. The Limits of Action 1

The digital economy has greatly expanded the platform of commerce and reduced the cost of business transactions. However, the digital economy has also exacerbated BEPS risks. That is why the tax challenges of the digital economy were listed as the first top priority on the agenda of BEPS project. To address BEPS concerns in the context of the digital economy, the Action Plan of 2013 established the Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs.

TFDE's core mission is to "identify the main difficulties that the digital economy poses for the application of existing international tax rules and to develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation." Regarding Action 1's focus on the tax challenges of the digital economy, the OECD states:

The report analyses BEPS risks exacerbated in the digital economy and shows the expected impact of the measures developed across the BEPS Project. Rules and implementation mechanisms have been developed to help collect value-added tax (VAT) based on the country where the consumer is located in the case of cross-border [business-to-consumer] transactions. These measures are intended to level the playing field between domestic and foreign suppliers and facilitate the efficient collection of VAT due on these transactions. Technical options to deal with the broader tax challenges raised by the digital economy such as nexus and data have been discussed and analyzed.

The TFDE identified certain specific issues generated by the key features of the digital economy that warrant attention from a tax perspective. These include: (i) "ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment [PE] status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status"; (ii) "the importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing"; (iii) addressing opportunities for tax planning by businesses engaged in VAT-exempt activities.

Although Action 1 "considered several options to address the broader tax challenges raised by the digital economy, including a new nexus in the form of a significant economic presence, none of these options were recommended at this stage." However, OECD and G20 countries have agreed to monitor developments and analyze data over time to address the tax challenges raised by developments in the digital economy.

Action 1 was unable to propose all the solutions to the BEPS concerns in the digital economy for the following two reasons. First, although the digital economy has exacerbated BEPS risks, it has not generated genuinely unique BEPS issues. Almost every BEPS issue is directly or indirectly rele-

vant to digital economy. Additionally, all the BEPS actions interconnect and interact with each other in the digital economy. Therefore, the ideal Action 1 report would focus on universal philosophy and methodology of the BEPS project from the perspective of digital economy. It is challenging and unwise for the TFDE to produce some unique measures in parallel with other measures of the BEPS project. Second, the staggered time frame of the BEPS Project makes it impossible for TFDE to foresee and analyze the effectiveness of the future BEPS package in addressing BEPS concerns in the digital economy. For the same reason, it is difficult for TFDE to “evaluate the ultimate scope of the more systemic tax challenges in the area of nexus, data, and characterization, and potential options to address them.”

However, the limitations of Action 1 report could be overcome by “continuing research on the broader tax challenges of the digital economy, and by proposing detailed and viable options to address those challenges, with appropriate focus on multi-sided business models and the participation of users and consumers in value creation.” On the one hand, TFDE needs to assist the implementation of other BEPS actions, such as Action 3 on CFC rules, Action 7 on artificial avoidance of PE, Actions 8–10 on transfer pricing. On the other hand, TFDE should update the Action 1 report based on the experience, performance and outcomes of the BEPS Project. As planned by TFDE, a supplementary report reflecting the outcomes of the continuing work will be finalized by December 2015.

We doubt whether the intended outcomes of the BEPS project would be available for assessment, given the fact that the implementation of the fifteen actions is a lengthy process domestically and internationally. In our opinion, the Action 1 report should be updated regularly based on the changing business models of digital economy.

F. The Limits of Action 2

The main purpose of hybrid mismatch arrangements is to generate excessive deductible interest payments via either intra-group or third party loan. In the Action 2 report, the OECD states:

Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. Country rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. While it may be difficult to determine which country has in fact lost tax revenue, because the laws of each country involved have been followed, there is a reduction of the overall tax paid by all parties

involved as a whole, which harms competition, economic efficiency, transparency and fairness.

To establish international coherence of corporate income taxation, the mission of Action 2 is to develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.”

The Action 2 report identifies a common approach that will facilitate the “convergence of national practices through domestic and treaty rules to neutralize the effects” of hybrid mismatch arrangements. The report provides internal law recommendations and an OECD Model treaty recommendation:

Internal laws [should] . . . deny a dividend exemption in respect of payments that are deductible in the country of residence of the payor, and to prevent taxpayers from using hybrid transfers to duplicate credits for source-country withholding tax. To avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions have adopted the rules, the recommended rules are divided into a primary response and a defensive rule. The defensive rule only applies where there is no hybrid mismatch rule in the other jurisdiction or the rule is not applied to the entity or arrangement.

In addition, the Action 2 report proposes including a new provision in the OECD Model Tax Convention to ensure that an entity that is a hybrid entity under the tax laws of two treaty countries is eligible for treaty benefits in appropriate circumstances but that treaty benefits are not allowed for income that neither treaty country treats as income of one of its residents:

[These recommendations] will help to prevent double non-taxation by eliminating the tax benefits of mismatches and to put an end to costly multiple deductions for a single expense, deductions in one country without corresponding taxation in another, and the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralizing the mismatch in tax outcomes, but not otherwise interfering with the use of such instruments or entities, the rules will inhibit the use of these arrangements as a tool for BEPS without adversely impacting cross-border trade and investment.

The solutions of Action 2 are soft recommendations, instead of minimum standards. Although countries have agreed to a general tax policy direction in neutralizing the effects of hybrid mismatch arrangements, it is difficult to achieve the agreements on minimum standards at this stage. As a result, the Action 2 has to choose a common approach to encourage the

countries to converge over time through the implementation of the recommendation at the levels of internal law and bilateral treaties.

However, it is not clear how long it will take the countries to converge in a harmonized way because changes of domestic law are left to the free choice of sovereign states based on the consideration of complex factors including different legal traditions. Some jurisdictions might wish to continue to treat certain instrument as indebtedness, while others might continue to treat it as equity. For similar reasons, some jurisdictions will continue to treat certain hybrid entities and reverse hybrid entities as fiscally transparent conduits, while some jurisdictions will continue to treat them as separately taxable entities.

If a few countries are very slow in the convergence process, the whole process of convergence will be delayed. Although all countries may argue that their own measures or paths are consistent with the right direction of the BEPS project, the real consequences might depart from the direction originally decided by the BEPS project. Even worse, it is possible that a few jurisdictions will return to the race to the bottom. In this event, the original direction of neutralizing the effects of hybrid mismatch arrangements might be compromised in some jurisdictions.

We propose that the international community replace the common approach by global minimum standards. To better coordinate Action 2 with other relevant Actions, in particular on interest expense deduction limitations, CFC rules and treaty shopping, the latter Actions should also be upgraded to minimum standards.

G. The Limits of Action 3

Many MNEs set up affiliated non-resident taxpayers, and route income of a resident enterprise through the non-resident affiliate. Although the OECD has not done significant work on CFC rules in the past, thirty countries participating in the BEPS project, including the United States introduced CFC rules and other anti-deferral rules to address the BEPS concerns. According to the OECD, “While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction.”

As the CFC rules in many countries do not always counter BEPS in a comprehensive manner, Action 3 aims at upgrading the CFC rules. The report outlines building blocks of effective CFC rules, while recognizing that the policy objectives of these rules vary among jurisdictions. The report states, “The six building blocks includes definition of a CFC, CFC exemptions and threshold requirements, definition of income, computation of income, attribution of income and prevention and elimination of double taxation.” Action 3 also “identifies the challenges to existing CFC rules posed by mobile income such as that from intellectual property, services and

digital transactions, and allows jurisdictions to reflect on appropriate policies in this regard.”

The recommendations of Action 3 are not minimum standards. The recommendations provide flexibility to implement CFC rules and design options that could be implemented to be compliant with EU law. However, they are “designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.”

Strong CFC rules are supposed to play an important role in tackling BEPS schemes. Action 3 should serve as a backstop to transfer pricing and other rules. Unfortunately, the CFC rules in the Action 3 are very weak. The building blocks in this Action are soft recommendations based on best practices, instead of hard minimum standards. In particular, the threshold for defining CFC income is very low. The weak CFC rules could be explained by the stubborn insistence on the tax incentives by some OECD countries, in particular the United Kingdom. According to the BEPS Monitoring Group, the United Kingdom and other countries “believe their assertions that they wish to see effective solutions to the problem of taxation of MNEs.”

It is unlikely that Action 3 will effectively reduce and deter the motivation of MNEs to abuse the system of exemption or deferral of tax on foreign income, and to shift income from operating affiliates in source jurisdictions to the tax havens. Moreover, the race to the bottom is likely to continue to attract the headquarters of MNEs. Traditional tax havens will continue their behaviors, while other countries will be motivated to adopt low effective tax rates on foreign income or exempting such income altogether to attract foreign direct capital.

Although compromise is inevitable in the process of developing Action 3, the OECD and G20 should seek a win-win solution by maximizing the common denominator of international tax. We urge the international community to strengthen the weak CFC rules of Action 3, adopt full-inclusion CFC rules in the future, and replace the recommendations with minimum standards.

H. The Limits of Action 4

Although the tax rules have significant influence on the location of debt within MNE groups, the loopholes of international tax rules enable BEPS schemes to be achieved by excessive deductible payments such as interest and other financial payments. The MNEs can multiply the level of debt at the individual entity level via intragroup financing. The unregulated deductibility of interest expense can give rise to double non-taxation in inbound and outbound investment scenarios. Accordingly, the mission of Action 4 is to “develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense . . . and other financial payments that are economically equivalent to interest payments.”

The Action 4 report recommends an approach based on “a fixed ratio rule, which limits an entity’s net deductions for interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA), as measured under relevant tax principles.” This approach includes a “corridor” of possible ratios between 10% and 30% for adoption by countries. In addition, Action 4 includes factors that countries should take into account in setting their fixed ratio, including “[a] worldwide group ratio rule that allows an entity to exceed this limit in certain circumstances may supplement this approach.” Action 4 is expected to ensure that an entity’s net interest deductions are directly linked to the taxable income generated by its economic activities and foster increased coordination of national rules in this space.

As lower transaction cost and more business opportunities are the core features and advantages of the corporate group, it is extremely abnormal for the interest deductions to be greater in aggregate than each corporate group’s consolidated interest costs to third parties. Theoretically speaking, if the interest cost of intragroup loans is unreasonably higher than the loans from third parties, the group and its members would reduce the interest loans. But the reality does not support this logic. One of the pressure areas for the BEPS concerns is that intragroup debt usually exceeds the firm’s overall borrowing from third parties, and the interest deductibility is excessive. The limitation of deductions of interest should be strong enough to root out the BEPS opportunities.

Unfortunately, the Action 4 report is not minimum standard. It facilitates the convergence of national rules in the area of interest deductibility. Therefore, its success depends on voluntary coordination between and among countries on enacting new domestic rules. If the progress of implementation and operation of the recommendations is not satisfactory as anticipated, the effectiveness of this Action will be compromised. It is very challenging for the jurisdictions to address excessive deductible payments and competitiveness considerations and ensure that appropriate interest expense limitations do not themselves lead to double taxation.

More problematic is the substance of Action 4, which prioritizes an interest deduction cap within a suggested band of 10% to 30%, with the option of using apportioned consolidated interest costs if they are higher. The formula of fixed cap does not match best with every sector and firm. That is why the Action 4 report recognizes the need to develop suitable and specific rules that address BEPS risks in banking and insurance industries. Although it does make sense to respect the specific features of banking and insurance industries, other industries might also claim the special treatments from the BEPS project. It is not realistic to design the specific rules for every firm, industry, or sector.

Before the proposal of a fixed cap was adopted, there were other better proposals. For example, based on the doctrine of unitary entity, a proposal suggested apportionment of the MNE group’s consolidated interest expenses

based on EBITDA. However, the initial proposals have been “watered down to recommendations prioritizing a fixed cap.”

We recommend that interest deductions may not be greater in aggregate than each corporate group’s consolidated interest costs to third parties. The recommendations in Action 4 do not prohibit countries from seeking better alternative solutions for effective control of interest deductibility. If the countries have no choice other than following the default recommendation of a fixed cap on deductions, they should use the lowest limit to deter aggressive interest deductions by MNEs. In fact, even the lowest limit still falls in the range of unrelated loans. Furthermore, coordination is always important to prevent the MNEs from defeating all of the countries by abusing the different rules around the world.

I. The Limits of Action 5

Harmful tax practices, especially preferential regimes together with a lack of transparency in connection with certain rulings, have been widely used by MNEs for artificial profit shifting. In response, the OECD has called for proposals “to develop solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance.” To advance this goal, the Forum on Harmful Tax Practices (FHTP) has been refocused to develop more effective solutions. The mission of Action 5 “is to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and requiring substantial activity for any preferential regime.”

The Action 5 report establishes a minimum standard based on an agreed methodology to assess whether there is substantial activity in a preferential regime. In the context of IP regimes, such as patent boxes, the “nexus” approach achieved consensus. The OECD explains:

This approach uses expenditures in the country as a proxy for substantial activity and ensures that taxpayers benefiting from these regimes did in fact engage in [R&D] and incurred actual expenditures on such activities. The same principle can also be applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

To improve the transparency of preference regimes, “a framework has been agreed upon for mandatory spontaneous exchange of information on rulings that could give rise to possible BEPS concerns.”

The harmful tax practices proliferating in many countries represent the major form of race to the bottom. Such practices have triggered and in-

created numerous BEPS opportunities. Hence, Action 5 is designed to effectively reverse the history of beggar-thy-neighbor, which damages all countries, including the jurisdiction with harmful tax practices. Different from the Actions 2 through 4, Action 5 establishes a minimum standard in terms of substance and transparency, and includes the results of the application of the elaborated substantial activity and transparency factors to a number of preferential regimes. Unfortunately, for a number of reasons, Action 5 continues to be too weak to be effective.

First, the effectiveness of implementation of Action 5 is still up to voluntary self-regulation and self-monitoring by individual countries. Irrational developed and developing countries could be addicted to harmful practices, in the name of national competitiveness or attracting international capital.

Second, although the work of the FHTP will be refocused to develop more effective solutions, no penalty could be imposed by FHTP. In fact, all forty-three preferential regimes reviewed by the FHTP “were inconsistent with the nexus approach.” However, there is no effective penalty against the violators. It remains very challenging for all countries to voluntarily bring their intellectual property regimes into compliance with the nexus approach.

Third, the application of the broad and general principles of nexus and substance to innovation boxes might create different and divergent standards and interpretations in different countries. The consideration of national competitiveness or specific domestic circumstances might lead to new forms of harmful preference regimes.

Fourth, some developed countries have set bad examples for the developing countries in fighting against the harmful practices. As observed by the BEPS Monitoring Group, “the [United Kingdom’s] strong defense of its ‘patent box’ introduced in 2012 resulted in a compromise . . . with Germany, based on a ‘modified nexus approach,’ and a transition to the new standard by 2021.”

As the harmful tax practices always end up hurting every country, we urge the international community to abandon the voluntary self-policing model, and to establish mandatory monitoring model based on transparency, accountability, condemnation, and even economic sanctions depending on the seriousness of the harmful schemes. Harmful tax practices are unjustified and immoral. They are against the core value of international tax law. Therefore, it is inadequate, and even inappropriate to require countries to conduct cost-benefit analyses of the harmful incentives.

Many countries still attempt to acquire the limited selfish benefit at the price of negative spill-overs on the other countries. The harmful tax practices themselves have demonstrated the failure of voluntary self-policing approach. All countries should be encouraged to behave themselves in terms of higher standards of transparency, monitoring, review, and accountability of tax incentives. If a country wants to win the global community’s trust, it must take the firm initiative. To activate the monitoring function of FHTP,

the mechanism of transparent investigation, impartial peer review, reasonable reward, and adequate sanction will be indispensable.

J. The Limits of Action 6

As treaty abuse, especially treaty-shopping, may give rise to double non-taxation, treaty abuse is one of the most important sources of BEPS concerns. Although the Commentary on Article 1 of the OECD Model Tax Convention before 2015 included a number of examples of provisions to address treaty abuse, “[t]ighter treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws are expected to restore source taxation” to some extent. Accordingly, Action 6 develops model treaty provisions and provides recommendations on the design of domestic rules to prevent granting treaty benefits in inappropriate circumstances.

The Action 6 report includes a minimum standard on preventing abuse (including abuse through treaty shopping) and new rules that “provide safeguards to prevent treaty abuse and offer a certain degree of flexibility regarding how to do so.” The rules first address treaty shopping, “which involves strategies through which a person who is not a resident of a State attempts to obtain the benefits of a tax treaty concluded by that State.” More targeted rules have been designed to address other forms of treaty abuse. Other changes to the OECD Model Tax Convention have been accepted to ensure that treaties do not inadvertently prevent the application of domestic anti-abuse rules. A clarification that tax treaties are not intended to be used to generate double non-taxation is provided through a reformulation of the title and preamble of the Model Tax Convention. The report also contains the policy considerations to be taken into account when entering into tax treaties with certain low or no-tax jurisdictions.

The Action 6 report outlines a three-part approach to counter treaty abuse. First, “countries would include in treaties a clear statement that tax evasion, avoidance, or treaty shopping is not condoned by the treaty countries.” Second, a “specific anti-abuse rule of limitation-on-benefits (LOB) will be included in the OECD Model treaty, to ensure that there is a sufficient connection between the entity and the country of residence.” Third, “a more general anti-abuse rule, based on the principal purposes of transactions or arrangements (the principal purposes test or PPT) will be included in the OECD Model treaty,” so as to address situations not caught under the LOB rule.

The three-part approach adopted by the Action 6 will help to counter treaty abuse, but LoB articles and PPT provisions have their own pros and cons. Although the LoB article is easily understood and applied, “a proliferation of treaty-specific varieties of LoB articles would lead to over complexity in the treaties or domestic legislation.” Although the PPT provision is general enough to cover all the treaty shopping schemes, its interpretation and application depends on discretionary decisions of the tax authorities or

the courts. Therefore, the success of PPT provision relies on the individual country's competence, expertise, and resources, especially the useful information relevant to the treaty shopping behaviors.

Unfortunately, many developing countries do not have the necessary capacity and information resources to make the best use of the PPT provision. To offer useful guidance and reference to the developing countries, we urge the OECD and G20 to publish all of the latest decided cases or rulings on the PPT article on a regular basis. To sharpen the competence of developing countries in applying the anti-abuse clauses, spontaneous, systematic exchange of information between treaty partners should be established to ascertain the prerequisites for the taxpayer to enjoy treaty benefits. A more ambitious, global, spontaneous, comprehensive, and systematic platform for exchange of BEPS data between and among all jurisdictions should be created in the future. CbCR is one of the important parts of this data bank.

Although the countries may vary substantially from each other in terms of the legislation framework, judicial interpretation tools, and administrative ability, all countries involved should do their best in endorsing the minimum standard of protection against treaty shopping. In this way, the model treaty provisions included in the Action 6 report will be better adapted to the specificities of individual states and the circumstances of the negotiation of bilateral conventions. To reduce the treaty renegotiation cost and prevent the emergence of new treaty shopping platforms, a clear and effective anti-abuse provision should be incorporated as the core article of the proposed multilateral convention.

Finally, another important issue is the policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.⁹⁸ The OECD will continue to evaluate issues related to entitlement to treaty benefits by certain types of investment funds by early 2016.⁹⁹ But it is challenging to achieve a satisfied consensus on some key issues, as there are different definitions of CIV in different jurisdictions. Furthermore, CIV may be organized in different forms, including partnerships, agreements, trusts or incorporated entities.

K. *The Limits of Action 7*

Current tax treaties “generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a [PE] to which the profits are attributable.” As a result of this provision, the definition of PE in tax treaties determines whether a non-resident enterprise must pay income tax in another State.

⁹⁸ See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, 10, 18 (2014).

⁹⁹ JOINT COMMITTEE ON TAXATION, *supra* note 97, at 22.

[However,] in many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this encouraged MNEs to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

To “address techniques used to inappropriately avoid the tax nexus, including via replacement of distributors with commissionaire arrangements or via the artificial fragmentation of business activities,” Action 7 developed changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties. According to the changes:

[I]f the agent habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in the name of the enterprise or for the transfer of, or the granting of the right to use, property of the enterprise or for the provision of services by the enterprise, the enterprise will be deemed to have a PE. A person who acts exclusively or almost exclusively on behalf of one or more closely related enterprises is not considered an independent agent. The exceptions from creating a fixed place of business for specific activities (such as storage, display or delivery of goods) apply only if the overall activity of the fixed place or business is of a preparatory or auxiliary character.

Although Action 7 developed changes to the definition of PE in Article 5 of the OECD Model Tax Convention, the changes are not substantially innovative. This is because the definition of taxable presence still rests on the obsolete PE concept, which requires physical presence for a period of six or twelve months in relation to the particular activity generating the profit attributable to it.

Both the traditional PE definition and the proposed changes in Action 7, are based on the independent entity principle. Without disconnection between the taxable presence and the independent entity principle, it is unlikely to make ground breaking groundbreaking progress in changing the

definition of PE. Action 7 only targets abuse of the PE definition, instead of rewriting the definition of PE itself. However, not all forms of abuse are covered in this Action. The anti-fragmentation rule in Action 7 is only applicable to artificial fragmentation of sales functions, but not to the artificial fragmentation of non-sales-related functions. This means that MNEs will be free to continue fragmentations of non-sales-related functions, and attribute higher profits to tax havens.

According to the findings of the BEPS Monitoring Group, the proposals of Action 7 could only affect some MNEs, such as those engaged in internet-based selling and which own warehouses in the country of sales. However, the proposals would not “deal with sales of immaterial products, or services, so they would affect physical but not electronic books, and DVDs but not streaming services.” In fact, the MNEs have already restructured their production chains to separate basic manufacturing, which can be allocated a “routine” profit, from functions such as R&D or design, which may be considered high-value-adding, and “can be located where they will be lightly taxed.” Even the rules against artificial fragmentation of sales functions have some loopholes. For instance, although an entity will be deemed to have a PE, if activities can be said to be “preparatory or auxiliary” to sales, the terms “preparatory or auxiliary” are not clearly defined. Therefore, uncertainties and disputes are likely to arise in the future.

It should be noted that there are different legal rules in the agency, especially the indirect agency in the civil law families and the common law families. Different jurisdictions may have different definitions of the agent. In European civil law jurisdictions, a commissionaire acts in its own name for the account of a principal, but no relationship is created between the customer and the principal. “As a commissionaire is not generally viewed as a dependent agent by virtue of the commissionaire status, the activities and place of business of a commissionaire are not attributed to the principal in civil law jurisdictions. However, such arrangement could create agency in common law countries.” Therefore, the anti-fragmentation rule should adopt a functional approach, which should be compatible with the different legal traditions of agency law in different countries.

According to the Action 7 report, follow-up works will be undertaken to provide additional guidance on profit attribution to the PEs resulting from the proposed changes, and to incorporate the proposed changes into the Model Tax Convention. For the latter work, additional clarification on the new treaty wording should be provided, any unintended consequences of the changes should be addressed, and the BEPS issue related to the global trading of financial products should be considered. We urge that the limited scope of the anti-fragmentation rule will be expanded to cover all the schemes of abuse of the PE definition. If possible, the continuing work should also reconsider the fundamental weakness of the ‘functionally separate entity’ approach and reorient the future reform of anti-fragmentation based on the single and unitary entity principle.

L. The Limits of Actions 8–10

A major BEPS concern is transfer pricing. Transfer pricing rules, which are described “in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the arm’s length principle the conditions, including the price, for transactions within an MNE group.” Transfer pricing rules allocates income earned by a MNE among the countries in which the company does business.

However, the existing transfer pricing rules fail in prices and efficient allocation of the income of MNEs among taxing jurisdictions. Some MNEs have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalization of lowly taxed group companies, and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.

Given that “special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalization to address these flaws,” the mission of Actions 8, 9, 10 is to assure that transfer pricing outcomes are in line with value creation. The existing standards in this area have been clarified and strengthened, including the guidance on the arm’s length principle, and an approach to ensure the appropriate pricing of hard-to-value-intangibles has been agreed upon within the arm’s length principle. Action 8, Action 9 and Action 10 are closely connected to each other in this area.

As misallocation of the profits generated by valuable intangibles has heavily contributed to BEPS concerns, Action 8 “develop[s] rules to prevent BEPS by moving intangibles among group members. This approach involves:

- (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 8 examines transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are often hard-to-value. To assure the appropriate pricing of hard-to-value intangibles, Action 8 has devised an additional tool for countries to address the use of information asymmetry between taxpayers and tax authorities to undervalue intra-group transfers of intangibles.

Action 9 aims to “[d]evelop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.” This process involves “adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.” The rules must align returns with value creation. Under Action 9, contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.

Action 10 aims to “[d]evelop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.” This Action adopted transfer pricing rules or special measures to: “(i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.” Action 10 deals with the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational, the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.

In aggregate, the Actions 8–10 report provides guidance on transfer pricing rules that better align operational profits with the economic activities which generate them. Additionally, the report contains “guidance on transactions involving cross-border commodity transactions and on low value-adding intra-group services.” Given the importance of these two areas to developing countries, “the guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base-eroding payments.”

Actions 8–10 are the most important part of the BEPS project in addressing related party transactions of MNEs. Of course, the transferring pricing documentation requirements in Action 13 are also closely related to these three actions. The purpose of Actions 8–10 is to assure that transfer pricing outcomes are in line with value creation. The proposals on transfer pricing have made extensive revisions to the OECD Transfer Pricing Guidelines, which in fact will further strengthen the discretionary power for tax authorities to adjust them. Many proposals take the form of international standards, which could have some direct effects as international soft law.

Although the goal is correct, the approach of Actions 8–10 is very problematic. The solutions still focus on patch up of the dysfunctional rules built on the arm’s length principle, which again is rooted in the principle of sepa-

rate independent entity. According to the arm's length principle, all intra-group transactions are supposed to be rational and reasonable as commercial transactions between unrelated parties in comparable economic circumstances.

To implement the arm's length principle, Actions 8–10 make transfer pricing rules more sophisticated and complex, so as to authorize tax authorities to re-characterize the related party transactions within the MNE group. To find the available comparables, the tax authorities are required to make careful, informed judgment in good faith based on subjective analysis of detailed facts and circumstances relevant to the functions, assets, and risks actually undertaken by different group members located in different jurisdictions.

As the approach of Actions 8–10 is inevitably subjective and discretionary, the real effect of attribution of the tax base of MNEs will rely on the interactive bargaining and negotiation between MNEs and tax authorities. If the game is not fair enough, either under-taxation or over-taxation will arise. To avoid under-taxation, tax authorities will tend to maximize their discretionary power of re-characterizing, which might lead to the strong opposition from the MNE taxpayers. For the similar reasoning, to avoid over-taxation, MNEs might upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will be increased, and more disputes will be created. Moreover, as the subjective judgment will be made independently and separately by different national authorities, different jurisdictions might make conflicting re-characterization conclusions on the same intra-group transaction.

The complicated and uncertain approach of re-characterizing intra-group transactions is most challenging for the developing countries, as they do not have the necessary resources and expertise to administer the revised version of Transfer Pricing Guidelines. Of course, it is also very costly or even impossible for the developed countries to search for really precise and genuine comparables. Although the G20 Development Working Group promised to “help the developing countries to deal with the problem of lack of comparables,” it is not clear whether a simple, effective win-win solution on pricing method will be made available in the near future. We don't wish to see any form of one-sided solutions, including purely subjective discretion favored by tax authorities, and purely notational transfer pricing method favored by MNEs.

As indicated earlier, the principle of separate independent entity and the principle of arm's length are at most beautiful legal fictions, which do not actually exist in the commercial reality. In fact, even the terms of transactions between independent and unrelated parties are not necessarily fair and reasonable, if the two parties do not have equivalent negotiation powers on a level playing field. As the comparability analysis is not practical and feasible as anticipated, we propose the formulary apportionment system based on the single unitary entity principle. In other words, MNE group will be treated as

single and unitary entity, and all intra-group transactions will be disregarded. Compared with the approach of separate entity, this route will be more simple, direct, and effective in addressing the BEPS concerns arising from intra-group related party transactions.

In fact, the OECD has already noticed the proposed alternative income allocation systems, including formula based systems. Unfortunately, the OECD finally refused to replace the current transfer pricing system. The reason is not the flaw of the proposed alternatives, but the familiarity with the current approach and the reluctance to switch to new approach by launching ambitious reform. In the words of the OECD, “the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalization.”

As early as 2013, the OECD claimed that “there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioral changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach”.

Although the US and some other states stubbornly defended and insisted on the dysfunctional arm’s length principle for transfer pricing adjustments and resisted alternatives, there is no credible evidence to indicate that 34 OECD members have reached clear and concrete agreement on unanimously opposing the system of formulary apportionment of profits based on the single entity principle. Moreover, there are no scientific research findings to indicate that the single entity approach has more weakness and less strength than separate entity approach.

To offer easy, certain, clear and predictable solutions to the BEPS concerns arising from transfer pricing, formulary apportionment methodology should be adopted, and the allocation of assets, payroll, sales and other factors need to be restructured and weighted. This will better allocate the tax base of MNE according to the location where economic activities and value creation take place. Needless to say, to make the formulary apportionment approach successful and sustainable, the principle of separate independent entity needs to be replaced by the principle of single unitary entity.

M. The Limits of Action 11

As “significant data limitations severely constrain economic analyses of the scale and economic impact of BEPS,” improving the availability and analysis methodologies of data on BEPS is critical for the implementation of the BEPS project. The original title of Action 11 was “Establish methodologies to collect and analyze data on BEPS and the actions to address it.” This

action aims at “develop[ing] recommendations regarding indicators of the scale and economic impact of BEPS and ensuring that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.”

The Action 11 report slightly adjusted the original title to “Measuring and Monitoring BEPS.” For data collection, the report defines BEPS as “arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all.”

The report constructed a dashboard of six BEPS indicators, including (1) the concentration of foreign direct investment (FDI) relative to GDP; (2) high profit rates of low-taxed affiliates of top global MNEs; (3) high profit rates of MNE affiliates in lower-tax locations; (4) effective tax rates of large MNE affiliates relative to non-MNE entities with similar characteristics; (5) concentration of royalty receipts relative to research and development spending; and (6) interest expense to income ratios of MNE affiliates in countries with above-average statutory tax rates. This dashboard provides strong signals that BEPS exists and suggests it has been increasing over time.

The research also finds significant non-fiscal economic distortions arising from BEPS, and proposes recommendations for taking better advantage of available tax data and improving analyses to support the monitoring of BEPS in the future, including through analytical tools to assist countries to evaluate the fiscal effects of BEPS and impact of BEPS countermeasures for their countries. Going forward, enhancing the economic analysis and monitoring of BEPS will require countries to improve the collection, compilation and analysis of data.

Although the final report of Action 11 conducted in-depth research on measuring and monitoring BEPS and offered recommendations on collecting and disseminating data to facilitate analysis of BEPS, there are some weaknesses. For instance, this report emphasizes that analysis of BEPS should not rely on any one indicator, and requires that the indicators should be viewed collectively to determine the scale and scope of BEPS. It is impossible for each of the six indicators to have equal weight in each and every jurisdiction. Unfortunately, this report has not offered a scientific and reliable formula of differentiating the separate weights of the six indicators suitable for the jurisdictions.

This report offers recommendations concerning data collection and dissemination to facilitate the analysis of BEPS for participating countries, and proposes to collect new data under Action 5, 12 and 13. However, this report has not proposed publishing the CbCRs worldwide to make the transfer pricing information available to all countries and the public. We live in a society of big data. Unfortunately, this report has not offered satisfactory big data solution for the countries to use in a digital society. We believe that it is necessary to develop a big data deployment strategy, and set up a global

BEPS data bank as the basic platform for collecting, exchanging, disseminating and analyzing of BEPS information all over the world.

N. The Limits of Action 12

The availability of timely, targeted and comprehensive information on aggressive tax planning strategies is extremely essential to enable governments to quickly identify risk areas. However, such information is often unavailable to tax administrations. The lack of such information is one of the main challenges faced by tax authorities worldwide. While audits remain a key source of relevant information, they suffer from a number of constraints as tools for the early detection of aggressive tax planning techniques.

The mission of Action 12 is to require taxpayers to disclose their aggressive tax planning arrangements by developing recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

The Action 12 report provides a modular framework of guidance for the countries to design and improve a regime that guarantees early information on aggressive or abusive tax planning schemes and their users. . . . The recommendations provide the necessary flexibility to balance a country's need for better and [timelier] information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and [cooperation] between tax administrations.

The purpose of Action 12 report is to enable the governments to have early access to information, and to quickly respond to systemic tax risks through informed risk assessment, audits or changes to legislation or tax policies.

However, the recommendations on requirements for taxpayers to disclose their aggressive tax planning arrangements are not minimum standards. Countries are free to decide whether or not to introduce mandatory disclosure regimes. Currently, only seven countries have mandatory disclosure regime in their domestic legislation. As the recommendations are not universally mandatory, it is easy for the MNEs to avoid the mandatory requirements in certain jurisdictions by incorporation in another jurisdiction without such requirements. It is also possible for the jurisdictions to join the race to the bottom by refusing to adopt mandatory disclosure regime. In our opinion, mandatory disclosure rules should be introduced to each and every jurisdiction, and the liabilities for violation of the mandatory disclosure rules should be designed and enforced in fair and transparent manner.

O. The Limits of Action 13

For the administration of transfer pricing, the G20 and OECD carefully considered the asymmetry of information between taxpayers and tax administrations.¹⁰⁰ This asymmetry could “undermine[] the administration of the arm’s length principle and enhance opportunities for BEPS.”¹⁰¹ In many countries, tax administrations do not have a whole picture of a taxpayer’s global value chain.¹⁰² Divergences between approaches to transfer pricing documentation requirements could also increase the compliance costs for businesses.¹⁰³ For these reasons, “it is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services and other transactions is made available to the tax administration.”¹⁰⁴

Although MNEs demand transparency of tax law administration from the tax authorities, they are reluctant to be transparent to the tax authorities. BEPS opportunities are less likely to survive in a transparent international tax environment. Better-coordinated transfer pricing documentation can increase the quality of information provided to tax administrations and reduce the compliance burden on MNEs.¹⁰⁵ Therefore, it is urgent to “develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.”¹⁰⁶ In this context, the MNEs should provide “all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.”¹⁰⁷

The Action 13 report outlines “a three-tiered standardized approach to transfer pricing documentation, including a minimum standard on [CbCR].” The OECD summarizes the approach as follows:

First, the guidance on transfer pricing documentation requires [MNEs] to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a “master file” that is to be available to all relevant tax administrations. Second, it requires that detailed transactional transfer pricing documentation be provided in a “local file” specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions. Third, large MNEs

¹⁰⁰ See OECD, Action Plan on Base Erosion and Profit Shifting, *supra* note 97, at 22.

¹⁰¹ *Id.*

¹⁰² See *id.*

¹⁰³ See *id.*

¹⁰⁴ *Id.* at 23.

¹⁰⁵ See OECD, BEPS Project, Explanatory Statement, *supra* note 97, at 17.

¹⁰⁶ OECD, Action Plan on Base Erosion and Profit Shifting, *supra* note 97, at 23.

¹⁰⁷ *Id.*

are required to file a CbCR that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued and other indicators of economic activities. The large MNEs refer to those with annual consolidated group revenue equal to or exceeding EUR 750 million. CbCRs should be filed in the ultimate parent entity's jurisdiction and shared automatically through government-to-government exchange of information. In limited circumstances, secondary mechanisms, including local filing can be used as a backup. An agreed implementation plan will ensure that information is provided to the tax administration in a timely manner, that confidentiality of the reported information is preserved and that the CbCRs are used appropriately.

Regarding implementation, the OECD recommended that the first CbCRs be required to be filed for MNEs' fiscal years starting from January 1, 2016, while acknowledging that some jurisdictions may need time to transform the reporting system into their domestic legislation.

For the first time, the three documentation tiers will require taxpayers to disclose "consistent transfer pricing positions, and will provide tax administrations with useful information" of the entire picture of MNE operation, and enable them to assess transfer pricing risks and make determinations about whether, where, when, and how audit resources can most effectively be deployed. By standardizing transfer pricing documentation across countries and limiting the need for multiple filings of CbCRs, "MNEs will also see the benefits in terms of a more limited compliance burden." According to the OECD, "anticipation of this reporting system has already begun to discourage aggressive tax planning."

The annual CbCR is the most important measure in Action 13 to ensure the minimum transparency of transfer pricing. However, there are some limits to it.

First, the threshold of EUR 750 million of annual consolidated group revenue is unreasonably high for the major MNEs in developing countries, although this threshold is tailor made for the need of developed countries. Such threshold will exclude many large MNEs from the CbCR requirement, and deprive developing countries of the access to the information of MNEs below the threshold. In fact, many large MNEs have annual consolidated group revenue less than EUR 750 million. Needless to say, some large MNEs will be motivated enough to manipulate their group revenue to a level of less than EUR 750 million. In our opinion, all MNEs should be subject to CbCR requirement.

Second, all of the transfer pricing documents are only required to be submitted to the tax authorities, but not to the public and civil society organizations. It seems that the philosophy of this institutional arrangement is to preserve the confidentiality of the information and to ensure the appropriate

use by the government. However, the commercial confidentiality is not strong enough to defeat the right of the public to information of BEPS. The relevant stakeholders and the public need to have access to the MNEs' transfer pricing documentation. The reason is very simple, BEPS could hurt other taxpayers and stakeholders in relevant jurisdictions. We believe that the BEPS concerns will be more effectively addressed with the active and informed participation of the stakeholders and the public based on disclosed transfer pricing. Under the public pressure and support, the domestic legislatures and tax authorities will be more diligent and competent in tackling the BEPS issues. Of course, a high level of transparency will also benefit the MNEs, as it will significantly reduce compliance burden, and will improve their public image of credibility in terms of BEPS concerns.

Third, the CbCRs are only required to file with the tax authority of the MNE's ultimate parent entity's jurisdiction, instead of all the tax authorities of the jurisdictions where the MNEs have taxable business presences. To ensure rapid availability of CbCRs, we urge the CbCRs to be shared automatically and simultaneously between and among all the interested jurisdictions which have good reason to believe the existence of taxable presences by MNEs. Of course, if the MNEs' transfer pricing documentation is made available to the public, the double standards will be totally rooted out.

Fourth, although the content of the CbCRs covers the major issues of transfer pricing, it is difficult to exhaust all the data needed by tax authorities to assess the BEPS concerns arising from transfer pricing. Necessary data should be added into the CbCRs on a regular basis.

P. The Limits of Action 14

The interpretation and application of novel BEPS rules could inevitably introduce elements of uncertainty. To minimize and control the uncertain outcomes and to remove double taxation as an obstacle to cross-border trade and investment, it is necessary to "develop solutions to address obstacles that prevent countries from solving treaty-related disputes under [the mutual agreement procedure (MAP)], including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases."

The Action 14 report outlines "a minimum standard with respect to the resolution of treaty-related disputes[, including] . . . a strong political commitment to the effective and timely resolution of disputes through the [MAP]. The Forum on Tax Administration (FTA) will continue its efforts to improve MAP through its recently established MAP Forum. According to the report:

The commitment also includes the establishment of an effective monitoring mechanism to ensure the minimum standard is met and countries make further progress to rapidly resolve disputes. In ad-

dition, a large group of countries has committed to quickly adopt mandatory and binding arbitration in their bilateral tax treaties. . . . It is expected that rapid implementation of this commitment will be achieved through the inclusion of arbitration as an optional provision in the multilateral instrument to be developed to implement the BEPS treaty-related measures.

MAP is the ideal win-win platform to effectively resolve treaty-related disputes between two countries. However, the MAP does not always work effectively, because any party in the dispute could block the MAP unilaterally.

Unfortunately, the Action 14 has not offered remedies for the deadlock of MAP. Although mandatory arbitration is the suitable remedy for the MAP deadlock, Action 14 has not proposed the minimum standard of mandatory arbitration. At most, this Action encourages the inclusion of arbitration as an optional provision in the multilateral instruments. As some jurisdictions might exclude the arbitration clause in their bilateral and multilateral tax treaties, mandatory binding arbitration should be included in all bilateral and multilateral tax treaties.

It is important to note that mandatory binding arbitration should be supported by clear and predictable substantive rules, due process of law, and impartial and competent arbitrators. In our opinion, each party may freely appoint one arbitrator. If the two parties are unable to collaborate in choosing the chief arbitrator, the arbitration body may appoint the chief arbitrator.

Q. The Limits of Action 15

The success of the BEPS project depends on a swift implementation of the measures. According to the OECD, “Some actions of the BEPS project have resulted in recommendations regarding domestic law provisions, as well as . . . changes to the Commentary to the OECD Model Tax Convention and the Transfer Pricing Guidelines. However, changes to the OECD Model Tax Convention are not directly effective without amendments to bilateral tax treaties.” It would be very time-consuming and uncertain to amend the more than 3,000 bilateral treaties currently in existence on a treaty-by-treaty basis.

The Action 15 report explores the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties. It concludes:

[A] multilateral instrument is desirable and feasible, and . . . negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate has been developed for an ad-hoc group, open to the participation of all countries, to develop the multilateral instrument and open it for signature in 2016. So far, about 90 countries are participating in the work.

The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures by drafting a multilateral instrument. Although this Action represents a significant step towards multilateralism, the proposed multilateral instrument has not been provided for debate. To make the multilateral instrument coherent, inclusive and feasible, the developing process should be open and transparent. Namely, the negotiations should be really on equal footing, the proposals should be published, all relevant stakeholders should be heard, and public debate should be meaningful.

However, participation in developing the multilateral instrument is voluntary, and participating countries are not obligated to sign it. This liberal approach intends to encourage more countries to participate in the development process. But it is uncertain how many countries will sign it in the end. If the participating countries are obligated to sign the multilateral instrument, many countries will be not interested in participation. This dilemma reflects inadequate multilateralism represented by the OECD. Therefore, we believe that UN is the most qualified multilateral platform to develop a universally binding instrument to address BEPS.

IV. RECONSIDERING THE INTERNATIONAL TAX REGIME: A MULTILATERAL SOLUTION

It is time to re-evaluate the benefits principle. Most of the current issues can be solved by taxing passive income primarily at source and active income primarily at residence. For passive income, the number of source jurisdictions is much smaller than residence jurisdictions. Because most individuals are relatively risk averse, portfolio investment flows overwhelmingly to a small number of jurisdictions: the United States, European Union, and Japan. If these jurisdictions could impose a withholding tax on all outbound payments, most of the problem of taxing passive income could be resolved. Crucially, money cannot stay in tax havens and earn decent rates of return, so the cooperation of tax havens is not needed, unlike in the case of the MAATM. This approach would address the Sam Wyly problem because all of the income of the trusts would be currently taxed where it is invested.¹⁰⁸

For active income, about 90% of large multinationals are headquartered in G20 countries, and none of those countries have a corporate tax rate below 20%. If the G20 countries taxed their MNEs based on where the headquarters are located on a current basis and restricted the ability to move the headquarters, the problem of taxing active income would be largely resolved

¹⁰⁸ While FATCA takes care of the Wyly problem to some extent, it can be avoided by using banks that have no U.S. exposure. MAATM is unlikely to solve this issue because Wyly and tax evaders like him could place the trusts in a non-cooperating jurisdiction.

as well. This approach would address the Apple and Caterpillar problems because their offshore income would be subject to current U.S. taxation.¹⁰⁹

The precedent for this approach is the adoption of the CFC rules.¹¹⁰ Before 1961, no country taxed the foreign source income of subsidiaries of its MNEs because residence countries believed they lacked both source and residence jurisdiction over foreign source income of foreign corporations. However, in 1961 the Kennedy Administration proposed taxing all income of CFCs by using a deemed dividend mechanism that was copied from the Foreign Person Holding Company (FPHC) rules.¹¹¹

While this proposal was rejected, the resulting compromise (Subpart F) aimed at taxing income of CFCs that was unlikely to be taxed by source countries either because it was mobile and could be earned anywhere (passive income) or because it was structured to be earned in low-tax jurisdictions (base company income). Initially, the adoption of Subpart F seemed to have put U.S.-based MNEs at a competitive disadvantage because no other country had such rules. But gradually the picture changed. The United States was followed by Germany (1972), Canada (1975), Japan (1978), France (1980), the United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Africa (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008). Many other countries, such as India, are considering adopting such rules. As a result, most of our trading partners now have CFC rules.

Moreover, the later adopters improved the U.S. approach in two principal ways. First, they rejected the deemed dividend mechanism, which can lead to many unforeseen complications, in favor of taxing the shareholders on a pass-through basis. Second, they generally explicitly incorporate the effective foreign tax rate into the determination whether a CFC will be subject to current tax. This approach is better than the U.S. rule that is based solely on the type of income because, after 1980, it became quite easy to earn active income that is not subject to tax.¹¹²

The result is that the CFCs of EU-based MNEs are generally subject to tax at similar or higher rates than U.S.-based MNEs¹¹³ despite the non-taxation of dividends from active income under territoriality. This outcome is a classic example of constructive unilateralism. The United States led and

¹⁰⁹ Some of the BEPS action items (8–10) seek to address the types of profit shifting engaged in by Apple and Caterpillar, but they are not very effective.

¹¹⁰ We do not think unilateral action is possible on the evasion front, but as explained above coordinated withholding taxes by the United States and European Union should work.

¹¹¹ Reuven S. Avi-Yonah, *The Deemed Dividend Problem*, 4 J. TAXATION GLOBAL TRANS-ACTIONS 33 (2004).

¹¹² See Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, *supra* note 2, at 1577.

¹¹³ See Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals* 5 (Law & Economics Working Paper 41, 2011).

others followed, and the end result is that most MNEs are subject to similar effective tax rates, with no competitive disadvantage or advantage.¹¹⁴ The result is a world in which there is much less double non-taxation than in the absence of CFC rules.

Unfortunately, in the United States, Subpart F has been critically undermined by the adoption of check-the-box elections and the CFC-to-CFC exception, resulting in \$2 trillion of low-taxed accumulated earnings offshore by U.S.-based MNEs.¹¹⁵ This accumulation cannot happen in other countries with tougher CFC rules, and is a major part of the explanation why despite rampant tax competition most OECD members did not see the sharp drops in overall corporate tax revenues that are seen in developing countries.

The main argument in favor of territoriality (exempting dividends paid by U.S. CFCs from tax upon receipt by their parents) is the lock-out problem. About \$2 trillion in low-taxed foreign source income are in CFCs that cannot repatriate the income because of the 35% tax on repatriations and the absence of foreign tax credits.¹¹⁶ We know this is a real problem because of the effectiveness of the 2004–05 amnesty and because of various attempts by MNEs to avoid the rule (via inversions, “killer Bs,” and short-term loans).¹¹⁷

But it is less clear that the solution is a participation exemption. Why not abolish deferral and let the dividends flow back tax-free? This is a good opportunity for constructive unilateralism. No G20 country has a corporate tax rate below 20%. If the United States reduced the corporate tax to, say, 28%, and, at the same time, abolished deferral, other G20 countries, such as Germany or France, would likely follow suit.¹¹⁸ These countries need the extra revenue more than the United States, and concerns about competitiveness would be alleviated by the United States making the first move, like they were in the original CFC context.

Other G20 countries have more effective CFC rules than the United States, and those CFC rules already act as a de facto worldwide system with a minimum tax. If the foreign tax is below a set level (e.g., 25% in Germany or 20% in Japan), the CFC rules kick in to tax the income. The result is that there is much less lock out because most low-taxed foreign income is taxed by the CFC rules. The change to a worldwide system would be much less radical than usually envisaged. This is why for both the United Kingdom and

¹¹⁴ *Id.*

¹¹⁵ Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 81 TAX NOTES 3 (2016).

¹¹⁶ *Id.*

¹¹⁷ See STAFF OF S. COMM. ON PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, 112TH CONG., REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTATIONALS 5 (Comm. Print 2011).

¹¹⁸ 28% is the rate in which a revenue neutral corporate tax reform can be achieved if we abolished the three major corporate tax expenditures (deferral, accelerated depreciation, and the domestic manufacturing deduction). See MOLLY F. SHERLOCK & MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R43060, TAX REFORM IN THE 144TH CONGRESS: AN OVERVIEW OF PROPOSALS 3 (2016), <https://fas.org/sgp/crs/misc/R43060.pdf>.

Japan, there was no significant increase in repatriations after they adopted territoriality in 2009.¹¹⁹

But should the United States not adopt a minimum but lower tax on foreign source income for competitiveness reasons? This is what both the Obama and Congressman David Camp proposals envisage. Obama suggests a 28% corporate tax on domestic profits and a 19% tax on foreign income, while Camp proposed a 25% tax on domestic profits and a 12.5-15% tax on foreign income.

The problem, of course, is that such a gap would still encourage U.S.-based MNEs to shift profits overseas, with no repatriation tax to deter them. The United States can always fall back to such a system if needed. But, for now, we suggest taxing all income at the same rate, and if that rate has to be lower, so be it. As long as it is above 20% we do not think we will be outside G20 norms, and a rate in the 20% to 25% range will not put our MNEs at a significant competitive disadvantage given the effective minimum tax imposed by the CFC rules of our trading partners.

It is impossible to predict what will happen, but the history described above suggests that there is a good chance that other G20 countries will follow us if we abolish deferral at a lower rate.¹²⁰ If that happens, all the usual objections to worldwide taxation (competitiveness, inversions, and the various neutralities) lose their force. We do not think there is a significant risk involved in this move, and the potential upside is quite large.

CONCLUSION

The benefits principle should be reconsidered in light of the reality of globalization. We should tax passive income primarily at source and active income primarily at residence. This approach will enable the large economies to address both individual tax evasion and corporate tax avoidance. These problems must be addressed if we are to continue to maintain and expand the benefits of globalization. The U.S. public support of globalization hinges on the existence of a social insurance safety net. If the rich and large corporations are not perceived to pay their fair share, the public's willingness to pay tax to support this safety net is eroded. Once a culture of not

¹¹⁹ Stephen E. Shay, J. Clifton Fleming & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi* 141 TAX NOTES 173 (2013).

¹²⁰ See the most recent proposal of the EU Commission to tax currently CFC profits that are subject to an effective tax rate below 40% of the residence country rate if over 50% of the CFC's income is either passive or derived from sales to related parties. Council of the European Union, 14544/15, art. 9 (Dec. 2, 2015), <http://data.consilium.europa.eu/doc/document/ST-14544-2015-INIT/en/pdf>; see also European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, COM (2016) 26 final; European Commission, *Anti Tax Avoidance Package*, COM (2016) 23 final. But see Christian Oliver & Jim Brunnsden, *US blasts Brussels over tax probe bias*, FIN. TIMES (Jan. 29, 2016), <http://www.ft.com/cms/s/0/c63db5c8-c6b1-11e5-808f-8231cd71622e.html#axzz4CRV4Xfta>. Hopefully, the next U.S. Administration will take a more cooperative attitude.

paying taxes is established it is very hard to change. We need to do something about both tax evasion and avoidance before it is too late.

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A Global Treaty Override? The New OECD Multilateral Tax Instrument and Its Limits

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A GLOBAL TREATY OVERRIDE? THE NEW OECD MULTILATERAL TAX INSTRUMENT AND ITS LIMITS

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1. INTRODUCTION

On June 7, 2017, seventy-six countries met in Paris for the official signing of a new multilateral tax instrument (MLI).¹ The text and commentary of the MLI were published in November 2016 by the Organization for Economic Cooperation and Development (OECD). The OECD stated:

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS will implement minimum standards to counter treaty abuse and to improve dispute resolution mechanisms while providing flexibility to accommodate specific tax treaty policies. It will also allow governments to strengthen their tax treaties with other tax treaty measures developed in the OECD/G20 BEPS Project. . . .

The new instrument will transpose results from the OECD/G20 Base Erosion and Profit Shifting Project (BEPS) into more than 2,000 tax treaties worldwide.²

* Irwin I. Cohn Professor of Law, the University of Michigan. We would like to thank Kim Brooks, Nir Fishbien, Pasquale Pistone, Omri Marian, Gianluca Mazzoni, Steven Ratner, Richard Reinhold, Fadi Shaheen, Victor Thuronyi, and participants in the October, 2017 MJIL conference on the MLI for their very helpful comments.

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1. *Ground-breaking multilateral BEPS convention signed at OECD will close loopholes in thousands of tax treaties worldwide*, Org. for Econ. Co-Operation and Dev. [OECD] (June 7, 2017), <http://www.oecd.org/tax/ground-breaking-multilateral-beps-convention-will-close-tax-treaty-loopholes.htm>; see OECD, SIGNATORIES AND PARTIES TO THE MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHARING (Dec. 20, 2017), <http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf> (listing the countries that have signed the treaty, plus countries that intend to sign soon). The signatories include the major OECD and EU members (except for the U.S.), China and India, as well as many important treaty shopping jurisdictions (e.g., the Netherlands and Mauritius) and tax havens (e.g., Singapore and Hong Kong). As of October 2017, 71 jurisdictions have signed the MLI but only one (Austria) has ratified it; four more ratifications are needed for the MLI to enter into force, which is expected to occur by early 2018.

2. *Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system*, OECD (Nov. 24, 2016), <http://www.oecd.org/tax/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm>.

The OECD went on to explain that:

[t]he multilateral convention was developed over the past year, via negotiations involving more than 100 jurisdictions including OECD member countries, G20 countries and other developed and developing countries, under a mandate delivered by G20 Finance Ministers and Central Bank Governors at their February 2015 meeting . . . The OECD will be the depositary of the multilateral instrument and will support governments in the process of its signature, ratification and implementation.³

There is no question that this event represents a milestone in the evolution of the international tax regime (ITR).⁴ But it also raises important questions about the function of tax treaties in the twenty-first century and whether other steps can be taken to improve the tax treaty network beyond the MLI.

To appreciate the importance of the MLI, it is useful to take a step back and consider its historical significance. Bilateral tax treaties were first negotiated in the nineteenth century,⁵ but their importance grew after World War I because of increased income tax rates and the risk of taxation by both country of residence and country that sources the income.⁶ The result was the publication of the first model bilateral tax treaty under the auspices of the League of Nations in 1928,⁷ followed by the Mexico (1943)⁸ and London (1946)⁹ models. The OECD took over from the League after World War II and published its own bilateral model (based on the London model) in 1963,¹⁰ while the UN published a bilateral model based on the Mexico model in 1980.¹¹ These models in turn inspired a network of over three thousand bilateral tax treaties that form the bul-

3. *Id.*

4. See generally REUVEN AVI-YONAH, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* (2015) (discussing the international tax regime). For the importance of the MLI as a turning point in the evolution of the international tax regime, see A *GLOBAL ANALYSIS OF TAX TREATY DISPUTES* (Eduardo Baistrocchi ed., 2017).

5. For the history of the pre-World War I bilateral tax treaties, see, e.g., Sunita Jogarajan, *Prelude to the International Tax Treaty Network: 1815–1914 Early Tax Treaties and the Conditions for Action*, 31 *OXFORD J. OF LEGAL STUD.* 679 (2011). The first tax treaty was concluded between Prussia and Saxony in 1869. *Id.* at 696.

6. Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 *COLUM. J. TAX. L.* 1, 13 (2013).

7. See *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562M.178 1928 II (1928).

8. *Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion*, League of Nations Doc. C.2.M.2. 1945 II A (1945).

9. *Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion*, League of Nations Doc. C.88.M.88. 1946 II A. (1946).

10. OECD, *Draft double taxation convention on income and capital: report of the O.E.C.D. Fiscal Committee* (1963).

11. U.N. DEP'T OF ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. DOC. ST/ESA/102,

wark of the ITR.¹² About eighty percent of the words of any two tax treaties are identical and derive from the OECD or UN models (which are themselves over eighty percent identical to one another).¹³

From the beginning, the League of Nations was interested in the possibility of negotiating a multilateral tax treaty, but it concluded that the differences among the tax laws of different states were too vast to allow for a successful negotiation.¹⁴ Subsequent efforts to negotiate multilateral tax treaties also failed.¹⁵ Most recently, the European Court of Justice refused to apply its freedom of movement of capital jurisprudence to force a harmonization of withholding tax rates among treaties within the EU.¹⁶

However, in the academic world as well as in practice, there has been increasing recognition of the need for a multilateral tax treaty.¹⁷ There are three reasons why a multilateral tax treaty makes more sense than a network of bilateral tax treaties. First, the rise of the General Agreement on Tariffs and Trade (GATT), and then the WTO after World War II, has shown that multilateral treaties governing important areas of international economic law are feasible if space is allowed for reservations (i.e., allowing countries to opt out of specific provisions). Second, there has been increas-

U.N. Sales No. E.80.XVI.3 (1980). United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations, 1980).

12. REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL REGIME* 5 (2007).

13. Reuven Avi-Yonah, *Double Tax Treaties: An Introduction*, in *THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT* 99 (Karl P. Sauvant & Lisa E. Sachs, eds., 2009); Elliott Ash and Omri Marian, *The Making of International Tax Law: Empirical Evidence from Natural Language Processing*, NTA Annual Meeting, Philadelphia, November 9, 2017.

14. Eran Lempert, *Crossing the Barrier: Towards a Multilateral Tax Treaty* (2009) (unpublished J.S.D. dissertation, New York University) (on file with authors).

15. *Id.* For an early appreciation of the need for a multilateral treaty, see Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 *PROC. OF THE ANN. CONF. ON TAX'N UNDER THE AUSPICES OF THE NAT'L TAX ASS'N*, 192-199 (1929) ("Now, in the long run, whatever solutions are adopted by different pairs of nations, it is probable that Nation A in concluding a bi-lateral convention with Nation B will adopt some solution different from that which it might adopt in a similar treaty with Nation X. And if this piece-meal bargaining goes on for twenty years or more, as it is likely to go on, it may possibly result in a tangle of conflicting solutions applicable to the nationals of different countries, which will be highly complicated and highly mysterious, and about as bad as the situation that now exists. In short, there is in my mind, looking to the 'longer future, the strongest reason for the adoption of one uniform solution, if we could get it, or the settlement of this problem by a multilateral convention, in which a large group of nations would adopt the same solutions for the detailed problems which have to be set.").

16. Case C-376/03, *D v. Inspecteur van Belastingdienst*, 2005 E.C.R. I-05821.

17. See, e.g., Kim Brooks, *The Potential of Multilateral Tax Treaties*, in *TAX TREATIES: BUILDING BRIDGES BETWEEN LAW AND ECONOMICS* (Michael Lang et al. eds., 2010); Jung-hong Kim, *A New Age of Multilateralism in International Taxation?*, 21 *SEOUL TAX L. REV.* 227 (2015); Richard L. Reinhold, *Some Things That Multilateral Tax Treaties Might Usefully Do*, 57 *TAX LAW* 661 (2004); Thomas Rixen, *Bilateralism or Multilateralism? The Political Economy of Avoiding International Double Taxation*, 16 *EUR. J. OF INT'L REL.* 589 (2010); Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 *BROOK. J. INT'L L.* 1641 (2001).

ing convergence in the language of the various tax treaties; in particular, the OECD and UN models have become increasingly similar over time.¹⁸ Third, with globalization, tax competition treaty shopping (using treaties to obtain advantages for non-treaty country residents)¹⁹ and “triangular situations” (problems arising from treaty residents doing business in third countries in ways that affect the treaty but are not covered by it) have become far more common.²⁰

The main obstacle to a multilateral tax treaty has always been that investment flows vary by each pair of countries; therefore, appropriate withholding tax rates vary as well.²¹ That is the main reason for the remaining differences between the OECD and UN models, because flows between developed countries are more reciprocal than flows between developed and developing countries. But even that is changing, as more developing countries become capital exporters as well as importers.²² In addition, it has for some time been recognized that it may be possible to negotiate a multilateral treaty but leave the withholding tax rates to be settled by bilateral negotiation, as the UN model does.²³

The new OECD MLI represents the culmination of this line of thinking. It is not a full-fledged multilateral tax convention covering all the areas that are usually covered by bilateral tax treaties. Instead, it is a global consensual treaty override designed to apply the results of Base Erosion and Profit Shifting (BEPS) simultaneously to all the tax treaties where the countries involved agree. The MLI is implemented by countries signing and ratifying it according to their usual constitutional norms and then depositing the ratification with the OECD.²⁴ Upon ratification, the provisions of the MLI apply to modify the relevant provisions of the bilateral treaties of each depositing country with other depositing countries that

18. REUVEN SHLOMO AVI-YONAH, NICOLA SARTORI & OMRI MARIAN, *GLOBAL PERSPECTIVES ON INCOME TAXATION LAW* 150 (2011).

19. Reuven Avi-Yonah & C. H. Panayi, *Rethinking Treaty Shopping: Lessons for the European Union*, in *TAX TREATIES: BUILDING BRIDGES BETWEEN LAW AND ECONOMICS* 21 (Michael Lang et al. eds., 2010).

20. EMILY FETT, *TRIANGULAR CASES: THE APPLICATION OF BILATERAL INCOME TAX TREATIES IN MULTILATERAL SITUATIONS* (2014).

21. *Withholding Tax Rates 2017*, DELOITTE (Mar. 2017), <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-withholding-tax-rates.pdf>

22. For an overview of the general trends of participation of developing countries in world trade, see Comm. on Trade and Dev., *Participation of developing countries in World Trade: Overview of major trends and underlying factors*, WTO Doc. WT/COMTD/W/15 (Aug. 16, 1996).

23. See Lempert, *supra* note 14.

24. Org. for Econ. Co-Operation and Dev. [OECD], *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, art. 27 (June 7, 2017), <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> [hereinafter OECD 2017 MLI]; OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, ¶ 263, <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> [hereinafter OECD MLI Explanatory Statement].

they both designate as “covered tax agreements,” unless there is a reservation (which is not allowed in some cases involving minimum BEPS standards).²⁵

One of those minimum standards that has been agreed to by all seventy-one signatories of the MLI is the “primary purpose test” (PPT), which states:

A [treaty] benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of Covered Tax Agreement.²⁶

The PPT, which was adopted over strenuous opposition from the United States, may influence treaty interpretation beyond the signatories of the MLI. In particular, the reference to the “object and purpose” of the tax treaty should be interpreted in light of the new preamble to the OECD model, which clarifies that the object and purpose of tax treaties is to prevent both double taxation and double non-taxation.²⁷ This adoption of the “single tax principle” can have wide-ranging ramifications for the interpretation of tax treaties, and may even impact the United States as a non-signatory because the prevention of double non-taxation is also incorporated into the 2016 U.S. model.²⁸

In addition, the new OECD MLI has a wide-ranging dispute resolution mechanism including mandatory arbitration.²⁹ Mandatory arbitration has recently been introduced into the OECD and U.S. models,³⁰ but it is still lacking in the UN model and most actual treaties. The effect of including it in the MLI may be to force binding arbitration on many existing treaties, which is likely to prove controversial.³¹

25. OECD MLI Explanatory Statement, *supra* note 24, ¶ 280.

26. OECD 2017 MLI, *supra* note 24, art. 7(1).

27. OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report* 92 (Oct. 5, 2015), <http://dx.doi.org/10.1787/9789264241695-en> (“(State A) and (State B) . . . intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance”).

28. Reuven S. Avi-Yonah, *Full Circle: The Single Tax Principle, BEPS, and the New US Model*, 1 GLOBAL TAXATION 12 (2016).

29. OECD 2017 MLI, *supra* note 24, arts. 18–26.

30. U.S. DEP’T OF TREAS., UNITED STATES MODEL INCOME TAX CONVENTION, art. 25, ¶ 6–10, <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf>; OECD, *Model Tax Convention on Income and on Capital*, art. 25 (2008), <http://www.oecd.org/tax/treaties/42219418.pdf>.

31. Ehab Farah, *Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem*, 9 FLA. TAX REV. 703 (2008).

This article will proceed as follows. Section 2 summarizes the main provisions of the MLI. Section 3 discusses the purpose of tax treaties in the twenty-first century, because it can be argued that they are less necessary under conditions of tax competition. Section 4 raises the question whether tax treaties can be improved short of a full-fledged multilateral tax treaty by inserting a most favored nation (MFN) provision similar to those found in bilateral investment treaties. Such an MFN provision operates over time to create a de facto multilateral treaty without the negotiation of one. Section 5 concludes this article.

2. THE NEW OECD MULTILATERAL INSTRUMENT (NEW MLI)

2.1 *The Mission of the MLI*

The mission of the MLI is described in the preamble as follows:

[T]o ensure swift, co-ordinated and consistent implementation of the treaty-related BEPS measures in a multilateral context . . . to ensure that existing agreements for the avoidance of double taxation on income are interpreted to eliminate double taxation with respect to the taxes covered by those agreements without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in those agreements for the indirect benefit of residents of third jurisdictions) . . . to implement agreed changes in a synchronised and efficient manner across the network of existing agreements for the avoidance of double taxation on income without the need to bilaterally renegotiate each such agreement.³²

In short, the overall mission or purpose of the MLI is to implement tax-treaty-related BEPS measures in a swift, coordinated, and consistent manner across the network of existing tax treaties (Covered Tax Agreements) in a multilateral context without bilateral renegotiation of each agreement.

Although tax treaties have played an important role in eliminating double taxation and facilitating globalization of liberal investment and trade in past decades, the loopholes and mismatches in existing treaties are one of the root causes of widespread unregulated BEPS opportunism.³³ As a comprehensive response, BEPS Actions 2, 6, 7 and 14 have developed a series of treaty-related BEPS measures. Action 2 report aims at neutralizing the effects of hybrid mismatch arrangements.³⁴ Action 6 report aims at preventing the granting of treaty benefits in inappropriate circumstances.³⁵ Action 7 report aims at preventing the artificial avoid-

32. OECD 2017 MLI, *supra* note 24, preamble.

33. OECD, *Action Plan on Base Erosion and Profit Shifting* 13 (July 19, 2013), <http://dx.doi.org/10.1787/9789264202719-en>.

34. See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* (Oct.5, 2015), <http://dx.doi.org/10.1787/9789264241138-en>.

35. See OECD, *supra* note 27.

ance of Permanent Establishment (PE) (physical presence) status.³⁶ Action 14 report aims at making dispute resolution mechanisms more effective.³⁷

Beyond reflecting the BEPS measures in articles 3 through 26, the MLI further reinforces the single tax principle by “recognizing the importance of ensuring that profits are taxed where substantive economic activities generating the profits are carried out and where value is created,” and clarifying the position to eliminate both double taxation and non-taxation or reduced taxation through tax evasion or avoidance.³⁸

Multilateral problems demand multilateral solutions. Implementation of the BEPS Package will demand updates to model tax conventions, including the OECD Model Tax Convention and the UN Model Tax Convention, as well as the bilateral tax treaties that follow those model conventions.³⁹ Uncoordinated bilateral updates to the treaty network would be burdensome and time-consuming and would frustrate the implementation of BEPS measures by creating new BEPS opportunities.

To avoid uncoordinated and inconsistent unilateralism or bilateralism, pursuant to Action 15 Report, “Developing a Multilateral Instrument to Modify Bilateral Tax Treaties,” the MLI is intended to effectively and efficiently modify existing agreements in a multilateral context by creating and maintaining an effective, transparent, and reliable mechanism assisted by the Depositary, the Secretary General of OECD.⁴⁰ The MLI is not an amending protocol to a single existing treaty, and would not directly change the text of existing treaties.⁴¹ Instead, the MLI will be applied alongside existing tax treaties, serving as the compass to empower and enable the modification, interpretation, and application of the Covered Tax Agreements for the purpose of effective implementation of the treaty-related BEPS measures and the single tax principle.

The MLI would strengthen global partnerships and facilitate the smooth modification of the Covered Tax Agreements.⁴² All Parties would benefit from active participation either by developing consolidated versions of their Covered Tax Agreements as modified by the MLI, or by agreeing subsequently to different but functionally equivalent modifica-

36. See OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* (Oct. 5, 2015) <http://dx.doi.org/10.1787/9789264241220-en>.

37. See OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report* (Oct. 5, 2015), <http://dx.doi.org/10.1787/9789264241633-en>.

38. OECD 2017 MLI, *supra* note 24, preamble.

39. OECD MLI Explanatory Statement, *supra* note 24, ¶ 4.

40. See OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report*, at 18, ¶ 11 (Oct. 5, 2015), <http://dx.doi.org/10.1787/9789264241688-en>.

41. See OECD MLI Explanatory Statement, *supra* note 24 ¶ 15.

42. *Countries adopt multilateral convention to close tax treaty loopholes and improve functioning of international tax system*, OECD (Nov. 24, 2016), <http://www.oecd.org/tax/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm>.

tions to their Covered Tax Agreements.⁴³ It is not wise for any Party to be marginalized and isolated by the far-reaching reform of international tax regime led by the MLI and the BEPS project as a whole.

The MLI would ensure the coherent and consistent interpretation of the numerous Covered Tax Agreements. Article 31 of the Vienna Convention on the Law of Treaties requires that a treaty “be interpreted in good faith in accordance with the ordinary meaning of the terms of the treaty in context and in light of its object and purpose.”⁴⁴ Thus, the purpose of the MLI and the Covered Tax Agreement should be taken into account for the purpose of precisely understanding “the context” in question. To clarify the intent of the Parties to ensure that Covered Tax Agreements be interpreted in line with the mission of the MLI especially in controversial circumstances, article 6(1) requires the Covered Tax Agreements to be modified to include the penultimate paragraph of the preamble text of the MLI.⁴⁵

In addition to benefiting governments by closing the BEPS loopholes, the MLI is also intended to benefit MNEs by improving the transparency and predictability of the international tax regime and effectively minimizing and/or resolving disputes over the application of Covered Tax Agreements.⁴⁶

2.2 *The Principled Flexibilities in the MLI*

The MLI is both principled and flexible in response to the idealism and pragmatism of the BEPS package. The treaty-related minimum standards, including the prevention of treaty abuse under Action 6 and the improvement of dispute resolution under Action 14, must be implemented by and through the operation of the MLI in relation to the Covered Tax Agreements.⁴⁷ However, the MLI is principled not only because of its dedication to effective implementation of the minimum standards of BEPS measures, but also because of firm adherence to the single tax principle and multilateralism.⁴⁸

To some extent, it is difficult or even impossible to develop a “one-size-fits-all” BEPS solution.⁴⁹ Recognizing that not all the agreed BEPS

43. OECD MLI Explanatory Statement, *supra* note 24, ¶ 13.

44. Vienna Conventions on the Law of Treaties, art. 31, May 23, 1969, 1155 U.N.T.S. 331.

45. OECD 2017 MLI, *supra* note 24, art. 6.

46. Angel Gurría, Secretary-General, OECD, Remarks at Adoption Ceremony of the BEPS Treaty (Nov. 24, 2016), (transcript available at <http://www.oecd.org/tax/beps/remarks-at-adoption-ceremony-of-the-beps-treaty.htm>).

47. OECD, *Background Brief: Inclusive Framework on BEPS*, ¶ 5 (Jan. 2017), <https://www.oecd.org/ctp/background-brief-inclusive-framework-for-beps-implementation.pdf>.

48. For a brief discussion of the complexities of multilateralism in the context of BEPS, see CHRISTIANA HJI PANAYI, *ADVANCED ISSUES IN INTERNATIONAL AND EUROPEAN TAX LAW* 153–57 (2015).

49. MICHAEL LANG ET AL., *BASE EROSION AND PROFIT SHIFTING (BEPS): THE PROPOSALS TO REVISE THE OECD MODEL CONVENTION* 212 (2016).

measures are minimum standards or hard rules, and given that even the minimum standards can be achieved in multiple different ways, the MLI has to be flexible and moderate to enable the Parties to substantially and creatively meet the minimum standards and seek best practices pursuant to the purpose and object of the BEPS project. The Parties enjoy a variety of solutions to implement the MLI by and through free choice to opt in and/or opt out, win-win mutual agreements based on compromise, and invention of more effective methodology and tools in line with the mission and purpose of the MLI and the BEPS package.⁵⁰

First, the MLI only applies to the Covered Tax Agreements that are specifically listed by the Contracting Jurisdictions to those Agreements,⁵¹ although the MLI is intended to cover all existing tax treaties.⁵² A Party may choose to exclude a specific agreement from the scope of Covered Tax Agreements if such agreement “has been recently renegotiated to implement the outcomes of the BEPS Project, or is currently under renegotiation with the intent of implementing those outcomes in the renegotiated agreement.”⁵³

Second, the Parties may use a reservation to opt out of the entirety or parts of substantial provisions not reflecting the minimum standard in the MLI.⁵⁴ The reserved provision will not apply as between the reserving Party and all other Parties to the MLI, and the reserving Party is not obligated to modify the Covered Tax Agreements as foreseen by the reserved provision of the MLI.⁵⁵

Third, the Parties may use a reservation to opt out of the entirety or parts of provisions to be applied to “a subset of Covered Tax Agreements in order to preserve existing provisions that have specific, objectively defined characteristics.”⁵⁶ “[S]uch reservations will apply as between the reserving Party and all Contracting Jurisdictions to the Covered Tax Agreements covered by such reservations.”⁵⁷

Fourth, multiple alternatives or optional provisions addressing a particular BEPS issue offered in the MLI will apply only if all Contracting Jurisdictions to a Covered Tax Agreement affirmatively and expressly choose to apply them.⁵⁸ Parties may also feel free to supplement the main provision of the MLI with an additional provision in the Covered Tax Agreement.⁵⁹

50. OECD MLI Explanatory Statement, *supra* note 24, ¶ 13–14.

51. OECD 2017 MLI, *supra* note 24, art. 1–2.

52. OECD MLI Explanatory Statement, *supra* note 24, ¶ 26.

53. *Id.*, ¶ 14.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *E.g.*, OECD 2017 MLI, *supra* note 24, art. 7(7); OECD MLI Explanatory Statement, *supra* note 24, ¶ 14.

59. OECD MLI Explanatory Statement, *supra* note 24, ¶ 14.

Fifth, the MLI provides great flexibility on the provisions relating to a BEPS minimum standard. Where a minimum standard could be satisfied in multiple alternative ways, the Contracting Jurisdictions may adopt their own favorite approaches or solutions.⁶⁰ In case of conflicts or disputes arising from different approaches between contracting jurisdictions, the conflicts are expected to be settled amicably by a mutually satisfactory solution consistent with the minimum standard.⁶¹ If a Party's Covered Tax Agreements have already satisfied a specific minimum standard, this Party may opt out of the provision reflecting this minimum standard.⁶² To encourage best efforts and the honest implementation of minimum standards, the effectiveness and adequacy of certain Covered Tax Agreement in satisfying the minimum standard would be tested by the Inclusive Framework on BEPS.⁶³

Sixth, although Part VI provides for mandatory and binding arbitration,⁶⁴ Parties enjoy great autonomy and flexibility on the choice of arbitration rules. Part VI applies only between Parties that expressly choose to apply it with respect to their Covered Tax Agreements.⁶⁵ The Parties that choose to apply Part VI may also formulate their own reservations with respect to the scope of cases eligible for arbitration subject to acceptance by the other Parties, despite the defined reservations included in Part VI.⁶⁶

Seventh, the MLI encourages the Parties to choose recommended optional provisions.⁶⁷ Although many optional provisions are not required in order to meet the minimum standards, they are important "soft law" rules. Thus, it is wise for the Parties to introduce these best practices and policy recommendations into the Covered Tax Agreements. For instance, article 6 encourages Parties to include the following optional preamble language in their Covered Tax Agreements, "[d]esiring to further develop their economic relationship and to enhance their co-operation in tax matters."⁶⁸ If all Parties voluntarily pledge allegiance to the mission of the MLI, the solidarity of global partnership is expected to be further strengthened by and through more flexible and practical dialogue, negotiation, exchange and collaboration on the BEPS project.

60. *Id.*

61. *Id.*

62. *Id.*

63. OECD and G20 countries promised to work together to design and propose a more inclusive framework in early 2016 to support and monitor the implementation of the BEPS package. See OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, ¶ 11 (2015), <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>.

64. OECD 2017 MLI, *supra* note 24, art. 19.

65. *Id.*, art. 18.

66. *Id.*, art. 28.

67. OECD 2017 MLI, *supra* note 24, preamble.

68. OECD 2017 MLI, *supra* note 24, art. 6(3).

2.3 The Macro Structure of the MLI

The MLI of 39 articles could be perceived as a dragon, with the preamble as its eyes, Part I as its head, Parts II through VI as its body, and Part VII as its tail. The core value of a single tax principle and almost all treaty-related BEPS measures agreed to in the BEPS Package have been fully reflected in the MLI.⁶⁹

Part I is intended to clarify the scope of the MLI and interpretation of terms.⁷⁰ Under Article 1, the MLI modifies all Covered Tax Agreements as defined in article 2 (1)(a).⁷¹ Article 2 interprets four terms and provides the general rules of interpretation of other undefined terms used in the MLI.⁷²

Part II addresses the measures on hybrid mismatches covered by the Action 2 Report.⁷³ Article 3 addresses treaty provision on transparent entities.⁷⁴ In addition to addressing dual-resident entities, article 4 addresses the tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals covered by the Action 6 Report.⁷⁵ Article 5 addresses the exemption method and the credit method.⁷⁶

Part III addresses treaty abuse covered by the Action 6 Report.⁷⁷ The Preamble and article 6 of the MLI clarify that tax treaties are not intended to be used to generate double non-taxation.⁷⁸ Article 7(1) and (4) address the rules aimed at arrangements, one of the principal purposes of which is to obtain treaty benefits.⁷⁹ Article 7(8) through (13) focus on the LOB rule.⁸⁰ Article 8 focuses on dividend transfer transactions.⁸¹ Article 9 focuses on transactions that circumvent the application of article 13(4).⁸² Article 10 focuses on the anti-abuse rule for PEs situated in third States.⁸³ Article 11 focuses on application of tax treaties to restrict a Contracting State's right to tax its own residents.⁸⁴

Part IV is intended to amend existing tax treaties to counter the artificial avoidance of PE status covered by the Action 7 Report.⁸⁵ Articles 12

69. *See id.*, Annex.

70. *Id.* arts. 1 – 2.

71. *Id.*, art. 1.

72. *Id.*, art. 2.

73. *Id.*, arts. 3 – 5; OECD *supra* note 34.

74. OECD 2017 MLI, *supra* note 24, art. 3.

75. *Id.* art. 4.

76. *Id.* art. 5.

77. *Id.*, arts 6 – 11; OECD, *supra* note 27.

78. OECD 2017 MLI, *supra* note 24, preamble, art. 6.

79. *Id.*, arts. 7(1), 7(4).

80. *Id.*, arts. 7(8) – 7(13).

81. *Id.*, art. 8.

82. *Id.* art 9.

83. *Id.*, art. 10.

84. *Id.*, art. 11.

85. *Id.*, arts. 12-16; OECD, *supra* note 36.

addresses *commissionnaire* arrangements and similar strategies.⁸⁶ Article 13 addresses specific activity exemptions.⁸⁷ Article 14 addresses splitting-up of contracts.⁸⁸ Article 15 defines the term “a person closely related to an enterprise” frequently used in Part IV.⁸⁹

Part V and Part VI reflect the Action 14 Report on making dispute resolution mechanisms more effective.⁹⁰ Part V focuses on improving dispute resolution (article 16 and article 17) by clarifying the elements of a minimum standard to ensure the timely, effective and efficient resolution of treaty-related disputes and best practices.⁹¹

Part VI (article 18 through article 26) represents a set of cohesive provisions on mandatory binding arbitration of mutual agreement procedure (MAP) cases, in which the competent authorities are unable to reach timely agreement.⁹² It contains both substantive content and modalities of its technical application to Covered Tax Agreements. Rules for compatibility with existing provisions are consolidated in article 26, rather than being scattered in each article.⁹³

Part VII addresses the procedural issues from article 27 through article 39, including signature and ratification, acceptance or approval, reservations, notifications, subsequent modifications of covered tax agreements, conference of the parties, interpretation and implementation, amendment, entry into force, entry into effect, entry into effect of part VI, withdrawal, relation with protocols, and depositary.⁹⁴

To clarify the approach taken in the MLI, the types of provisions of Covered Tax Agreements intended to be covered and the detailed ways for the MLI to affect Covered Tax Agreements, an “explanatory statement” was adopted on November 24, 2016.⁹⁵ It reflects the consensus of the negotiators with respect to the MLI. It is intended to clarify the operation of the MLI to modify Covered Tax Agreements, but not to interpret the underlying BEPS measures, except with respect to Part VI.⁹⁶

86. OECD 2017 MLI, *supra* note 24, art. 12.

87. *Id.*, art. 13.

88. *Id.*, art. 14.

89. *Id.*, art. 15.

90. *See* OECD, *supra* note 37, nd art. 14.

91. OECD 2017 MLI, *supra* note 24, arts. 16 – 17.

92. *Id.* arts. 18 – 26.

93. *Id.* art. 26.

94. *Id.* arts. 27 – 39.

95. OECD MLI Explanatory Statement, *supra* note 24, ¶ 12.

96. *Id.*

2.4 *The Micro Structure of Each Substantive Provision of Part II, III, IV & V*

Almost every substantive provision in Part II, III, IV and V (i.e., all except Part VI) contains a BEPS measure clause, a compatibility clause, a reservation clause and a notification clause.⁹⁷

2.4.1 BEPS Measures Clause

As BEPS measures are the backbone of the MLI, it is necessary for articles 3 through 17 to duplicate the language of the provisions of the OECD Model Tax Convention developed during the course of the BEPS Project, with minor technical modifications.⁹⁸ For instance, “Covered Tax Agreement” and “Contracting Jurisdiction” replaced “Convention” and “Contracting State” used in the OECD Model Tax Convention and the UN Model Tax Convention, respectively.⁹⁹ References to specific articles and paragraphs in provisions of existing tax agreements are also replaced with descriptions of those provisions for the purpose of precisely identifying specific provisions in Covered Tax Agreements.¹⁰⁰

2.4.2 Compatibility Clauses

The provisions of the MLI may overlap or conflict with provisions of Covered Tax Agreements on the same tax matters.¹⁰¹ To clarify the relationship between the provisions of the MLI and Covered Tax Agreements, there are four major types of compatibility clauses, whose uses depend on policy considerations and factual circumstances.¹⁰² First, a specified MLI provision applies only “in place of” an existing provision, and does not apply where such existing provision does not exist.¹⁰³ Second, a specified MLI provision “applies to” or “modifies” an existing provision by changing the application of the existing provision without replacing it.¹⁰⁴ Third, a specified MLI provision applies “in the absence of” an existing provision.¹⁰⁵ Fourth, a specified MLI provision applies “in place of or in the absence of” an existing provision, regardless of whether such existing provision exists and/or whether such existing provision has been notified to the Depository.¹⁰⁶ If an incompatible or conflicting provision exists, the provision of the MLI shall prevail.¹⁰⁷ In the absence of such existing provi-

97. *Id.*, ¶ 15. *See, e.g.*, OECD 2017 MLI, *supra* note 24, art. 3 (providing four paragraphs that respectively represent each kind of clause).

98. OECD MLI Explanatory Statement, *supra* note 24, ¶ 15.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *See, e.g.*, OECD 2017 MLI, *supra* note 24, art. 5(7).

104. *See, e.g., id.*, art. 7(5).

105. *See, e.g., id.*, art. 16(4)(b)(i).

106. *See, e.g., id.*, art. 3(4).

107. OECD MLI Explanatory Statement, *supra* note 24, ¶ 15.

sion, the provision of the MLI shall be deemed to be automatically added to the Covered Tax Agreement.¹⁰⁸

2.4.3 Reservation Clauses

Reasonable reservations are necessary to respect the Parties' autonomy and to keep the elasticity of the MLI, while unregulated reservations would make chaos.¹⁰⁹ To ensure its harmonious application, the MLI contains reservation clauses to define and regulate the reservations.¹¹⁰ Parties may opt out of applying certain provisions to their Covered Tax Agreements within a closed list of permitted reservations specified in the reservation clauses.¹¹¹ To ensure transparency, a reserving Party is required to provide a list of the existing provisions within the scope of that reservation.¹¹² The reservation will apply as between the reserving Party and all other Parties to the MLI.¹¹³

2.4.4 Notification Clauses

To safeguard clarity, transparency, certainty, and predictability of its application, the MLI requires Parties to notify the Depositary of their choices and/or significant information regarding the Covered Tax Agreements.¹¹⁴ First, Parties should report their choices of optional provisions to the Depositary, "and describe the consequences of a mismatch between the Contracting Jurisdictions to a Covered Tax Agreement."¹¹⁵ Second, Parties should notify the Depositary of specific types of existing provisions within the scope of compatibility clauses that are superseded or modified by the MLI.¹¹⁶ Parties are expected to identify, notify, and disclose all provisions within the objective scope of the compatibility clause.¹¹⁷ In case of inadvertent omission of existing provisions, additional notifications are expected to be forthcoming.¹¹⁸ If the contracting jurisdictions disagree on whether existing provisions are within the scope of a compatibility clause, such disputes should be settled either through the mutual agreement procedure, or a Conference of the Parties.¹¹⁹

108. *Id.*

109. *Id.*, ¶ 14.

110. *Id.*

111. See OECD 2017 MLI, *supra* note 24, art. 28.

112. OECD MLI Explanatory Statement, *supra* note 24, ¶ 271.

113. OECD 2017 MLI, *supra* note 24, art. 28(3).

114. *Id.*, art. 29.

115. OECD MLI Explanatory Statement, *supra* note 24, ¶ 15; See e.g. OECD 2017 MLI, *supra* note 24, art. 5(10).

116. OECD MLI Explanatory Statement, *supra* note 24, ¶ 15; See e.g. OECD 2017 MLI, *supra* note 24, art. 8(4).

117. OECD MLI Explanatory Statement, *supra* note 24, ¶ 15.

118. OECD 2017 MLI, *supra* note 24, art. 29(6); OECD MLI Explanatory Statement, *supra* note 24, ¶ 18.

119. OECD MLI Explanatory Statement, *supra* note 24, ¶ 18.

2.5 Interpretation of Terms

2.5.1 Covered Tax Agreement

Article 2(1)(a) of the MLI defines the term “Covered Tax Agreement” as “an agreement for the avoidance of double taxation with respect to taxes on income . . . in force between two or more Parties[] and/or jurisdictions or territories . . . for whose international relations a Party is responsible, and with respect to which each such Party has made a notification to the Depository listing the agreement as well as any amending or accompanying instruments thereto . . . as an agreement which it wishes to be covered by this Convention.”¹²⁰

While agreements simultaneously covering capital taxes, taxes on capital gains, and income taxes are also Covered Tax Agreements, agreements applying solely to shipping and air transport or social security are not covered by the MLI.¹²¹

Under article 2 (1)(a)(i) of the MLI, Covered Tax Agreements are supposed to be in force between two or more Parties and/or jurisdictions or territories.¹²² If an agreement has been signed but has not yet entered into force, a Party may include such agreement in the list of Covered Tax Agreements, and must notify the Depository of the date of entry into force of that agreement.¹²³ Such an inclusive and enabling approach to interpretation would improve the transparency of the potential Covered Tax Agreements.

2.5.2 Party

Article 2(1)(b) defines the term “Party” used throughout the MLI as a State for which the MLI is in force, or a jurisdiction which has signed the MLI and for which the MLI is in force.¹²⁴ Therefore, Parties can be either States or Non-State jurisdictions.¹²⁵

2.5.3 Contracting Jurisdiction

The term “Contracting Jurisdiction” refers to a party to a Covered Tax Agreement, including States, jurisdictions, or territories.¹²⁶ Thus, “Contracting Jurisdiction” is broader than “Contracting State.” While “Contracting Party” exclusively refers to a Party to the MLI, “Contracting Jurisdiction” exclusively refers to a Party to the Covered Tax Agreements.¹²⁷

120. OECD 2017 MLI, *supra* note 24, art. 2(1)(a).

121. OECD MLI Explanatory Statement, *supra* note 24, ¶ 25.

122. OECD 2017 MLI, *supra* note 24, art. 2(1)(a).

123. OECD MLI Explanatory Statement, *supra* note 24, ¶ 32.

124. OECD 2017 MLI, *supra* note 24, art. 2(1)(b).

125. OECD MLI Explanatory Statement, *supra* note 24, ¶ 35.

126. *Id.*

127. *Id.*, ¶¶ 34-35.

The MLI may cover tax agreements entered into by a State Party on behalf of a non-State jurisdiction or territory for whose international relations it is responsible.¹²⁸ In such cases, the State Party should include those tax agreements in its list of tax agreements, and the list of reservations and notifications regarding that jurisdiction or territory may differ from the State Party's own list.¹²⁹

2.5.4 Signatory

The term "Signatory" exclusively used in Part VII, refers to a State or jurisdiction that has signed the MLI but for which the MLI is not yet in force.¹³⁰

2.5.5 Interpretation of Other Undefined Terms

Article 2(2) provides a general rule of interpretation for undefined terms used in the MLI.¹³¹ Unless the context requires otherwise, an undefined term "has the meaning that it has under the relevant Covered Tax Agreement at the time the Convention is being applied."¹³² As noted above, the purpose of the MLI and of the Covered Tax Agreement should be taken into account for the purpose of understanding "the context" required by article 2(2).¹³³

2.6 Hybrid Mismatches

2.6.1 Transparent Entities

Article 3 of the MLI is intended to address the application of tax treaties to the income earned through transparent entities, including partnerships and trusts, and to ensure that treaty benefits are granted in appropriate cases but not granted where neither Contracting State treats the income of an entity as the income of one of its residents.¹³⁴

Based on article 1(2) of the OECD Model Tax Convention of 2014 produced by the Action 2 Report, Article 3(1) restates that income derived by or through an entity or arrangement treated as fiscally transparent under the tax law of either Contracting Jurisdiction, shall be considered to be income of a resident of a Contracting Jurisdiction, but only to the extent that the income is treated for purposes of taxation by that Contracting Jurisdiction as the income of its resident.¹³⁵

To modify the application of the provisions related to methods for the elimination of double taxation, article 3(2) clarifies that the Provisions of a

128. OECD 2017 MLI, *supra* note 24, art. 2(1)(a)(i)(B).

129. OECD MLI Explanatory Statement, *supra* note 24, ¶¶ 27 – 28.

130. OECD 2017 MLI, *supra* note 24, art. 2(1)(d).

131. *Id.* art. 2(2).

132. OECD MLI Explanatory Statement, *supra* note 24, ¶ 37.

133. *Id.*

134. *Id.*, ¶¶ 39-40.

135. OECD 2017 MLI, *supra* note 24, art. 3(1).

Covered Tax Agreement that require Contracting Jurisdiction X to exempt from income tax or provide a deduction or credit equal to the income tax paid with respect to income derived by its resident which may be taxed in Contracting Jurisdiction Y according to the Covered Tax Agreement, shall not apply to the extent that such provisions allow taxation by Jurisdiction Y solely because the income is also income derived by its resident.¹³⁶

Article 3(3) addresses the link between article 3 and the saving clause in article 11 by adding an additional sentence to the end of paragraph 1: “In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction’s right to tax the residents of that Contracting Jurisdiction.”¹³⁷ It shall apply with respect to any Covered Tax Agreement for which one or more Parties has made reservation described in Article 11(3)(a).¹³⁸

Under the compatibility clause in article 3(4), article 3(1) will apply instead of or in the absence of existing provisions of the same type, whether such provisions are framed either through a general rule, or by identifying in detail the treatment of specific fact patterns or specific types of entities or arrangements.¹³⁹

Given that “a provision on fiscally transparent entities is not required in order to meet a minimum standard,”¹⁴⁰ the reservation clause in article 3(5) permits Parties to opt out of the entirety or part of Article 3.¹⁴¹ Parties may opt out of article 3(1) while retaining existing provisions denying benefits in the case of transparent entities established in third jurisdictions and/or identifying in detail the treatment of specific fact patterns and types of entities or arrangements.¹⁴² Parties may opt out of article 3(2).¹⁴³ Parties may reserve the right for article 3(1) to replace existing detailed provisions, while keeping existing shorter provisions.¹⁴⁴

To ensure clarity, article 3(6) provides the notification requirements for the Parties.¹⁴⁵

136. *Id.*, art. 3(2).

137. *Id.*, art. 3(3).

138. *Id.*

139. *Id.*, art. 3(4).

140. OECD MLI Explanatory Statement, *supra* note 24, ¶ 46.

141. OECD 2017 MLI, *supra* note 24, art. 3(5)(a).

142. *Id.*, art. 3(5).

143. *Id.*, art. 3(5)(f).

144. *Id.*, art. 3(5)(g).

145. *Id.*, art. 3(6).

2.6.2 Dual Resident Entities

Based on article 4(3) of the OECD Model Tax Convention of 2014,¹⁴⁶ Article 4(1) of the MLI is designed to modify the rules for determining the treaty residence of dual-resident entities.¹⁴⁷

Under article 4(1):

where by reason of the [existing] provisions . . . a person is a resident of more than one Contracting Jurisdiction, the competent authorities . . . shall endeavour to determine by mutual agreement the Contracting Jurisdiction of which such person shall be deemed to be a resident . . . having regard to its place of effective management, the place where it is incorporated or otherwise constituted, and any other relevant factors.¹⁴⁸

“In the absence of such agreement, the entity shall not be entitled to any relief or exemption . . . as may be agreed upon by the competent authorities.”¹⁴⁹ Since the failure to grant such benefits cannot be viewed as violation of the Covered Tax Agreement, the cases in which benefits are denied due to an agreement failure would not be eligible for arbitration under Part VI.¹⁵⁰

Under the compatibility clause in article 4(2), article 4(1) shall apply in place of or in the absence of all types of tie-breaker rules on the residence of entities, but it would not replace existing provisions “specifically addressing the residence of companies participating in dual-listed company arrangements”¹⁵¹ across several jurisdictions.

Recognizing that provisions addressing dual-resident entities are not required to meet the minimum standard,¹⁵² the reserving clause in article 4(3) permits Parties to opt out of the entirety of article 4 in different ways.¹⁵³ For instance, a Party may opt out of applying it to existing agreements that contain provisions with specific, objectively defined characteristics, by requiring the competent authorities to endeavor to reach tie-breaker agreement, setting out the treatment of an entity in case of agreement failure or simply denying treaty benefits without such requirement.¹⁵⁴

To ensure clarity, article 4(4) provides the notification requirements for the Parties.¹⁵⁵ In general, each Party should “notify the Depository of

146. OECD MLI Explanatory Statement, *supra* note 24, ¶ 49.

147. OECD 2017 MLI, *supra* note 24, art. 4(1).

148. *Id.*

149. *Id.*

150. OECD MLI Explanatory Statement, *supra* note 24, ¶ 58.

151. OECD 2017 MLI, *supra* note 24, art. 4(2).

152. OECD MLI Explanatory Statement, *supra* note 24, ¶ 54.

153. OECD 2017 MLI, *supra* note 24, art. 4(3).

154. *Id.*, arts. 4(3)(b)-(d).

155. *Id.* art. 4(4).

[the existing] provision . . . not subject to a reservation”.¹⁵⁶ Such a provision would be replaced by article 4(1) where all parties to the Covered Tax Agreement have notified accordingly.¹⁵⁷ “In other cases, [article 4(1)] would apply to the Covered Tax Agreement, [but would] supersede the [existing] provisions only to the extent that those provisions are incompatible with article 4(1).”¹⁵⁸

2.6.3 Application of Methods for Elimination of Double Taxation

As recommended by the Action 2 Report,¹⁵⁹ article 5 offers three options for Parties to address problems arising from the inclusion of the exemption method in treaties with respect to items of income not taxed in the jurisdiction of source.¹⁶⁰ Article 5(1) permits a Party to choose one or none of the options.¹⁶¹ Recognizing that asymmetrical application is normal in provisions on elimination of double taxation, the option chosen by each Jurisdiction shall apply with respect to its own residents, where Contracting Jurisdictions make different choices.¹⁶²

Under Option A, existing provisions

[t]hat would otherwise exempt income derived or capital owned by a resident of Contracting [Jurisdiction X] from tax in its jurisdiction for the purpose of eliminating double taxation shall not apply where Contracting Jurisdiction Y applies existing provisions to exempt such income or capital from tax or to limit the rate . . . In the latter case . . . [Jurisdiction X] shall allow as a deduction from the tax on the income or capital of that resident an amount equal to the tax paid in [Jurisdiction Y].¹⁶³

Under Option B, existing provisions

[t]hat would otherwise exempt income derived by a resident of Contracting [Jurisdiction X] from tax in its jurisdiction for the purpose of eliminating double taxation, because such income is treated as a dividend by [Jurisdiction X], shall not apply where such income gives rise to a deduction for the purpose of determining the taxable profits of a resident of [Contracting Jurisdiction Y] under the laws of [Jurisdiction Y]. In such case, [Jurisdiction X] shall allow as a deduction from the tax on the income of that resi-

156. *Id.*

157. *Id.*

158. *Id.*

159. OECD, *supra* note 34, ¶¶ 442-444.

160. OECD 2017 MLI, *supra* note 24, art. 5.

161. *Id.*, art. 5(1).

162. *Id.*, art. 5(1).

163. *Id.*

dent an amount equal to the income tax paid in [Jurisdiction Y].¹⁶⁴

Under Option C,

[w]here a resident of Contracting [Jurisdiction X] derives income or owns capital which may be taxed in Contracting [Jurisdiction Y] in accordance with the [existing] provisions . . . , [Jurisdiction X] shall allow, as a deduction from the tax on the income [or capital] of that resident, an amount equal to the income tax [or capital tax] paid in [Jurisdiction Y]. . . Such deduction shall not exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable to the income or the capital which may be taxed in [Jurisdiction Y]. Where in accordance with any [existing] provision, income derived or capital owned by a resident of Contracting [Jurisdiction X] is exempt from tax in [its] jurisdiction, [Jurisdiction X] may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.¹⁶⁵

To address the concerns that accepting asymmetrical application unconditionally might disrupt the balance of certain bilateral tax treaties “where the provision on the elimination of double taxation was the subject of bilateral compromise”,¹⁶⁶ article 5(8) allows a Party that chooses none of the Options to “reserve the right for the entirety of [article 5] not to apply with respect to . . . [its Covered Tax Agreements].¹⁶⁷ Given that “some Parties . . . comfortable with the asymmetrical application of Option A or B . . . may prefer to address more significant changes . . . through bilateral negotiation”,¹⁶⁸ article 5(9) permits a Party not choosing Option C, to permit the other Contracting Jurisdiction to not apply Option C.¹⁶⁹

Under the notification clause in article 5(10), “each Party . . . [choosing] to apply an Option . . . shall notify the Depositary of its choice of Option”.¹⁷⁰ To ensure clarity, “an Option shall apply with respect to a provision of a Covered Tax Agreement only . . . [if the choosing Party] made such a notification¹⁷¹

164. *Id.*

165. *Id.* art. 5(6)(b).

166. OECD MLI Explanatory Statement, *supra* note 24, ¶ 72.

167. OECD 2017 MLI, *supra* note 24, art. 5(8).

168. OECD MLI Explanatory Statement, *supra* note 24, ¶ 73.

169. OECD 2017 MLI, *supra* note 24, art. 5(9).

170. *Id.*, art 5(10).

171. *Id.*

2.7 Treaty Abuse

2.7.1 Purpose of a Covered Tax Agreement

As the minimum standard for protection against the abuse of tax treaties under Action 6 of BEPS project,¹⁷² article 6(1) requires a Covered Tax Agreement to incorporate the following preamble language:

[I]ntending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).¹⁷³

The compatibility clause in article 6(2) describes the interaction between article 6(1) and the preamble language of Covered Tax Agreements.¹⁷⁴

Article 6(3) encourages Parties to include the full preamble language produced in the Action 6 Report by adding the other part of the preamble of the OECD Model Tax Convention: “[d]esiring to further develop their economic relationship and to enhance their co-operation in tax matters.”¹⁷⁵ Since such an inclusion is not required to meet a minimum standard, article 6(3) shall modify a Covered Tax Agreement only where all Contracting Jurisdictions choose to apply it.¹⁷⁶

Article 6(4) permits a Party to opt out of applying article 6(1) only with respect to Covered Tax Agreements already satisfying the minimum standard.¹⁷⁷ Parties may preserve preamble language in their Covered Tax Agreements that “already . . . [refer to the intent] to eliminate double taxation without creating opportunities for non-taxation or reduced taxation, whether that language is limited to cases of tax evasion or avoidance . . . ”.¹⁷⁸

2.7.2 Prevention of Treaty Abuse

To address situations of treaty abuse, the Action 6 Report requests that countries implement (i) a principal purpose test (PPT) only; (ii) a PPT and either a simplified or detailed LOB provision; or (iii) a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties.¹⁷⁹ Based on Article X

172. OECD, *supra* note 29 ¶ 72.

173. OECD 2017 MLI, *supra* note 24, art. 6(1).

174. *Id.*, art. 6(2).

175. *Id.*, art. 6(3).

176. *Id.*, art. 6(6).

177. *Id.*, art. 6(4).

178. *Id.*

179. OECD, *supra* note 27, ¶ 22.

(Entitlement to Benefits) of the OECD Model Tax Convention, a result of the Action 6 Report, article 7 is the lengthiest article in the MLI.

Given that a PPT alone is the only approach that can satisfy the minimum standard, article 7(1) presents the PPT as the default option.¹⁸⁰ A treaty benefit

shall not be granted in respect to an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.¹⁸¹

Although the PPT is intended to identify the purpose behind the arrangement or transaction, this test is objective, rather than subjective, in terms of practical operation.

Under the compatibility clause in article 7(2), article 7(1)

shall apply in place of or in the absence of provisions of a Covered Tax Agreement that deny all or part of the benefits that would otherwise be provided where the principal purpose or one of the principal purposes of any arrangement or transaction, or of any person concerned with an arrangement or transaction, was to obtain those benefits.¹⁸²

Although article 7(1) is intended to replace narrower PPT provisions with a broader provision, it would not restrict the scope or application of various types of anti-abuse rules besides a PPT in existing agreements.¹⁸³

Given that the competent authorities need necessary discretion to grant benefits to qualified taxpayers in certain circumstances, Article 7(3) permits non-reserving Parties under Article 7(15)(a) to add Article 7(4) in Covered Tax Agreements.¹⁸⁴ Where a treaty benefit:

[I]s denied to a person under provisions of the Covered Tax Agreement . . . , the competent authority of Contracting [Jurisdiction X] that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that the benefits would have been granted to that per-

180. OECD MLI Explanatory Statement, *supra* note 24, ¶ 90.

181. OECD 2017 MLI, *supra* note 24, art. 7(1).

182. *Id.*, art. 7(2).

183. OECD MLI Explanatory Statement, *supra* note 24, ¶ 95.

184. OECD 2017 MLI, *supra* note 24, art. 7(3).

son in the absence of the transaction or arrangement. The competent authority . . . requested by a resident of Contracting [Jurisdiction Y] shall consult with the competent authority of [Jurisdiction Y] before rejecting the request.¹⁸⁵

Article 7(4) is an optional provision, and shall apply to a Covered Tax Agreement only where all Contracting Jurisdictions have chosen to apply it.¹⁸⁶

The compatibility clause in article 7(5) clarifies that article 7(4) shall apply to a PPT of a Covered Tax Agreement.¹⁸⁷ As a result, article 7(1) and article 7(4) may apply together in practice.¹⁸⁸

Article 7(6) permits Parties to supplement the PPT by choosing to apply a simplified LOB provision, which is optional, and applies with respect to a Covered Tax Agreement only “where all Contracting Jurisdictions have chosen to apply it”.¹⁸⁹ Where Parties disagree on its application, the PPT alone applies symmetrically by default.¹⁹⁰ However, it is problematic where one Party chooses the simplified LOB provision and opts out of article 7 entirely, while another contracting Party chooses not to apply the simplified LOB provision. To avoid such deadlock in the bilateral relationship, the simplified LOB provision shall apply when some but not all Contracting Jurisdictions have chosen to apply it, provided that there is agreement under article 7(7)(a) or (b).¹⁹¹ There are two possible outcomes. First, “all Contracting Jurisdictions choosing to apply the PPT alone may agree that the simplified LOB Provision applies symmetrically.”¹⁹² Second, all Contracting Jurisdictions choosing to apply the PPT alone may affirmatively permit asymmetrical application of the simplified LOB Provision.¹⁹³ Consequently, the Contracting Jurisdictions choosing to apply the simplified LOB Provision would apply both the PPT and the simplified LOB Provision, while the other Contracting Jurisdictions would apply the PPT alone.¹⁹⁴

Articles 7(8) through 7(13) contain a simplified LOB provision.¹⁹⁵ “Except as otherwise provided in the Simplified LOB Provision, a resident of a Contracting Jurisdiction shall not be entitled to a benefit that would otherwise be accorded by the Covered Tax Agreement”, unless such resi-

185. *Id.*

186. *Id.*, art. 17(b); OECD MLI Explanatory Statement, *supra* note 24, ¶ 98.

187. OECD 2017 MLI, *supra* note 24, art. 7(5).

188. OECD MLI Explanatory Statement, *supra* note 24, ¶ 99.

189. OECD 2017 MLI, *supra* note 24, art. 7(6).

190. OECD MLI Explanatory Statement, *supra* note 24, ¶ 101.

191. OECD 2017 MLI, *supra* note 24, art. 7(7).

192. *Id.*, art. 7(7)(a).

193. *Id.*, art. 7(7)(b).

194. OECD MLI Explanatory Statement, *supra* note 24, ¶ 102.

195. OECD 2017 MLI, *supra* note 24, arts., 7(8) – (13).

dent is a “qualified person” at the time that the benefit would be accorded.¹⁹⁶

Article 7(9) lists five categories of “qualified persons” as follows:

a) an individual; b) a Contracting Jurisdiction, or a political subdivision or local authority thereof, or an agency or instrumentality of any such Contracting Jurisdiction, political subdivision or local authority; c) a company or other entity, if the principal class of its shares is regularly traded on one or more recognized stock exchanges; d) a person, other than an individual, that i) is a non-profit organization of a type agreed to by the Contracting Jurisdictions through an exchange of diplomatic notes or ii) is an entity or arrangement established in that Contracting Jurisdiction, treated as a separate person under its domestic taxation laws, and is: A) established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and regulated as such by that Contracting Jurisdiction or one of its political subdivisions or local authorities; or B) established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in Subdivision A); e) a person other than an individual, if, on at least half the days of a twelve-month period that includes the time when the benefit would otherwise be accorded, persons who are residents of that Contracting Jurisdiction and that are entitled to benefits of the Covered Tax Agreement under subparagraphs a) to d) own, directly or indirectly, at least fifty percent of the shares of the person.¹⁹⁷

Under article 7(10),

[A] resident of Contracting Jurisdiction X will be entitled to benefits with respect to an item of income derived from Contracting Jurisdiction Y, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in [Jurisdiction X] and the income derived from [Jurisdiction Y] emanates from, or is incidental to, that business.¹⁹⁸

[I]f a resident of [Jurisdiction X] derives income from business activity conducted by that resident in [Jurisdiction Y], or arising in [Jurisdiction Y] from a connected person, the [qualification] conditions . . . for the benefits shall be considered to be satisfied with respect to such income only if the business activity carried on by the resident in [Jurisdiction X] to which the income is related is substantial in relation to the same activity or a complementary

196. *Id.*, art. 7(8).

197. *Id.*, art. 7(9).

198. *Id.*, art. 7(10).

business activity carried on by the resident or such connected person in [Jurisdiction Y].¹⁹⁹

Under article 7(11),

A resident of a Contracting Jurisdiction to a Covered Tax Agreement that is not a qualified person shall also be entitled to a benefit that would otherwise be accorded by the Covered Tax Agreement with respect to an item of income if, on at least half of the days of any twelve-month period that includes the time when the benefit would otherwise be accorded, persons that are equivalent beneficiaries own, directly or indirectly, at least seventy-five percent of the beneficial interests of the resident.²⁰⁰

Under article 7(12),

[I]f a resident of [Contracting Jurisdiction X] . . . is neither a qualified person . . . nor entitled to benefits under [article 7(10) or (11)], the competent authority of [Contracting Jurisdiction Y] may nevertheless grant the benefits . . . or benefits with respect to a specific item of income, taking into account the object and purpose of the Covered Tax Agreement, but only if [the] resident demonstrates to the satisfaction of [the] competent authority that neither its establishment, acquisition, maintenance, nor the conduct of its operations, had [the acquisition of treaty benefits] as one of its principal purposes. . . . Before either granting or denying a request made . . . by a resident of [Jurisdiction X], the competent authority of [Jurisdiction Y] . . . shall consult with its counterpart in [Jurisdiction X].²⁰¹

Article 7(13) defines five terms for the purposes of the Simplified LOB Provision, including “recognized stock exchange,” “principal class of shares,” “equivalent beneficiary,” “shares” and “connected persons.”²⁰²

Unlike the Simplified LOB Provision, article 7 does not include a detailed LOB provision, which necessitates substantial bilateral customization.²⁰³ Parties preferring a detailed LOB provision may either opt out of the PPT and agree to endeavor to reach a bilateral agreement that satisfies the minimum standard²⁰⁴ or accept the PPT in article 7(1) as an interim measure and express such intent in their notification to the Depository.²⁰⁵

The compatibility clause in article 7(14) clarifies that the simplified LOB Provision is intended to apply in place of or in the absence of ex-

199. *Id.* art. 7(10)(b).

200. *Id.*, art. 7(11).

201. *Id.*, art. 7(10).

202. *Id.*, art. 7(13).

203. OECD MLI Explanatory Statement, *supra* note 24, ¶ 90.

204. *Id.*

205. *Id.*

isting LOB provisions, but not to restrict the scope or application of other types of anti-abuse rules in Covered Tax Agreements.²⁰⁶

Under the reservation clause in article 7(15), Parties intending to satisfy the minimum standard by adopting a combination of a detailed LOB provision and either rules to address conduit financing structures or a PPT, may opt out of article 7(1) but should “endeavor to reach a mutually satisfactory solution [satisfying the minimum standard].”²⁰⁷ Parties may opt out of either articles 7(1) and 7(4) with respect to Covered Tax Agreements already containing a PPT, or the simplified LOB Provision with respect to their Covered Tax Agreements already containing a LOB provision described in article 7(14).²⁰⁸

Under article 7(16), “except where the Simplified LOB Provision applies [under Article 7(7)], a Party [choosing under article 7(6)] to apply the Simplified LOB Provision may reserve the right to have the entirety of [article 7] not apply with respect to its Covered Tax Agreements . . . [and] the Contracting Jurisdictions shall endeavor to reach a mutually satisfactory solution [meeting] the minimum standard.”²⁰⁹

Article 7(17) describes very detailed notification requirements to ensure clarity as to the application of article 7.²¹⁰

2.7.3 Dividend Transfer Transactions

Based on article 10(2) of the OECD Model Tax Convention revised by the Action 6 Report,²¹¹ article 8(1) introduced a minimum shareholding period for a company to be entitled to exemption or a reduced rate on dividends from a subsidiary.²¹²

Provisions of a Covered Tax Agreement [exempting from tax] dividends paid by a company which is a resident” of Contracting Jurisdiction X or limiting the tax rate on dividends “provided that the beneficial owner or the recipient . . . is a resident of [Contracting Jurisdiction Y] and . . . owns, holds, or controls more than a certain amount of the capital, shares, stock, voting power, voting rights, or similar ownership interests of the company paying the dividends, shall apply only if the ownership conditions described in those provisions are met throughout a 365-day period that includes the day of the payment of the dividends.”²¹³

206. OECD 2017 MLI, *supra* note 24, art. 7(14).

207. *Id.*, art. 7(15)(a).

208. *Id.*, art. 7(15)(b) and (c).

209. *Id.*, art. 7(16).

210. *Id.*, art. 7(17).

211. *See* OECD, *supra* note 27, ¶ 36.

212. OECD 2017 MLI, *supra* note 24, art. 8(1).

213. *Id.*

However, article 8(1) is not intended to modify conditions or elements of Covered Tax Agreement, including tax rates, ownership thresholds and forms of ownership.²¹⁴

The compatibility clause in article 8(2) clarifies that the 365-day minimum shareholding period “shall apply in place of or in the absence of a minimum holding period in [existing] provisions”²¹⁵

Given that a provision addressing dividend transfer transactions is not required in order to meet a minimum standard, the reservation clause in Article 8(3) allows Parties to opt out of Article 8 entirely, either unconditionally or conditionally to the extent that the existing provisions already include a minimum holding period, regardless of whether it is shorter or longer than a 365-day period.²¹⁶

To ensure clarity, the notification clause in Article 8(4) sets out notification requirements and clarifies that Article 8(1) “shall apply with respect to an [existing] provision only where all Contracting Jurisdictions have made such a notification with respect to the that provision”.²¹⁷

2.7.4 Capital Gains from Alienation of Shares or Interests of Entities Deriving Their Value Principally from Immovable Property

Based on Article 13(4) of the OECD Model Tax Convention as revised by the Action 6 Report and Article 13(4) of the UN Model Tax Convention,²¹⁸ Article 9(1) addresses situations in which assets are contributed to an entity shortly before the sale of shares or comparable interests in that entity in order to dilute the proportion of the value of the entity that is derived from immovable property.²¹⁹

Under Article 9(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 or rights 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

214. OECD MLI Explanatory Statement, *supra* note 24, ¶ 122.

215. OECD 2017 MLI, *supra* note 24, art. 8(2).

216. *Id.* art. 8(3).

217. *Id.* art. 8(4).

218. *See* OECD, *supra* note 27, ¶ 44.

219. OECD 2017 MLI, *supra* note 24, art. 9(1).

interests are not already covered) in addition to any shares or rights already covered by the provisions.”²²⁰

Given that article 9(1) is intended to “introduce a testing period and to [expand the scope of covered interests], the threshold provided in existing provisions would be preserved”.²²¹ The exceptional rule on the application of the existing provisions would continue to apply.²²² For example, “some Covered Tax Agreements may exclude gains derived from the alienation of shares of listed companies. . .”.²²³

The compatibility clause in article 9 (2) clarifies that the 365-day testing period “shall apply in place of or in the absence of a time period for determining whether the relevant value threshold in [existing] provisions was met”.²²⁴

Under article 9(3), parties may apply optional article 9(4), based on article 13(4) of the OECD Model Tax Convention,²²⁵ “to their Covered Tax Agreements, rather than incorporating a testing period and expanding interest covered by existing capital gains provisions”.²²⁶

[F]or purposes of a Covered Tax Agreement, gains derived by a resident of Contracting Jurisdiction [X] from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in Contracting [Jurisdiction Y] if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than fifty percent of their value directly or indirectly from immovable property (real property) situated in [Jurisdiction Y].²²⁷

The compatibility clause in article 9(5) clarifies that article 9(4) “shall apply in place of or in the absence of [existing]provisions of Covered Tax Agreements . . . [addressing capital gains] from the alienation of shares or [interests in entities] . . . [deriving their value principally] from immovable property”.²²⁸

“Given that a provision addressing capital gains from alienation of shares or interests in entities deriving their value principally from immovable property is not required in order to meet the minimum standard,”²²⁹ the reservation clause in article 9(6) allows Parties to opt out of either

220. *Id.*

221. OECD MLI Explanatory Statement, *supra* note 24, ¶ 131.

222. *Id.*

223. *Id.*

224. OECD 2017 MLI, *supra* note 24, art. 9(2).

225. OECD MLI Explanatory Statement, *supra* note 24, ¶ 133.

226. OECD 2017 MLI, *supra* note 24, art. 9(3).

227. *Id.* art. 9(4).

228. *Id.* art. 9(5).

229. OECD MLI Explanatory Statement, *supra* note 24, ¶ 136.

article 9(1) entirely, or opt out of article 9(1)(a) and (b) separately.²³⁰ Parties may also opt out of [article 9(4)] with respect to their Covered Tax Agreements that already contain a provision described in article [9(5)] . . .”²³¹

The reservation clause in article 9(7) clarifies that article 9(1) “shall apply with respect to a provision of a Covered Tax Agreement only where all Contracting Jurisdictions have made a notification with respect to that provision”.²³²

Under article 9(8), article 9(4) “shall apply to a Covered Tax Agreement only where all Contracting Jurisdictions have [chosen to apply it and notified the Depository of its choice]”.²³³ In such a case, article 9(1) would not apply.²³⁴

2.7.5 Anti-abuse Rule for PEs Situated in Third Jurisdictions

Articles 10(1) through (3) are based on the text of the OECD Model Tax Convention produced in the Action 6 Report.²³⁵ Under Article 10(1),

[W]here an enterprise of Contracting [Jurisdiction X] derives income from Contracting [Jurisdiction Y] and [Jurisdiction X] treats such income as attributable to a PE of the enterprise situated in a third [jurisdiction Z], and the profits attributable to that PE are exempt from tax in [Jurisdiction X], the [treaty] benefits shall not apply to any item of income on which the tax in [jurisdiction Z] is less than sixty percent of the tax that would be imposed in [Jurisdiction X] on that item of income if that PE were situated in [Jurisdiction X].²³⁶ In such a case, any income to which the provisions of [article 10(1)] apply shall remain taxable according to the domestic law of [Jurisdiction Y], notwithstanding any other provisions of the Covered Tax Agreement.²³⁷

However, under article 10(2), article 10(1)

[S]hall not apply if the income [of Jurisdiction Y is] derived in connection with or is incidental to the active conduct of a business carried on through the PE (other than the business of making, managing, or simply holding investments for the enterprise’s own account, unless these activities are banking, insurance, or securi-

230. OECD 2017 MLI, *supra* note 24, art. 9(6).

231. *Id.*, art. 9(6)(f).

232. *Id.*, art. 9(7).

233. *Id.*, art. 9(8).

234. *Id.*, art. 9(6).

235. OECD, *supra* note 27, ¶ 52.

236. OECD 2017 MLI, *supra* note 24, art. 10(1).

237. *Id.*

ties activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).²³⁸

Article 10(3) empowers the competent authorities to grant treaty benefits in certain justified circumstances.²³⁹ “If benefit[s] . . . are denied pursuant to [article 10(1)] with respect to an item of income derived by a resident of [Jurisdiction X], the competent authority of [Jurisdiction Y] may, nevertheless, grant these benefits with respect to that item of income, if . . . [the] authority determines that granting such benefits is justified in light of the reasons [the] resident did not satisfy the requirements of [article 10(1) and (2)]”.²⁴⁰ “The competent authority . . . shall consult with [its counterpart in Jurisdiction X] before either granting or denying the request”.²⁴¹

The compatibility clause in article 10(4) clarifies that articles 10(1) through (3) shall apply in place of or in the absence of a provision addressing PEs situated in third jurisdictions.²⁴²

“Given that a provision addressing [PE]s situated in third jurisdictions is not required in order to meet the minimum standard,”²⁴³ the reservation clause in Article 10(5) permits a Party to opt out of article 10 in three different ways.²⁴⁴

The notification clause in article 10(6) requires the non-reserving Parties to notify the Depository.²⁴⁵ “Where all Contracting Jurisdictions have [notified] with respect to a provision of a Covered Tax Agreement, that provision shall be replaced by [articles 10(1) through (3)]”.²⁴⁶ Articles 10(1) through (3) shall supersede the existing provisions only to the extent of incompatibility.²⁴⁷

2.7.6 Application of Tax Agreements to Restrict a Party’s Right to Tax Its Own Residents

Based on article 1(3) of the OECD Model Tax Convention as set out in the Action 6 Report,²⁴⁸ the saving clause in article 11(1) is intended to preserve the right of a Contracting Jurisdiction to tax its own residents.²⁴⁹

Under article 11(1), a Covered Tax Agreement shall not affect the taxation by a Contracting Jurisdiction of its residents, except with respect

238. *Id.*, art. 10(2).

239. *Id.*, art. 10(3).

240. *Id.*

241. *Id.*

242. *Id.*, art. 10(4).

243. OECD MLI Explanatory Statement, *supra* note 24, ¶ 145.

244. OECD 2017 MLI, *supra* note 24 art. 10(5).

245. *Id.*, art. 10(6).

246. *Id.*

247. *Id.*

248. OECD, *supra* note 27, ¶ 63.

249. OECD 2017 MLI, *supra* note 24, art. 11(1).

to the following ten categories of treaty benefits: i) business profits of a PE or profits of an associated enterprise; ii) government service; iii) qualified student, business apprentice or trainee, teacher, professor, lecturer, instructor, researcher or research scholar; iv) credit method and exemption method); v) non-discrimination; vi) mutual agreement procedure; vii) members of diplomatic missions, government missions, or consular posts; viii) pensions or other payments made under social security legislation; ix) pensions and similar payments, annuities, alimony payments, or other maintenance payments; or x) other provisions that expressly limit taxation rights of the residence jurisdiction or allow taxation rights exclusively to the source jurisdiction.²⁵⁰

The compatibility clause in article 11(2) clarifies that article 11(1) replaces existing provisions “stating that the Covered Tax Agreements would not affect the taxation by a Contracting Jurisdiction of its residents,” or is added where such provisions do not exist.²⁵¹

“Given that a saving clause is not required to meet the minimum standard,”²⁵² and recognizing that some Parties may prefer a more targeted solution,²⁵³ article 11(3)(a) allows Parties to opt out of article 11 entirely.²⁵⁴ In such a case, article 3(3) applies to introduce a saving clause that relates solely to the provision in article 3(1).²⁵⁵ Recognizing that an existing saving clause provision is usually customized based on the content of such Agreements, article 11(3)(b) allows the Parties to opt out of article 11 entirely with respect to Covered Tax Agreements already containing a saving clause.²⁵⁶

The notification clause in article 11(4) clarifies that an existing provision of a Covered Tax Agreement would be replaced by the provisions of article 11(1), “where all Contracting Jurisdictions have made such a notification with respect to the [existing provision]”.²⁵⁷ In other cases, article 11(1) would supersede the existing provisions only to the extent of incompatibility.²⁵⁸

2.8 Avoidance of PE Status

2.8.1 Artificial Avoidance of PE Status Through *Commissionnaire* Arrangements and Similar Strategies

Article 12(1) of the new MLI, based on article 5(5) of the OECD Model Tax Convention produced in the Action 7 Report,²⁵⁹ states that:

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250. *Id.*
 251. *Id.*, art. 11(2).
 252. OECD MLI Explanatory Statement, *supra* note 24, ¶ 153.
 253. *Id.*
 254. OECD 2017 MLI, *supra* note 24, art. 11(3)(a).
 255. *Id.*, art. 3(3).
 256. *Id.*, art. 11(3)(b).
 257. *Id.*, art. 11(4).
 258. OECD MLI Explanatory Statement, *supra* note 24, ¶ 155 .
 259. OECD, *supra* note 36, at 16.

[W]here a person is acting in a Contracting Jurisdiction . . . on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are: a) in the name of the enterprise; or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement.²⁶⁰

Based on article 5(6)(a) of the OECD Model Tax Convention produced in the Action 7 Report,²⁶¹ article 12(2) clarifies that article 12(1) “shall not apply where the person acting in Contracting [Jurisdiction X] on behalf of [an enterprise of Contracting Jurisdiction Y carries on business in Jurisdiction X as] an independent agent and acts for the enterprise in the ordinary course of that business”.²⁶² “Where, however, 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 []with respect to any such enterprise.”²⁶³

The compatibility clause in article 12(3) describes the interaction between article 12(1) and (2) and various existing provisions.²⁶⁴ Article 12(1) “would [replace existing provisions] describing the conditions under which an enterprise shall be deemed to [have a] PE in a Contracting Jurisdiction in respect of an activity which a person other than an [independent] agent undertakes for the enterprise, but only to the extent that such provisions address the situation in which [the] person has, and habitually exercises, [authority] in that Contracting Jurisdiction to conclude contracts in the name of the enterprise”.²⁶⁵ However, article 12(1) would not apply to a provision providing that an enterprise can be deemed to have a PE for a reason other than an authority to conclude contracts that are binding on another enterprise.²⁶⁶ Article 12(2) would replace existing provisions providing “that an enterprise shall not be deemed to have a PE in a Con-

260. OECD 2017 MLI, *supra* note 24, art. 12(1).

261. OECD, *supra* note 36, at 7.

262. OECD 2017 MLI, *supra* note 24, art. 12(2).

263. *Id.*, art. 12(2).

264. *Id.* art. 12(3).

265. *Id.*, art. 12(3)(a).

266. *Id.*

tracting Jurisdiction in respect of an activity which an agent of an independent status undertakes for the enterprise”.²⁶⁷

Given that provisions addressing the issues of article 12 are not required to meet the minimum standard,²⁶⁸ article 12(4) allows a Party to opt out of article 12 entirely.²⁶⁹

The notification clauses in article 12(5) and (6) clarify that article 12(1) or (2) would apply with respect to an existing provision only where all Contracting Jurisdictions to such Agreement have made such a notification.²⁷⁰

2.8.2 Artificial Avoidance of PE Status Through the Specific Activity Exemptions

Article 13 is intended to reflect the changes brought by the Action 7 Report to the wording of article 5(4) of the OECD Model Tax Convention of 2014, so as to address situations in which the specific activity exemptions give rise to BEPS concerns.²⁷¹ Article 13(1) permits a Party to choose to apply Option A or Option B or to apply neither Option.²⁷²

To address concerns of artificial avoidance of PE status through the specific activity exemptions, Option A explicitly states:

[T]hat the activities listed therein will be deemed not to constitute a PE only if they are of a preparatory or auxiliary character, including: a) the activities specifically listed in [existing provisions] as activities deemed not to constitute a PE, whether or not that exception from PE status is contingent on the activity being of a preparatory or auxiliary character; b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a); c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b).²⁷³

Option B is designed as an alternative provision to address inappropriate use of the specific activity exemptions through anti-fragmentation rules.²⁷⁴ The term “PE” shall be deemed not to include:

a) the activities specifically listed in the [existing provisions] as activities deemed not to constitute a PE, whether or not that exception from PE status is contingent on the activity being of a preparatory or auxiliary character, except to the extent that the

267. *Id.*, art. 12(3)(b).

268. OECD MLI Explanatory Statement, *supra* note 24, ¶ 165.

269. OECD 2017 MLI, *supra* note 24, art. 12(4).

270. *Id.*, art. 12(5) – (6).

271. OECD MLI Explanatory Statement, *supra* note 24, ¶ 168.

272. OECD 2017 MLI, *supra* note 24, art. 13(1).

273. *Id.*, art. 13(2).

274. OECD MLI Explanatory Statement, *supra* note 24, ¶ 169.

relevant [existing] provisions provides explicitly that a specific activity shall be deemed not to constitute a PE provided that the activity is of a preparatory or auxiliary character; b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a), provided that this activity is of a preparatory or auxiliary character; c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.²⁷⁵

The application of Option A will permit Parties to preserve the exceptions for activities described in existing provisions, but will require that those activities must be preparatory or auxiliary.²⁷⁶ In contrast, the application of Option B will permit Parties to preserve the exceptions for activities described in existing provisions, but “will require that those exceptions will apply irrespective of whether the activity is of a preparatory or auxiliary character”.²⁷⁷

To address the fragmentation of activities between closely related parties and avoid the abuse of the exceptional rules on the definition of PE, article 13(4) clarifies that a provision of a Covered Tax Agreement

[T]hat lists specific activities deemed not to constitute a PE shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting Jurisdiction and: a) that place or other place constitutes a PE for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a PE; or b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.²⁷⁸

The compatibility clause in article 13(5) (a) clarifies that Option A or Option B “shall apply in place of the relevant parts of [existing] provisions [listing] specific activities that are deemed not to constitute a PE even if

275. OECD 2017 MLI, *supra* note 24, art. 13(3).

276. OECD MLI Explanatory Statement, *supra* note 24, ¶ 171.

277. *Id.*, ¶ 173.

278. OECD 2017 MLI, *supra* note 24, art. 13(4).

the activity is carried on through a fixed place of business”.²⁷⁹ Further, Article 13(5)(b) “shall apply to existing provisions [listing] specific activities that are deemed not to constitute a PE even if the activity is carried on through a fixed place of business”.²⁸⁰ Such existing provisions would include those modeled after article 5(4) of the OECD Model Tax Convention of 2014 or article 5(4) of the UN Model Tax Convention of 2011 and bilaterally negotiated provisions of the same type.²⁸¹

“Given that provisions addressing artificial avoidance of PE status through the specific activity exemptions [] are not required to meet the minimum standard”,²⁸² article 13(6) permits a Party to opt out of either article 13 entirely, or Option A with respect to existing provisions already explicitly stating “that [listed] activities shall be deemed not to constitute a PE only if [the activities is] preparatory or auxiliary”, or Article 13(4).²⁸³

The notification clause in article 13(7) requires Parties choosing “to apply an Option [to] notify the Depository of its choice of Option”.²⁸⁴ “An Option shall apply [] to a provision [] only where all Contracting Jurisdictions have chosen to apply the same Option and have made such a notification . . .”.²⁸⁵

Article 13(8) requires Parties not opting out of applying article 13(4) (or the entirety of Article 13) to notify the Depository of each of its Covered Tax Agreements that includes specific activity exemptions.²⁸⁶ Article 13(4) “shall apply to [an existing] provision only where all Contracting Jurisdictions have made [such] a notification . . .”.²⁸⁷

2.8.3 Splitting-up of Contracts

Article 14 is designed to address abusive splitting-up of contracts as a potential strategy for the artificial avoidance of PE status, as a response to the Action 7 Report.²⁸⁸

Under article 14(1), “for the sole purpose of determining whether the period (or periods) referred to in an [existing] provision that stipulates a period (or periods) of time after which specific projects or activities shall constitute a PE has been exceeded”:

- a) where an enterprise E of Contracting Jurisdiction X carries on activities in Contracting Jurisdiction Y at a place that constitutes a building site, construction project, installation pro-

279. *Id.* art. 13(5).

280. *Id.*, art. 13(5)(a).

281. OECD MLI Explanatory Statement, *supra* note 24, ¶ 178.

282. *Id.*, ¶ 179.

283. OECD 2017 MLI, *supra* note 24, art. (6).

284. *Id.*, art. 13(7).

285. *Id.*

286. *Id.*, art. 13(8).

287. *Id.*

288. OECD MLI Explanatory Statement, *supra* note 24, ¶ 182.

ject or other specific project identified in the relevant existing provision, or carries on supervisory or consultancy activities in connection with such a place, in the case of an existing provision referring to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant existing provision;

- b) where connected activities are carried on in Jurisdiction Y at (or in connection with) the same building site, construction or installation project, or other place identified in the relevant existing provision during different periods of time, each exceeding 30 days, by one or more enterprises closely related to enterprise E, these different periods of time shall be added to the aggregate period of time during which enterprise E has carried on activities at that building site, construction or installation project or other place identified in the relevant existing provision.²⁸⁹

The compatibility clause in article 14(2) clarifies that article 14(1) “shall apply in place of or in the absence of [existing] provisions to the extent that such provisions address the division of contracts into multiple parts to avoid the application of a time period or periods” that determine whether a PE exists for specific projects or activities.²⁹⁰ Although anti-splitting rules in many treaties apply to a wide range of activities, article 14(2) is only intended to replace existing rules to the extent that they relate to the activities described in article 14(1), and leaves those rules intact with respect to activities not within the scope of article 14(1).²⁹¹

Given that anti-splitting provisions are not required in order to meet the minimum standard,²⁹² the reservation clause in article 14(3) permits a Party to opt out of the entirety of Article 14.²⁹³ Recognizing that the anti-contract-splitting rules addressing the exploration for or exploitation of natural resources are generally carefully negotiated,²⁹⁴ a Party may opt out of the entirety of article 14 “with respect to [existing] provisions relating to the exploration for or exploitation of natural resources”.²⁹⁵

The notification clause in article 14(4) clarifies that article 14(1) shall replace anti-splitting provisions to the extent provided in article 14(2) where all Contracting Jurisdictions to the Covered Tax Agreement have notified accordingly.²⁹⁶ “In other cases, [article 14(1)] shall apply to [the

289. OECD 2017 MLI, *supra* note 24, art. 14(1).

290. *Id.*, art. 14(2).

291. OECD MLI Explanatory Statement, *supra* note 24, ¶ 185.

292. *Id.*

293. OECD 2017 MLI, *supra* note 24, art. 14(3)(a).

294. OECD MLI Explanatory Statement, *supra* note 24, ¶ 186.

295. OECD 2017 MLI, *supra* note 24, art. 14(3)(b).

296. *Id.*, art. 14(4).

Covered Tax Agreement, but will] supersede the existing provisions only to the extent of incompatibility . . .”²⁹⁷

2.8.4 Definition of a Person Closely Related to an Enterprise

Based on article 5(6)(b) of the OECD Model Tax Convention,²⁹⁸ article 15(1) describes the conditions under which a person will be considered “closely related” to an enterprise for the purposes of articles 12, 13 and 14.²⁹⁹

A person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. [Specifically], a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than fifty percent of the beneficial interest in the other (or, in the case of a company, more than fifty percent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than fifty percent of the beneficial interest (or, in the case of a company, more than fifty percent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise.³⁰⁰

Since article 15(1) is essential to understand the term “closely related to an enterprise” used in the MLI, Parties can opt out of Article 15 only if they have made the reservations described in Article 12(4), Article 13(6)(a) or (c), and Article 14(3)(a).³⁰¹

2.9 Improving Dispute Resolution

Given that the minimum standard for improving dispute resolution declared in the Action 14 Report can be complemented by a set of best practices, Part V of the MLI is designed to provide ways to incorporate some of those best practices into Covered Tax Agreements.³⁰²

2.9.1 Mutual Agreement Procedure

To provide for taxpayer’s rights in the context of international tax law, articles 16(1) through (3) are intended to effectively incorporate articles 25(1) through (3) of the OECD Model Tax Convention into Covered Tax Agreements and to set out the requirements for the mutual agreement procedure (MAP).³⁰³

297. *Id.*

298. OECD, *supra* note 36, at 16 –17.

299. OECD 2017 MLI, *supra* note 24, art. 15(1).

300. *Id.*

301. *Id.*, art. 15(2).

302. OECD MLI Explanatory Statement, *supra* note 24, ¶ 191.

303. *Id.*, ¶ 191.

Where a person considers that the actions of one or both of the Contracting Jurisdictions result or will result for that person in taxation not in accordance with the provisions of the Covered Tax Agreement, that person may present the case to the competent authority of either Contracting Jurisdiction within three years of the first notification of the [aforesaid action] The competent authority shall endeavor, . . . to resolve the case by mutual agreement with its counterpart in the other Contracting Jurisdiction, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting Jurisdictions. The competent authorities shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention³⁰⁴

The compatibility clause in Article 16(4) permits Parties to retain existing provisions relating to dispute resolution to the extent that those provisions are consistent in content with the provisions of article 16(1) through (3), and subject to any reservations provided in article 16(5).³⁰⁵

The reserving clause in article 16(5) permits Parties to implement element 1.1 of the Action 14 minimum standard through administrative measures, as provided under elements 3.1 and 3.3 of the Action 14 minimum standard.³⁰⁶

A Party may opt out of applying the first sentence of article 16(1)

[On the basis that it intends to meet the minimum standard [under the BEPS Package by ensuring] that under each of its Covered Tax Agreements, . . . the taxpayer may present its case to the competent authority of the Contracting Jurisdiction of which it is a resident . . . or a national and that [such] competent authority will implement a bilateral notification or consultation process with [its counterpart] in the other Contracting Jurisdiction for [the MAP] cases in which [such] competent authority [does not consider the taxpayer's objection to be justified].³⁰⁷

A Party may opt out of applying the three-year period requirement of article 16(1) on the basis that it intends to meet the minimum standard by ensuring that, “where its tax treaty does not contain a provision stipulating the time period for the taxpayer to present the [MAP] case”, the taxpayer is allowed to present the MAP case within a period of at least three years.³⁰⁸ “It is anticipated, therefore, that this reservation would only be

304. *Id.*, art. 16(3).

305. *Id.*, art. 16(4).

306. OECD MLI Explanatory Statement, *supra* note 24, ¶ 199.

307. OECD 2017 MLI, *supra* note 24, art. 16(5)(a).

308. OECD 2017 MLI, *supra* note 24, art. 16(5)(b).

made by a Contracting Jurisdiction if its domestic regulations apply automatically and are more favorable in their effects to the taxpayer, either because they allow a longer time for presenting objections or because they do not set any time limits for such purpose.”³⁰⁹

A Party may also reserve on the application of the second sentence of article 16(2) only on the basis that either (i) all MAP agreements “shall be implemented notwithstanding any time limits in the domestic law of the Contracting Jurisdictions”³¹⁰; or (ii) it intends to meet the minimum standard by accepting, in its bilateral treaty negotiations, alternative treaty provisions that limit the time during which a Contracting Jurisdiction may make an adjustment pursuant to provisions modeled after article 9(1) or article 7(2) of the OECD Model Tax Convention, in order to avoid late adjustments with respect to which MAP relief will not be available.³¹¹

Article 16(6) requires a number of notifications to ensure clarity as to how Covered Tax Agreements will be modified by article 16.³¹²

2.9.2 Corresponding Adjustments

Given that the Action 14 Report noted that it would be more efficient if jurisdictions had the possibility to unilaterally provide for corresponding adjustments in cases in which they find the objection of the taxpayer to be justified.³¹³ Recognizing that Best Practice No. 1 contained in the Action 14 Report states that jurisdictions should include article 9(2) of the OECD Model Tax Convention in their tax treaties,³¹⁴ article 17 is intended to provide a mechanism for Parties to implement this Best Practice.³¹⁵

Article 17(1) requires corresponding adjustments.³¹⁶ “Where a Contracting Jurisdiction [X] includes in the profits of an enterprise of [its] Jurisdiction —and taxes accordingly— profits on which an enterprise of [] Contracting Jurisdiction [Y] has been charged to tax in Jurisdiction [Y], and the profits so included are profits which would have accrued to the enterprise of Jurisdiction [X] (if the conditions made between the two enterprises had been those which would have been made between independent enterprises), then [Jurisdiction Y] shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Covered Tax Agreement and the competent au-

309. OECD MLI Explanatory Statement, *supra* note 24, ¶ 201.

310. OECD 2017 MLI, *supra* note 24, art. 16(4)(b).

311. OECD 2017 MLI, *supra* note 24, art. 16(5)(c).

312. *Id.*, art. 16(6).

313. OECD, Making Dispute Resolution Mechanisms More Effective, *supra* note 37, ¶ 43.

314. *Id.*

315. OECD MLI Explanatory Statement, *supra* note 24, ¶ 209.

316. OECD 2017 MLI, *supra* note 24, art. 17(1).

thorities of [Jurisdictions X and Y] shall if necessary consult each other.”³¹⁷

The compatibility clause in article 17 (2) provides that article 17(1) “shall apply in the place of or in the absence of a provision that requires a Contracting Jurisdiction to make an appropriate adjustment. . . where the other Contracting Jurisdiction [makes an adjustment that reflects the arm’s length profits of an enterprise] . . .”³¹⁸ Some existing provisions are modeled after article 9(2) of the OECD Model Tax Convention or the UN Model Tax Convention. If certain existing provisions only *permit*, but do not *require*, a Contracting Jurisdiction to make a corresponding adjustment, such provisions would be outside the scope of article 17(2) and would continue to apply except in the case of incompatibility.³¹⁹ If such provisions would permit a Contracting Jurisdiction to choose not to make an appropriate adjustment even when the adjustment made by the other Contracting Jurisdiction was justified, the provisions would be superseded by article 17(1).

“Given that the inclusion of article 9(2) of the OECD Model Tax Convention in tax treaties is a best practice . . . , not the minimum standard, [and recognizing that] element 1.1 of the Action 14 minimum standard requires that jurisdictions provide access to the MAP in transfer pricing cases and implement the resulting mutual agreements regardless of whether the tax treaty contains a provision modeled after article 9(2) of the OECD Model Tax Convention,”³²⁰ the conditional reservation clauses in Article 17(3) permit a Party to reserve the right for article 17 not to apply to its Covered Tax Agreements that already contain a provision of the same type.³²¹ “A Party may also opt out of article 17 “on the basis that in the absence of a provision referred to in [article 17(2)], in [article 17(1)], it shall make the appropriate adjustment referred to in [article 17(1)], or its competent authority shall endeavor to resolve the case under the [existing] provisions [relating to MAP].”³²² A reserving Party under article 16(5)(c)(ii) may opt out of article 17 “on the basis that in its bilateral treaty negotiations it shall accept a treaty provision of the type contained in [article 17(1)], provided that the Contracting Jurisdictions were able to reach agreement on that provision and on the provisions described in [article 16(5)(c)(ii)].”³²³

The notification clause in article 17(4) requires Parties to notify the Depository of whether each of its Covered Tax Agreements contains an existing requirement to make a corresponding adjustment.³²⁴ The provisions of article 17(1) will replace such provisions where all Contracting

317. *Id.*

318. *Id.*, art. 17(2).

319. *But c.f. Id.*

320. OECD MLI Explanatory Statement, *supra* note 24, ¶ 212.

321. OECD 2017 MLI, *supra* note 24, art. 17(3)(a).

322. *Id.*, art. 17(3)(b).

323. *Id.*, art. 17(3)(c).

324. *Id.*, art. 17(4).

Jurisdictions to a Covered Tax Agreement have made such a notification.³²⁵ In other cases, article 17(1) will supersede existing provisions only in the case of incompatibility.³²⁶

2.10 Arbitration

2.10.1 Choice to Apply Part VI

Article 18 encourages Parties to choose to apply Part VI of the MLI with respect to its Covered Tax Agreements.³²⁷ However, Part VI is intended to apply only between Parties that explicitly choose to apply it by notifying the Depository of such choice.³²⁸ “A Party is permitted to formulate reservations with respect to the scope of cases eligible for arbitration”.³²⁹

2.10.2 Mandatory Binding Arbitration

Article 19 (1) contains the core arbitration provision.³³⁰ “Where the competent authorities are unable to reach an agreement on a case pursuant to the MAP under the Covered Tax Agreement . . . within a period of two years . . . any unresolved issues arising from the case shall, at the request of the person presenting the case, be submitted to arbitration in the manner described in [Part VI].”³³¹ However, prior to the expiration of the two-year period, the competent authorities may agree to a longer or shorter time period with respect to a particular case, and should notify the person presenting the case of such agreement.³³² Article 19 (8) permits a Party to reserve the right to substitute a three-year period for the two-year period for the purposes of applying article 19 to its Covered Tax Agreements.³³³

Article 19 (2) is intended to avoid a complicated and unpredictable situation and to ensure that one remedy process will take place before the other, where a taxpayer’s case goes through both the MAP and domestic court or administrative proceedings.³³⁴ The period for arbitration request shall stop running if a competent authority has suspended the MAP because a case related to one or more of the same issues is pending before the court or administrative tribunal.³³⁵ The period will start running again when a final decision has been rendered by the court or administrative

325. *Id.*

326. *Id.*

327. *Id.*, art. 18.

328. *Id.*

329. OECD MLI Explanatory Statement, *supra* note 24, ¶ 216.

330. OECD 2017 MLI, *supra* note 24, art. 19(1).

331. *Id.*

332. *Id.*, art. 19(1)(b).

333. *Id.*, art. 19(8).

334. OECD MLI Explanatory Statement, *supra* note 24, ¶ 217.

335. OECD 2017 MLI, *supra* note 24, art. 19(2).

tribunal or the case has been suspended or withdrawn.³³⁶ The period will also stop running if a person presenting the case and a competent authority have agreed to suspend the mutual agreement process for any reason, especially for taxpayer-friendly consideration of unexpected personal hardships. The period will start running again once that suspension has been lifted.³³⁷

Given that additional information from the taxpayer might be requested by either competent authority to undertake substantive consideration of the case, article 19(3) permits the period for arbitration request to be extended, “where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any [requested] additional material information . . . for an amount of time equal to the period beginning on the date [of] information request and ending on the date of ultimate provision of information . . .”.³³⁸

Article 19(4)(b) is intended to clarify the validity of the arbitration decision.³³⁹ First, the arbitration decision shall be final,³⁴⁰ and “cannot be changed either by the competent authorities or by the arbitration panel unless . . . article 24 appl[ies] to permit agreement on a different resolution.”³⁴¹ Second, because the arbitration process is an extension of the MAP in case of deadlock, and the arbitration decision is *per se* unable to automatically resolve all the issues without the subsequent supportive mutual agreement, the arbitration decision shall be implemented through mutual agreement concerning the case.³⁴² “Third,

[T]he arbitration decision shall be binding on both Contracting Jurisdictions except in [three circumstances]: i) if a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision. In such a case, the case shall not be eligible for any further consideration by the competent authorities) . . . ; ii) if a final decision of the courts of one of the Contracting Jurisdictions holds that the arbitration decision is invalid. In such a case, the request for arbitration [] shall be considered not to have been made, and the arbitration process shall be considered not to have taken place, . . . and a new request for arbitration may be made unless the competent authorities agree that such a new request should not be permitted); and iii) if a person directly affected by the case pursues litigation on the issues

336. *Id.*

337. *Id.*

338. *Id.*, art. 19(3).

339. *Id.*, art. 19(4)(b).

340. *Id.*, art (19(4)(a).

341. OECD MLI Explanatory Statement, *supra* note 24, ¶ 220.

342. OECD 2017 MLI, *supra* note 24, art. 19(4)(a); OECD MLI Explanatory Statement, *supra* note 24, ¶ 220.

which were resolved in the mutual agreement implementing the arbitration decision in any court or administrative tribunal.”³⁴³

Articles 19(5) through (7) set forth detailed requirements as to the dates for the competent authority to notify the person presenting the case and the other competent authority regarding the receipt of the MAP request and the request for additional information.³⁴⁴

Articles 19(8) through (9) provide detailed rules to establish the start date of the period before unresolved issues in a case are first eligible to be submitted to arbitration, depending on whether the competent authorities have requested additional information.³⁴⁵

To ensure smooth and predictable functioning of the arbitration process by and through close collaboration between the competent authorities based on jointly agreed procedural and operational rules, article 19(10) requires that the competent authorities “settle the mode of application of the [arbitration] provisions [by mutual agreement] . . . , including the minimum information necessary for each competent authority to undertake substantive consideration of the case. Such an agreement shall be concluded before the date on which unresolved issues in a [MAP] case are first eligible to be submitted to arbitration.”³⁴⁶ This mode of application may be changed from time to time thereafter.³⁴⁷

Article 19(11) allows a Party to “reserve the right to replace the two-year period set forth in [Article 19(1)(b)] with a three-year period”³⁴⁸ for the purposes of applying Part VI to its Covered Tax Agreements.

Under Article 19(12), a Party may reserve the right to exclude from arbitration issues with respect to which a decision has been rendered by a court or administrative tribunal of either Contracting Jurisdiction.³⁴⁹ First, “any unresolved issue arising from a [MAP] case shall not be submitted to arbitration, if a decision on this issue has already been rendered by a court or administrative tribunal of either Contracting Jurisdiction.”³⁵⁰ Second, the arbitration process shall terminate, if a court or administrative tribunal decision is rendered during the arbitration process.³⁵¹ The reason is that some jurisdictions do not permit a mutual agreement concluded by the competent authority to override the decision of domestic court or administrative tribunal, either as a matter of law or practice.³⁵²

343. OECD 2017 MLI, *supra* note 24, art. (4)(b).

344. *Id.*, art. 19(5) – (7).

345. *Id.*, art. 19(8) – (9).

346. *Id.*, art. 19(10).

347. OECD MLI Explanatory Statement, *supra* note 24, ¶ 230.

348. OECD 2017 MLI, *supra* note 24, art. 19(11).

349. *Id.*, art. 19(12).

350. *Id.*, art. 19(12)(a).

351. *Id.*, art. 19(12)(b).

352. OECD MLI Explanatory Statement, *supra* note 24, ¶ 232.

2.10.3 Appointment of Arbitrators

Although Article 20 sets out detailed default rules for the appointment and qualifications of arbitrators, the competent authorities may mutually agree on different rules, either generally or with respect to a particular case.³⁵³

“The arbitration panel consist of three individual members with expertise or experience in international tax matters.”³⁵⁴ “Each competent authority shall appoint one panel member within 60 days of the date of request for arbitration.”³⁵⁵ The two members shall then, “within 60 days of the latter of their appointments, appoint a third member who is not a national or resident of either Contracting Jurisdiction to serve as Chair of the panel.”³⁵⁶ Each member must maintain her or his impartiality and independence of the arbitrators through the arbitration proceedings.³⁵⁷

If the competent authority fails to appoint a panel member, or if the two initial members fail to appoint the Chair, within the specified or agreed time periods, the highest ranking official of the OECD Centre for Tax Policy and Administration that is not a national of either Contracting Jurisdiction, shall appoint the vacant member or the Chair respectively.³⁵⁸

2.10.4 Confidentiality of Arbitration Proceedings

Confidential information in arbitration proceeding is not supposed to be leaked without due authorization process.³⁵⁹ Article 21 is intended to ensure smooth arbitration proceedings without undermining the confidentiality of the MAP.³⁶⁰

The “information received by the arbitration panel or prospective arbitrators and information that the competent authorities receive from the arbitration panel shall be considered information [] exchanged [under the exchange of information and administrative assistance provisions of the Covered Tax Agreement]”.³⁶¹ “The competent authorities . . . shall ensure that [panel] members and their staff agree in writing . . . to treat any information relating to the arbitration proceeding consistently with the confidentiality and nondisclosure [requirements].³⁶² . . .The consequences of breach of confidentiality will be determined under the agreement terms and the domestic laws of the Contracting Jurisdictions.³⁶³

353. OECD 2017 MLI, *supra* note 24, art. 20(1); OECD MLI Explanatory Statement, *supra* note 24, ¶ 234.

354. OECD 2017 MLI, *supra* note 24, art. 20(2)(a).

355. *Id.*, art. 20(2)(b).

356. *Id.*

357. *Id.* art. 20(2)(c).

358. *Id.*, art. 20(3).

359. OECD MLI Explanatory Statement, *supra* note 24, ¶ 238.

360. *See id.*

361. OECD 2017 MLI, *supra* note 24, art. 21(1).

362. *Id.*, art. 21(2).

363. OECD MLI Explanatory Statement, *supra* note 24, ¶ 239.

2.10.5 Resolution of a Case Prior to the Conclusion of the Arbitration

Given that arbitration is the last resort for the disputes between the competent authorities arising from MAP cases,³⁶⁴ and recognizing the significance of the taxpayer's autonomy, article 22 provides that if the competent authorities reach a mutual agreement to resolve the case, or if the taxpayer withdraws either its request for arbitration or MAP during the arbitration process, the MAP and the arbitration procedure with respect to such case shall terminate.³⁶⁵

2.10.6 Type of Arbitration Process

To expedite the arbitration process, article 23 offers the "final offer" approach and the "independent opinion" approach as default types.³⁶⁶ However, the competent authorities may mutually agree on different rules.³⁶⁷

Under the "final offer" approach, "the competent authorities [] shall [each] submit to the panel . . . a proposed resolution which addresses all unresolved issue(s) in the case, . . . [but including only] the disposition of specific monetary amounts [] or [] the maximum rate of tax charged pursuant to the Covered Tax Agreement."³⁶⁸ Where the unresolved issues include threshold questions, "such as whether an individual is a resident or whether a permanent establishment exists, the competent authorities may submit alternative proposed resolutions . . . contingent on resolution of [the unresolved] threshold questions".³⁶⁹ Each competent authority may submit a supporting position paper or a reply submission in response to the proposed resolution and supporting position paper submitted by the other competent authority.³⁷⁰ The panel shall select one of the proposed resolutions, and shall not include a rationale or any other explanation of the decision.³⁷¹

A Party unwilling to accept the "final offer" approach may adopt the "independent opinion" approach.³⁷² Each competent authority shall provide all panel members with any information necessary for the arbitration decision.³⁷³ The panel shall decide the issues pursuant to the applicable provisions of the Covered Tax Agreement and, subject to these provisions, of the domestic laws of the Contracting Jurisdictions.³⁷⁴ The panel shall also consider any other sources identified by mutual agreement of the

364. *Id.*, ¶ 240.

365. OECD 2017 MLI, *supra* note 24, art. 22.

366. OECD MLI Explanatory Statement, *supra* note 24, ¶¶ 242, 246.

367. OECD 2017 MLI, *supra* note 24, art. 23(1).

368. *Id.*, art. 23(1)(a).

369. *Id.*

370. *Id.*, art. 23(1)(b).

371. *Id.*, art. 23(1)(c).

372. *Id.*, art. 23(2).

373. *Id.*, art. 23(2)(a).

374. *Id.*, art. 23(2)(b).

competent authorities.³⁷⁵ The decision shall indicate the sources of law relied upon and the reasoning which led to its result.³⁷⁶

The arbitration decision shall be delivered to the competent authorities in writing but will not have any precedential value.³⁷⁷

Where two Parties prefer different types of arbitration processes, the competent authorities shall endeavor to reach agreement on the type of arbitration process that shall apply with respect to all cases arising under that Covered Tax Agreement.³⁷⁸ Until such an agreement is reached, article 19 shall not apply.³⁷⁹

A Party may choose to apply article 23(5) “with respect to its Covered Tax Agreements.”³⁸⁰ The competent authorities, prior to the beginning of arbitration proceedings, should ensure that each taxpayer presenting the case and their advisors sign a confidentiality agreement.³⁸¹ A material breach of the nondisclosure agreement after the request for arbitration and before the panel has delivered its decision shall result in the termination of the MAP and the arbitration proceedings on the case.³⁸² However, Parties may opt out of article 23(5).³⁸³ A Party choosing to apply article 23(5) may reserve the right for Part VI not to apply with respect to all Covered Tax Agreements with the reserving Contracting Jurisdiction.³⁸⁴

Articles 23(4) though article 23(7) are intended to encourage the best practice of confidentiality.³⁸⁵ Where Parties disagree on the significance of confidentiality, Parties considering confidentiality essential may opt out of arbitration entirely if a Party opts out of the nondisclosure rule.³⁸⁶

2.10.7 Agreement on a Different Resolution

Article 24 permits both Contracting Jurisdictions to choose to apply an optional provision, which allows the competent authorities to depart from the arbitration decision and to agree on a different resolution within three calendar months after the decision has been delivered to them.³⁸⁷ Given that such a provision would be unlikely to be applied where the “final offer” approach is used, Parties may apply article 24 only to its Cov-

375. *Id.*

376. *Id.*, art. 23(2)(c).

377. *Id.*

378. *Id.*, art. 23(3).

379. *Id.*

380. *Id.*, art. 23(4).

381. *Id.*, art. 23(5).

382. *Id.*

383. *Id.*, art. 23(6).

384. *Id.* art. 23(7).

385. See OECD MLI Explanatory Statement, *supra* note 24, ¶¶ 250-251.

386. *Id.* ¶ 251.

387. OECD 2017 MLI, *supra* note 24, art. 24.

ered Tax Agreements for which the “independent opinion” approach applies.³⁸⁸

2.10.8 Costs of Arbitration Proceedings

Under article 25, costs of arbitration proceedings “shall be borne by the Contracting Jurisdictions in a manner to be settled by mutual agreement between the competent authorities”³⁸⁹ “In the absence of such agreement, each Contracting Jurisdiction shall bear its own expenses and those of its appointed [arbitrator]”.³⁹⁰ “The cost of the chair . . . and other expenses associated with the conduct of the arbitration proceedings shall be borne by the Contracting Jurisdictions in equal shares.”³⁹¹

2.10.9 Compatibility

The compatibility clause in article 26 clarifies that Part VI

[S]hall apply in place or in the absence of provisions of a Covered Tax Agreement that provide for arbitration of unresolved issues arising from a [MAP] case. Each Party that chooses to apply Part VI shall notify the Depository [accordingly] Where two Contracting Jurisdictions have made [such] a notification . . . , that provision shall be replaced by [Part VI] as between those Contracting Jurisdictions.³⁹²

To avoid duplicative arbitration efforts,³⁹³ “any unresolved issue arising from a [MAP] case . . . shall not be submitted to arbitration [under Part VI] if an arbitration panel or similar body has previously been set up [with respect to the issue under another] bilateral or multilateral convention that provides for mandatory binding arbitration [for] unresolved issues”³⁹⁴

Nothing in Part VI is intended to “affect the fulfillment of wider obligations with respect to the arbitration of unresolved issues arising in the context of a [MAP] resulting from other conventions to which the Contracting Jurisdictions are or will become parties.”³⁹⁵

“A Party may preserve the right for . . . Part [VI] not to apply with respect to one or more identified Covered Tax Agreements . . . that al-

388. OECD MLI Explanatory Statement, *supra* note 24, ¶ 252.

389. OECD 2017 MLI, *supra* note 24, art. 25.

390. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, art. 25.

391. *Id.*

392. *Id.*

393. OECD MLI Explanatory Statement, *supra* note 24, ¶ 257.

394. OECD 2017 MLI, *supra* note 24, art. 26(2).

395. *Id.*, art. 26(3).

ready provide for mandatory binding arbitration of unresolved issues arising from a [MAP] case.”³⁹⁶

2.11 Final Provisions of the MLI

2.11.1 Signature and Ratification, Acceptance, or Approval

As of December 31, 2016, the MLI was open for signature by all States, three listed jurisdictions, and any other non-State jurisdiction authorized to become a Party by consensus of Parties and Signatories. Signature of the MLI shall be followed by ratification, acceptance, or approval.³⁹⁷

2.11.2 Reservations

Article 28 (1) lists twenty-one authorized reservations by reference to the provision in which they are set out.³⁹⁸ With the exception of reservations to Part VI, these are the only reservations which may be made under the MLI.³⁹⁹

To provide Parties committing to arbitration with flexibility to tailor the scope of cases based on their domestic policies,⁴⁰⁰ article 28(2) permits any Party that chooses to apply Part VI to formulate one or more reservations as to the scope of cases eligible for arbitration under Part VI.⁴⁰¹ Reservations are subject to acceptance.⁴⁰²

Article 28(3) clarifies the symmetric effect (i.e., reciprocal application) of reservations made under article 28(1) or (2) on the application of the relevant provisions of the MLI between the reserving Party and the other Parties.⁴⁰³ “Unless explicitly provided otherwise . . . , a reservation will modify . . . the [relevant] provisions of the Convention” as between the reserving Party and all other Parties to the Convention in a symmetric way.⁴⁰⁴

Article 28(4) requires the State Party responsible for the international relations of a jurisdiction or territory to deposit a separate list of reservations for that jurisdiction or territory, which may be different from the State Party’s own list of reservations.⁴⁰⁵

Articles 28(5) through (7) impose the timing requirements for making reservations.⁴⁰⁶ A provisional list of reservations shall be provided to the

396. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* Id., art. 26(4).

397. *Id.*, art. 27.

398. *Id.*, art. 28(1).

399. OECD MLI Explanatory Statement, *supra* note 24, ¶ 264.

400. *Id.*, ¶ 265.

401. OECD 2017 MLI, *supra* note 24, art. 28(2).

402. *Id.*, art. 28(2)(b).

403. *Id.*, art. 28(3).

404. *Id.*

405. *Id.*, art. 28(4).

406. *Id.*, art. 28(5) – (7).

Depositary at the time of signature,⁴⁰⁷ and a final list of reservations shall be provided at the time of the deposit of the instrument of ratification, acceptance, or approval.⁴⁰⁸ It is permitted for a final list of reservations to be provided to the Depositary at the time of signature.⁴⁰⁹ If reservations are not made at the time of signature, a provisional list of expected reservations shall be provided to the Depositary at that time.⁴¹⁰

Under article 28(8), when reservations are made under the fifteen types of listed provisions, an exhaustive list of the Covered Tax Agreements which are within the scope of the reservation as defined in the relevant provision must be provided.⁴¹¹

To encourage comprehensive modifications of the Covered Tax Agreements by the MLI, article 28(9) permits a Party to withdraw a reservation or replace it with a reservation which is more limited in scope by notifying the Depositary.⁴¹² Articles 28(9)(a) and (b) set out the dates on which such a withdrawal or replacement of a reservation will take effect.⁴¹³

2.11.3 Notifications

Article 29 sets forth detailed requirements for the notification procedure.⁴¹⁴ The twenty categories of notification specified in the MLI shall be made either at the time of signature or when depositing the instrument of ratification, acceptance, or approval.⁴¹⁵ The State Party responsible for the international relations of the jurisdiction or territory shall provide a list of notifications with respect to that jurisdiction or territory, which may be different from the State Party's own list of notifications.⁴¹⁶

"If notifications are made at the time of signature, they shall be confirmed upon deposit of the instrument of ratification, acceptance, or approval, unless the document containing the notifications explicitly specifies that it is to be considered definitive."⁴¹⁷ "If notifications are not made at the time of signature, a provisional list of expected notifications shall be provided at that time."⁴¹⁸

The list of agreements described in article 2(1)(a)(ii) may be extended at any time by notifying the Depositary.⁴¹⁹ If the agreement falls

407. *Id.*, art. 28(7).

408. *Id.*, art. 28(6).

409. OECD MLI Explanatory Statement, *supra* note 24, ¶ 276.

410. OECD 2017 MLI, *supra* note 24, art. 28(7).

411. *Id.*, art. 28(8).

412. *Id.*, art. 28(9).

413. *Id.*, art. 28(9)(a), 28(9)(b).

414. *Id.*, art. 29.

415. OECD MLI Explanatory Statement, *supra* note 24, ¶ 292.

416. OECD 2017 MLI, *supra* note 24, art. 29(2).

417. *Id.*, art. 29(3).

418. *Id.*, art. 29(4).

419. *Id.*, art. 29(5).

within the scope of any of the reservations made by the Party listed in article 28(8), the Party must specify this in this notification.⁴²⁰ The Party shall also specify any additional required notifications to reflect the inclusion of additional agreements.⁴²¹ “If the extension results for the first time in the inclusion of a tax agreement entered into by or on behalf of a [non-State jurisdiction or territory] . . . , [the responsible Party] shall specify [at that time] any reservations or notifications applicable to Covered Tax Agreements.”⁴²² On the date on which a newly added agreement becomes a Covered Tax Agreement, “Article 35 . . . shall govern the date on which the modifications to the Covered Tax Agreement shall have effect.”⁴²³

Parties may make additional notifications under articles 29(1)(b) through (s) by notifying the Depository.⁴²⁴ Articles 29(6)(a) and (b) clarify when such additional notifications will take effect.⁴²⁵ The provision mirrors article 28(9) relating to the date on which the withdrawal or replacement of a reservation will take effect.⁴²⁶

2.11.4 Subsequent Modifications of Covered Tax Agreements

Recognizing the necessity of subsequent treaty modification,⁴²⁷ article 30 provides that “the provisions in [the MLI] . . . are without prejudice to subsequent modifications to a Covered Tax Agreement which may be agreed to by the Contracting Jurisdictions.”⁴²⁸

2.11.5 Conference of the Parties

Article 31 authorizes the Parties to “convene a Conference of the Parties for the purposes of taking any decisions or exercising any functions as may be required or appropriate under the provisions of . . . [the MLI]”.⁴²⁹ “Any Party may request a Conference by communicating a request to the Depository.”⁴³⁰ The Depository will then convene a Conference provided that the request is supported by one-third of the Parties within six calendar months of the communication by the Depository of the request.⁴³¹

2.11.6 Interpretation and Implementation

Under article 32, “any question[s] arising from the interpretation or implementation of the provisions of a Covered Tax Agreement . . . shall be

420. *Id.*

421. *Id.*

422. *Id.*

423. *Id.*

424. *Id.*, art. 29(6).

425. *Id.*, art. 29(6)(a), 29(6)(b).

426. OECD MLI Explanatory Statement, *supra* note 24, ¶ 307.

427. OECD MLI Explanatory Statement, *supra* note 24, ¶ 310.

428. OECD 2017 MLI, *supra* note 24, art. 30.

429. *Id.*, art. 31(1).

430. *Id.*, art. 31(3).

431. *Id.*

determined under the relevant provision(s) of [that] . . . Agreement [itself] . . . [and] any questions arising as to the interpretation or implementation of . . . [the MLI] may be addressed either by a Conference of the Parties” or by the agreement between the competent authorities.⁴³²

2.11.7 Amendment

Article 33 permits any Party to propose an amendment to the MLI “by submitting the proposed amendment to the Depository.”⁴³³ “A Conference of the Parties may be convened to consider the proposed amendment.”⁴³⁴

2.11.8 Entry into Force

Under article 34, the MLI “shall enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification, acceptance, or approval.”⁴³⁵ “For each Signatory ratifying, accepting, or approving . . . [the MLI] after the . . . [fifth deposit], . . . [the MLI] shall enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of the deposit by such Signatory of its instrument of ratification, acceptance, or approval.”⁴³⁶

2.11.9 Entry into Effect

Article 35 sets out when the provisions of the MLI shall take effect in each Contracting Jurisdiction with respect to two categories of taxes which fall within the scope of a Covered Tax Agreement.⁴³⁷

Article 35(1)(a) addresses the entry into effect of provisions of the MLI “with respect to taxes withheld at source on amounts paid or credited to non-residents”.⁴³⁸ The first taxes for which the MLI shall have effect are those for which “the event giving rise to such taxes occurs on or after the first day of the next calendar year that begins on or after the latest of the dates on which the [MLI] enters into force for each Contracting Jurisdiction . . .”.⁴³⁹

Article 35(1)(b) addresses the entry into effect of provisions of the MLI “with respect to all other taxes levied by a Contracting Jurisdiction”.⁴⁴⁰ Unless the Contracting Jurisdictions agree to apply a shorter period, the first taxes for which provisions of the MLI will enter into effect

432. *Id.*, art. 32.

433. *Id.*, art. 33(1).

434. *Id.*, art. 33(2).

435. *Id.*, art. 34(1).

436. *Id.*, art. 34(2).

437. *Id.*, art. 35(1).

438. *Id.*, art. 35(1)(a).

439. *Id.*

440. *Id.*, art. 35(1)(b).

are those levied “with respect to taxable periods beginning on or after the expiration of a period of six calendar months from the latest of the dates on which the MLI enters into force for each of the Contracting Jurisdictions . . .”.⁴⁴¹

To address the situations in which the taxable period does not follow the calendar year in some Contracting Jurisdictions, article 35(2) permits a Party to “choose to substitute “taxable period” for “calendar year”” solely for the purposes of its own asymmetrical application of article 35(1)(a) and (5)(a).⁴⁴²

To allow the MLI to enter into effect only after the start of a calendar year in certain Contracting Jurisdictions,⁴⁴³ article 35(3) permits a Party to replace the reference to “taxable periods beginning on or after the expiration of a period” with a reference to “taxable periods beginning on or after 1 January of the next calendar year beginning on or after the expiration of a period” solely for the purposes of its own asymmetrical application of article 35(1)(b) and (5)(b).⁴⁴⁴

To ensure that the MAP provisions apply as soon as possible,⁴⁴⁵ article 35(4) clarifies that article 16 “shall have effect with respect to a Covered Tax Agreement for a case presented to the competent authority on or after the latest of the dates on which the MLI enters into force for each of the Contracting Jurisdiction”, except for cases that were ineligible to be presented prior to the modification of Covered Tax Agreement by the MLI, regardless of the taxable period to which the case relates.⁴⁴⁶ However, a Party may opt out of article 35(4),⁴⁴⁷ in which case the entry into effect of article 16 for its Covered Tax Agreement will be governed by article 35(1) through (3).⁴⁴⁸

Article 35(5) provides for the entry into effect in each Contracting Jurisdiction of the MLI’s provisions for new Covered Tax Agreements resulting from an extension of the list of agreements notified under article 2(1)(a)(ii).⁴⁴⁹ The time periods run similarly to those described in article 35(1) in many respects.⁴⁵⁰

Article 35(7) permits a Party to reserve the right to delay the date of entry into effect of the provisions of the MLI, of the withdrawal or replacement of a reservation, of an additional notification with respect to that Covered Tax Agreement, or of Part VI (Arbitration), until that Party

441. *Id.*

442. *Id.*, art. 35(2).

443. OECD MLI Explanatory Statement, *supra* note 24, ¶ 331.

444. OECD 2017 MLI, *supra* note 24, art. 35(3).

445. OECD MLI Explanatory Statement, *supra* note 24, ¶ 333.

446. OECD 2017 MLI, *supra* note 24, art. 35(4).

447. *Id.*, art. 35(6).

448. OECD MLI Explanatory Statement, *supra* note 24, ¶ 337.

449. OECD 2017 MLI, *supra* note 24, art. 35(5).

450. OECD MLI Explanatory Statement, *supra* note 24, ¶ 335.

has completed its internal procedures for this purpose.⁴⁵¹ In such cases, the default specific rules on entry into effect would apply as from the date 30 days after the Depositary has received the latest notification by each reserving Contracting Jurisdiction that it has completed its internal procedures for the entry into effect of the provisions of the MLI with respect to that specific Covered Tax Agreement.⁴⁵²

2.11.10 Entry into Effect of Part VI

Article 36 exclusively addresses the entry into effect of the provisions of Part VI, notwithstanding the provisions of article 28(9) (addressing the withdrawal of a reservation), article 29(6) (addressing additional notifications), and article 35 (other than paragraph 7) (addressing the entry into effect of the Convention).⁴⁵³

Under article 36(1), Part VI shall take effect with respect to cases presented to the competent authority . . . on or after the later of the dates on which the [MLI] enters into force for each of the Contracting Jurisdictions”.⁴⁵⁴ However, to allow competent authorities to reasonably defer the eligibility of existing cases until they have agreed on the mode of application of Part VI, Part VI shall take effect “with respect to cases presented to the competent authority [] prior to the later of the dates on which the [MLI] enters into force for each of the Contracting Jurisdictions [], on the date when both Contracting Jurisdictions have notified the Depositary that they have reached mutual agreement [on the application of Part VI], along with information regarding the date or dates on which such cases shall be considered to have been presented to the competent authority . . . according to the terms of that mutual agreement.”⁴⁵⁵

Recognizing that the arbitration eligibility deferral under article 36(1)(b) is unlikely to alleviate the challenging resource constraints for Contracting Jurisdictions with a large backlog of cases to apply Part VI effectively to those cases, article 36(2) permits Parties to “reserve the right for Part VI to apply to an [existing MAP] case . . . only to the extent that [both] competent authorities agree that it will apply to that specific case”.⁴⁵⁶

Articles 36(3) through 36(5) address the entry into effect of Part VI in the case in which a Party begins applying Part VI to a Covered Tax Agreement only after incorporating a new Covered Tax Agreement into the extended list of agreements, withdrawing or replacing a reservation made “under article [26(4)] pursuant to [article 28(9)], or the withdrawal of an

451. OECD 2017 MLI, *supra* note 24, art. 35(7).

452. OECD 2017 MLI, *supra* note 24, art. 35(5); OECD MLI Explanatory Statement, *supra* note 24, ¶ 338.

453. OECD 2017 MLI, *supra* note 24, art. 35(6).

454. *Id.*, art. 36(1)(a).

455. *Id.*, art. 36(1)(b).

456. *Id.*, art. 36(2).

objection to a reservation made under article [28(2)]”.⁴⁵⁷ In all such cases, the date of entry into effect is based on the date of communication by the Depositary of the notification of the extension of the list of agreements, withdrawal or replacement of reservation, or withdrawal of objection, rather than the date of entry into force of the MLI.⁴⁵⁸

2.11.11 Withdrawal

Article 37 permits any Party to withdraw from the MLI at any time.⁴⁵⁹ In cases where the MLI has entered into force with respect to all Contracting Jurisdictions to a Covered Tax Agreement before the date on which a Party’s withdrawal becomes effective, that Covered Tax Agreement shall remain as modified by this Convention.⁴⁶⁰ The rationale is that a unilateral withdrawal from the MLI does not have any retrospective effects, and would not reverse the modifications already made to the Covered Tax Agreement.⁴⁶¹

2.11.12 Relation with Protocols

Article 38 provides that the MLI may be supplemented by one or more protocols.⁴⁶² To become a party to a protocol, a State or jurisdiction must be a Party to the MLI.⁴⁶³ “A Party to . . . [the MLI] is not bound by a protocol unless it becomes a party to the protocol in accordance with its provisions.”⁴⁶⁴

2.11.13 Depositary

Article 39 defined the role of the Depositary.⁴⁶⁵ The Secretary-General of the OECD shall be the Depositary of the MLI and any protocols.⁴⁶⁶ “The Depositary shall notify the Parties and Signatories within one calendar month” of the specified list of acts, notifications, or communications in relation to the MLI.⁴⁶⁷ The Depositary shall maintain publicly available lists of Covered Tax Agreements, reservations made by the Parties, and notifications made by the Parties.⁴⁶⁸

457. *Id.*, art. 36(3) – 36(5).

458. *Id.*

459. *Id.*, art. 37(1).

460. *Id.*, art. 37(2).

461. OECD MLI Explanatory Statement, *supra* note 24, ¶ 353.

462. OECD 2017 MLI, *supra* note 24 art. 38(1).

463. *Id.*, art. 38(2).

464. *Id.*, art. 38(3).

465. *Id.*, art. 39.

466. *Id.*, art. 39(1).

467. *Id.*, art. 39(2).

468. *Id.*, art. 39(3).

3. Why Are Tax Treaties Necessary?

Before we proceed to evaluate the MLI, it is helpful to raise a more fundamental question: Why are tax treaties needed in the twenty-first century?

Traditionally, tax treaties were thought to be needed to prevent classical “juridical” double taxation, in which both the source and the residence jurisdictions taxed the same taxpayer on the same income, one on the basis of source (in rem) jurisdiction and the other on the basis of residence (in personam) jurisdiction.⁴⁶⁹ This problem was the reason the League of Nations drafted the first model “convention for the prevention of double taxation” in 1927 – 28.⁴⁷⁰ But as Stanley Surrey already pointed out in 1957 and as Tsilly Dagan has emphasized more recently, tax treaties are not needed to prevent double taxation because almost all residence countries grant relief from double taxation by way of credit or exemption unilaterally, without the need for a treaty.⁴⁷¹ Other double taxation situations (dual residence, source/source) are not always resolved even with a tax treaty in place.

As Dagan also pointed out, the main function of tax treaties is to enforce the “Benefits Principle”, i.e., the compromise reached in the 1920s between the tax claims of residence and source jurisdictions.⁴⁷² Under the Benefits Principle, which is incorporated into every tax treaty, active (business) income should be taxed primarily at source as long as the taxpayer meets the “Permanent Establishment” threshold, while passive (investment) income should be taxed primarily at residence.⁴⁷³ Since without a treaty both active and passive income are taxed at source with relief granted by the residence jurisdiction, the main function of the treaty is to shift the right to tax passive income from source to residence by limiting withholding tax rates. Under the OECD model, withholding taxes are limited to fifteen percent for dividends, ten percent for interest and zero per-

469. For example, Article 1 of the Mexico and London Models states that “[t]he present Convention is designed to prevent double taxation in the case of taxpayers of the contracting states.” *Model Bilateral Convention for the Prevention of International Double Taxation of Income and Fiscal Evasion*, *supra* note 10, art. I (Mexico Draft); *Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property*, *supra* note 11, art. I (London Draft).

470. MICHAEL KOBETSKY, *INTERNATIONAL TAXATION OF PERMANENT ESTABLISHMENTS: PRINCIPLES AND POLICY* 106 – N 108 (2011).

471. Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT’L L. & POL. 939, 939 (2000); Stanley S. Surrey, *The Pakistan Tax Treaty and “Tax Sparing”*, 11 Nat’l Tax J. 156, 156 (1958).

472. Dagan, *supra* note 471, at 941 – 942.

473. Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185, 188 (2016). On the benefits principle and its origins, see REUVEN S. AVI-YONAH, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* ch. 1 (2015); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996).

cent for royalties, capital gains and “other income” (e.g., payments on derivatives).⁴⁷⁴ That leaves the residence country with the right to tax such payments without granting too much foreign tax credit.

Dagan goes on to argue that this means that tax treaties are helpful among developed countries because the investment flows are reciprocal, but injurious to developing countries.⁴⁷⁵ Others (including the developing countries) have rejected this argument because they believe tax treaties are helpful in attracting investment and guaranteeing some measure of tax stability to the investors.⁴⁷⁶

But are tax treaties necessary to enforce the Benefits Principle? It can be argued that the answer is no under conditions of tax competition. Economists have long argued that a small, open economy should not tax inbound investment because the tax will cause the investment to either go elsewhere or be shifted to source country taxpayers, who can be taxed directly.⁴⁷⁷ The latter is not entirely convincing because it may be administratively easier for the source country to levy withholding taxes even if the burden is shifted, but the argument that the investment will go elsewhere is generally convincing, especially for interest but increasingly also for dividends (capital gains cannot usually be taxed by withholding).

Under conditions of tax competition to attract investment, there are two possible scenarios. The first and more common is that the same return can be earned in many places and is therefore subject to tax competition. For interest that is clearly the case and that is why after the United States unilaterally eliminated its withholding on interest in 1984,⁴⁷⁸ most countries went along.⁴⁷⁹ No tax treaty is needed to reduce withholding on portfolio interest, while “direct” interest among related parties is better policed by transfer pricing and thin capitalization rules.

In the case of dividends, it can perhaps be argued that an investment is more unique, but (a) it is hard to distinguish dividends from interest, especially if derivatives that can be used to convert equity to debt are not taxed at source, and (b) the uniqueness of equity investments is declining as multinationals become more similar to each other under globalization. In addition, dividends are optional and not deductible, so it is not clear what

474. OECD, *Model Tax Convention on Income and on Capital* arts. 10–13, 21 (July 15, 2014).

475. See Dagan, *supra* note 471.

476. See, e.g., Arjan Lejour, *The Foreign Investment Effect of Tax Treaties*, (CPB Neth. Bureau for Econ. Policy Analysis, Working Paper No. 14/03, 2014), http://www.eesc.europa.eu/resources/docs/2014-the-foreign-investment-effects-of-tax-treaties_oxford-univ-centre-for-business-taxation.pdf.

477. Assaf Razin & Efraim Sadka, *Capital Income Taxation in the Globalized World*, (Nat'l Bureau of Econ. Research Working Paper No. 10630, 2004), <http://www.nber.org/papers/w10630.pdf>.

478. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648-50 (codified as amended at I.R.C. § 871(h) (1994)).

479. Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1581 (2000).

function is achieved by having a withholding tax on dividends, and a tax treaty should not be needed to eliminate such taxes.

This leaves royalties, where the tax treaty is the only effective way to reduce withholding tax. But royalties from intellectual property generally represent economic “rents,” i.e., unique returns from specific assets, and in that case, it is hard to see the rationale for reducing the withholding tax because the investor cannot earn the returns elsewhere. Admittedly, multinationals have become extremely adept at locating IP in low-taxed jurisdictions and using deductible royalties to shift profits there. But that is precisely why royalties should be subject to full withholding tax rates by source countries (or alternatively not be deductible). Most royalties in any case are paid within multinationals and represent active income that should be taxed at source.

Thus, it can be argued that treaties are not needed to enforce the Benefits Principle under conditions of tax competition because the income can either be earned somewhere else, in which case the competition will lead to unilateral erosion of the withholding tax, or not, in which case the withholding tax should not be reduced.

But what about the function of tax treaties to attract investment and guarantee tax stability? While the empirical literature does suggest that tax treaties help investment, the same function can be achieved by bilateral investment treaties (BITs).⁴⁸⁰ BITs have two advantages over tax treaties: they are closer to being functionally multilateral because they contain a “most favored nation” (MFN) clause,⁴⁸¹ and they have much stronger dispute resolution mechanisms.⁴⁸² If a source country changes its tax rules in a way that injures investors, they can force it into binding arbitration under the BIT, as the government of India found out recently when it overturned its own Supreme Court to tax Vodafone retroactively.⁴⁸³

So can we just dispense with tax treaties? The question may seem too theoretical to be worth pursuing. However, current developments, and es-

480. See Peter H. Egger et. al, *The Impact of Endogenous Tax Treaties on Foreign Direct Investment: Theory and Evidence*, 39 CANADIAN J. ECON. 901 (2006); Mumtaz Hussain Shah & Saba Qayyum, *Impact of Double Taxation Treaties on Inward FDI in Latin American and Caribbean Developing Countries*, 7 BUS. & ECON. REV. 1 (2015); Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?*, 43 J. DEV. STUD. 1501 (2007); Bruce A. Blonigen & Ronald B. Davies, *The Effects of Bilateral Tax Treaties on U.S. FDI Activity* (Univ. of Or. Econ. Dep’t Working Paper No. 2001-14, 2011), <https://ssrn.com/abstract=445980>; K. V. Bhanu Murthy & Niti Bhasin, *The Impact of Bilateral Tax Treaties on FDI Inflows: The Case of India* (March 18, 2013) (unpublished manuscript), <https://ssrn.com/abstract=2234966>.

481. MFN clauses link investment agreements by ensuring that parties to one treaty provide treatment no less favorable than the treatment they provide investors under other treaties. See, e.g., German Model Treaty 1998, art. 3.

482. See U.N. Conference on Trade and Development, *Dispute Settlement: Investor-State*, U.N. Doc UNCTAD/ITE/IIT/30, at 41 (May 2003) (noting that in a survey of 335 BITs in force in 1992, 334 contained provisions for arbitration).

483. See Stephanie Soong Johnston, *Vodafone Goes To International Court Over Indian Tax Dispute*, 82 TAX NOTES INT’L 41 (2016).

pecially the proliferation of new taxes designed to avoid treaty limitations such as the UK “diverted profits tax” and similar enactments elsewhere,⁴⁸⁴ raise the possibility that the whole bilateral tax treaty network will collapse, and perhaps that is no great loss. Countries will either tax at the source or not, depending on whether the tax competition market allows them to do so. Double taxation will be avoided unilaterally, and in those cases in which source countries can tax, the BIT network (which is larger than the tax treaty network) will prevent abuses by the source country.

However, tax treaties in the twenty-first century have another function: they can serve to enforce the other principle underlying the ITR, the Single Tax Principle. The Single Tax Principle is the idea that underlies the OECD BEPS project, namely that cross-border income should not be subject to double taxation but also not to double non-taxation.⁴⁸⁵ This means that source taxation should generally not be reduced unless residence taxation is in place.⁴⁸⁶

For active income, the Single Tax Principle can be achieved without a treaty because if this income is not taxed at source, residence jurisdictions can tax it under “controlled foreign corporation” (CFC) rules without a tax treaty (in fact, tax treaties have been used in some cases to undermine CFC rules).⁴⁸⁷ But for passive income, in the absence of a tax treaty network, reduction of withholding taxes are achieved unilaterally by tax competition without any assurance that the income will be taxed at source. The prime culprit is the U.S. portfolio interest exemption from 1984, which has led not just to massive capital flight from developing countries to the “tax haven” United States, but also to U.S. residents pretending to be foreign and investing into the United States through “incorporated pocketbooks” in the Caymans and friendly Swiss banks.⁴⁸⁸ This practice is illegal but hard to prevent in the absence of withholding or information exchange, and the latter can only be achieved by treaty.

For individual taxpayers, the needed exchange of information to enforce residence based taxation can be achieved by special treaties like bilateral tax information exchange agreements (TIEAs) and the new

484. On these developments see Reuven S. Avi-Yonah, *Three Steps Forward, One Step Back? Reflections on “Google Taxes” and the Destination-Based Corporate Tax*, 2 *Nordic Tax J.* 69 (2016).

485. Reuven S. Avi-Yonah & Haiyan Xu, *supra* note 473, at 208 (2016); see OECD 2017 MLI, *supra* note 24, pmb1. See also Reuven S. Avi-Yonah, *supra* note 28, at 12–22; Daniel Shaviro, *The Two Faces of the Single Tax Principle* (N.Y. Univ. Law & Econ. Working Papers, Paper 419, 2015), http://lsr.nellco.org/cgi/viewcontent.cgi?article=1421&context=nyu_lewp.

486. See Reuven Avi-Yonah, *Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy*, 59 *N. Y. L. SCH. L. REV.* 305 (2015).

487. Marcellin N. Mbwa-Mboma, *France-Switzerland Treaty Overrides CFC Regime, French Tax Court Rules*, 27 *TAX NOTES INT’L* 143 (2002).

488. Reuven Avi-Yonah, *What Goes Around Comes Around: Why the US is Responsible for Capital Flight (And What It Can Do About It)* (Jan. 23, 2013) (Univ. of Mich. Pub. Law & Legal Theory Research Paper Series, Paper No. 307, 2013), <https://ssrn.com/abstract=2208553>.

Multilateral Agreement on Administrative Assistance in Tax Matters (MAATM).⁴⁸⁹ These instruments do not require a full-fledged tax treaty, although in our opinion they are imperfect and it would be preferable if the United States and the EU could agree to reinstate withholding taxes on interest and only reduce them by treaty (so that only residents in countries that tax income and exchange information could benefit from reduced withholding tax rates). Since portfolio interest is always earned in developed countries, the cooperation of tax havens is not needed to achieve this result.

But for corporate taxpayers, the tax treaty network is needed to implement the single tax principle. That can be seen from the experience of countries that allow one of their treaties to be abused by not enforcing a limitation on benefit principles, so any taxpayer can come and use the treaty. The result is a reduction in source taxes on active income (business profits, royalties, direct dividends) without assurance that the income is taxed at residence.

The whole point of the BEPS project and the MLI is to enforce the single tax principle by ensuring that source taxation will apply in situations where there is no residence taxation because of tax arbitrage or the use of pass-through entities.⁴⁹⁰ And that is why in the absence of the MLI treaties could become useless, but with the MLI they are still quite useful.

A United States example can be used to illustrate this point. Before 1984, investors into the United States used the Netherlands Antilles treaty as a way of deriving interest, dividends, and royalties from U.S. sources at reduced rates.⁴⁹¹ The Antilles treaty was a “treaty with the world,” like the Russia-Cyprus or India-Mauritius treaties (although the latter was recently revised).⁴⁹² But in 1984 the United States unilaterally terminated the Antilles treaty and at the same time started inserting Limitation on Benefits (LOB) clauses in all its treaties.⁴⁹³ LOBs are designed to enforce the Single Tax principle, and they have become an essential and non-negotiable element in U.S. treaty practice and now through the MLI OECD treaty practice as well.

In the absence of treaties with LOBs, it is increasingly likely that corporate taxpayers could derive not just interest but even royalties without paying tax at source or at residence. That is the situation in Europe because of the EU Directives, which override the treaties.⁴⁹⁴ The MLI is

489. See Reuven Avi-Yonah & Gil Savir, *IGAs vs. MAATM: Has Tax Bilateralism Outlived Its Usefulness?* (Univ. of Mich. Pub. Law & Legal Theory Research Paper Series, Paper No. 384, 2014), <https://ssrn.com/abstract=2392702>.

490. See Avi-Yonah, *supra* note 28; Reuven Avi-Yonah & Haiyan Xu, *supra* note 473.

491. See Avi-Yonah, *supra* note 28 at 14.

492. For a general discussion, see Leslie E. Papke, *One-Way Treaty with the World: The U.S. Withholding Tax and the Netherlands Antilles*, 7 INT'L TAX & PUB. FIN. 295 (2000).

493. Avi-Yonah, *supra* note 486.

494. See Phillipe Freun & Kelly Stricklin-Coutinho, *United Kingdom, in TAXATION OF INTERCOMPANY DIVIDENDS UNDER TAX TREATIES AND EU LAW 984* (Guglielmo Maisto ed., 2012); HM REVENUES & CUSTOMS, *UK Residents with Foreign Income or Gains: Divi-*

designed to prevent this type of BEPS by requiring LOBs so that source taxes are not reduced unless there is likely to be tax at residence. That is what the treaties are needed for in the twenty-first century, and that is why the MLI is such a useful addition.

3. A MFN CLAUSE FOR TAX TREATIES?

Now that the MLI has been adopted by most of the OECD and G20 (excluding the United States), what next?

A full-fledged multilateral tax convention remains an unlikely idea even if the withholding tax rates and method for preventing double taxation are left for bilateral negotiations.⁴⁹⁵ But there may be another way to create a de facto multilateral treaty: inserting a MFN clause into tax treaties.⁴⁹⁶

BITs have MFN clauses.⁴⁹⁷ The effect has been that innovations in any given BIT tend to spread automatically, and by now the BIT network is close to a de facto multilateral one, despite the lack of consensus that derailed the attempt to negotiate the multilateral investment agreement in the 1990s.⁴⁹⁸

dends: EC Directive, in INTERNATIONAL MANUAL (2018), <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm164030>.

495. Although the desire to develop a multilateral convention has been expressed as early as 1927, *Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216.M.85. 1927 II (1927), at 8, and expressed again in 1958, Fiscal Committee of the Org. for European Econ. Cooperation, *The Elimination of Double Taxation* (1958), the introduction to the 2014 OECD Model Convention still states that “[t]here are no reasons to believe that the conclusion of a multilateral tax convention involving all member countries could now be considered practicable.” Model Tax Convention on Income and on Capital, *supra* note 30, at 16.

496. See Albert J. Radler, *Most Favored Nation Concept in Tax Treaties*, in MULTILATERAL TAX TREATIES: NEW DEVELOPMENTS IN INTERNATIONAL TAX LAW 1–14 (Michael Lang, ed., 1998). It should also be pointed out that there has been a discussion on whether the non-inclusion of MFN treatment in EU bilateral tax treaties violates EU law. See, e.g., Georg W. Koeffler, *Most-Favored-Nation Treatment in Direct Taxation: Does EC Law Provide For Community MFN in Bilateral Double Taxation Treaties?*, 5 Houston Bus. & Tax L.J. 1 (2005); Luc Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law - Applications of the Rules*, 4 EC Tax Review, 209 (1995); Helmut Loukota, *Multilateral Tax Treaty versus Bilateral Treaty Network*, in MULTILATERAL TAX TREATIES: NEW DEVELOPMENTS IN INTERNATIONAL TAX LAW 100–101 (Michael Lang, ed., 1998).

497. See, e.g., 2012 U.S. Model Bilateral Investment Treaty art. 4, which provides the following: (1.) Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory. (2.) Each Party shall accord to covered investments treatment no less favorable than that it accords, in like circumstances, to investments in its territory of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

498. Chalamish, Efraim, *The Future of Bilateral Investment Treaties: A De Facto Multilateral Agreement?* 34 BROOK. J. INT’L L. 304, 304–53 (2009).

The obvious difference between tax treaties and BITs is that tax treaties directly affect revenues and therefore countries may resist MFNs because that will force them to give up revenue if investment flows differ from one treaty partner to another.

But this argument is not entirely convincing. First, investment flows can change under current treaties, and that does not deter countries from entering treaties. They know that treaties can be renegotiated if the change in flows upsets the treaty bargain.

Second, the knowledge that MFN exists can simply be incorporated in treaty negotiations. Suppose the United States had MFN in its tax treaties and that it did not wish to reduce its withholding tax rate on portfolio dividends below fifteen percent. Knowing that MFN exists would simply ensure that it sticks by this position because it knows that a lower rate will spread to all existing treaties. On the other hand, suppose the United States decided that the right rate for direct dividends is zero rather than five percent. Having an MFN clause would mean this new negotiating position spreads automatically to all U.S. treaties without requiring opening treaties to renegotiation.⁴⁹⁹

In the case of a country like the United States that already has treaties with most of the countries that it wants to have treaties with, and that already reduces most withholding taxes to zero by its existing treaties (the U.S. model has zero for interest, royalties, capital gains and other income), adopting MFN is unlikely to lead to significant revenue losses and can make it easier to install innovations like the zero-tax rate for direct dividends across the U.S. treaty network. It is likely that other OECD member countries are in the same position.⁵⁰⁰ Developing countries may be more reluctant, and should be free to avoid the MFN, but for the OECD

499. An MFN clause is included in several Indian treaties. For example, under the tax treaty between India and Switzerland, if the Indian government grants better terms to another OECD member country with respect to taxes on interest, dividends, and royalties, and for fees for technical services, an automatic most-favoured-nation clause applies, whereby the reduced rate of tax granted to the other OECD member country is automatically provided to Switzerland under the tax treaty. There are many double tax treaties that include MFN clauses or clauses with similar consequences. *E.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Protocol ¶ 3, Arg.-Belg., June 12, 1996, 2091 U.N.T.S. 279; Agreement on the Promotion and Reciprocal Protection of Investment, Protocol Ad. art. 5, Mex.-Switz., July 7, 1995, 1965 U.N.T.S. 269; Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Certain Other Taxes art. 24, ¶ 4, Can.-Ger., July 17, 1981, 1387 U.N.T.S. 135; Convention with Respect to Taxes on Income and Capital art. XXV, Can.-U.S., Sept. 26, 1980, T.I.A.S. No. 11087. The IBFD Tax Research Platform yields almost 250 treaties in force that include MFN clauses.

500. Interestingly, although paras. 54 and 55 of the 1977 OECD Commentary on Model Tax Convention explicitly rejected the application of MFN treatment, both of these paragraphs were deleted from the 1992 OECD Commentary on Model Tax Convention. Compare OECD, *Commentaries on the Articles of the Model Tax Convention* ¶¶ 54, 55 (1977), with OECD, *Commentaries on the Articles of the Model Tax Convention* p. C(24)–31 (1992).

including the MFN clause in tax treaties would seem a logical next step toward the ultimate goal of a full-fledged multilateral tax convention.

4. CONCLUSION: THE MLI AND THE FUTURE OF THE ITR

The MLI is an important innovation in international law. Hitherto, international economic law was built primarily on bilateral treaties (e.g., tax treaties and BITs) or multilateral treaties (the WTO agreements). The problem is that in some areas, like tax and investment, multilateral treaties have proven hard to negotiate, but only a multilateral treaty can be amended simultaneously by all its signatories.

The MLI provides an ingenious solution: a multilateral instrument that automatically amends all the bilateral treaties of its signatories. If the MLI succeeds, it can be a useful model in other areas, such as investment, where a multilateral agreement was not successful but there is a growing consensus about the need to adjust the terms of BITs to address investor responsibilities and the definition of investment comprehensively.

Whether the MLI will succeed remains to be seen. While its adoption by seventy countries (with more to come) is an achievement, the absence of the United States is important, and other OECD members have agreed to only a limited set of provisions. On the other hand, the MLI may prove more appealing to developing countries because it enhances source-based taxation and limits treaty shopping.

If the MLI is successfully adopted by the majority of taxing jurisdictions, this will have implications for non-taxing jurisdictions as well. For example, it is likely that the PPT will be used by courts in signatory countries to interpret treaties with non-signatory countries like the United States if those countries have signaled their agreement with the single tax principle embodied in the PPT by, for example, incorporating the LOB in their tax treaties.

Even a limited MLI would be a step forward. The current tax reform proposals in the United States pose a significant threat to the ITR, because they would sharply reduce the U.S. corporate effective tax rate to attract investment from other jurisdictions.⁵⁰¹ Countries that wish to limit the damage would be wise to accede to the MLI this year and prevent a massive race to the bottom that could ensue if the United States becomes (from the perspective of the rest of the world) a giant tax haven.

501. On these proposals see Reuven S. Avi-Yonah & Kimberly Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint*, 8 Colum. J. Tax L. 229 (2017); for the current tax reform framework, which has dropped the controversial border adjustment tax but retains a lower effective corporate tax rate see Reuven S. Avi-Yonah, *Slicing and Dicing: The Structural Problems of the Tax Reform Framework* (U of Michigan Law & Econ Research Paper No. 17-015, 2017), <https://ssrn.com/abstract=3048375>.

Article

China and BEPS

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Abstract: This article provides an overview of China’s reaction to the G20/OECD Base Erosion and Profit Shifting (BEPS) project. From 2013 to 2015, the OECD developed a series of actions designed to address BEPS activities by multinational enterprises, culminating in a final report of 15 action steps. The article reviews and explains China’s reaction to the BEPS project and its actions in detail, with a particular focus on transfer pricing issues. It shows that China has actively participated in both developing and implementing the BEPS project. The article further suggests that in the post-BEPS era, China is expected to implement the BEPS project in a more consistent and coherent way, and will take whatever measures necessary to guarantee the successful implementation of the BEPS package in collaboration with the global community.

Keywords: BEPS; China

1. Introduction

Following the financial crisis of 2008 and ensuing austerity, the OECD and G20 launched the Base Erosion and Profit Shifting (BEPS) project in 2013. The BEPS project culminated in October, 2015 with the release of a series of action steps that the OECD and G20 countries have undertaken to adopt.¹ OECD Secretary-General Angel Gurría has stated that “Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. However beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: They will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective” (OECD 2015).

China has actively participated in both developing and implementing the BEPS project. China’s tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or substantially reduced taxation.

In the first three earlier decades since the late 1970s, China had received more inbound foreign direct investments including advanced technologies and intangibles than the outbound investment of Chinese investors. However, as China started to implement the “Going-out” strategy in the 21st century, in particular the initiative of “one belt and one road” (OBOR), more and more China-based corporations are increasingly active in outbound investment and intangibles export overseas. In response to the new scenario of increasingly accelerated globalization of China-based MNE groups, China has to

¹ On BEPS see, e.g., (Ault 2013; Dharmapala 2014a, 2014b; Brauner 2014; Ault et al. 2014; Vann 2014; Shaviro; Rosenzweig 2014; Grinberg 2015).

take a very holistic approach to deal with the BEPS challenges from different perspectives, including domestic action items (items 2–5), treaty-based action items (items 6–7) and transfer pricing measures (items 8–10 and 13).

In the post-BEPS era, China is expected to implement the BEPS project in a more consistent and coherent way, and will take whatever measures necessary to guarantee the successful implementation of the BEPS package in collaboration with the global community. That is why the SAT has quickly translated many minimum standards and recommendations of BEPS project into domestic regulations.

The following sections describe China's involvement in the BEPS project in detail, with particular emphasis on transfer pricing. They explain why China needs to continue to implement the BEPS action steps and what problems might be anticipated as it does so.

2. Overview of China's Involvement in the BEPS Project

2.1. China as a Victim of BEPS

Although China is the second largest economy, the largest trader of goods, the top third country of outbound direct investment in the world ([Ministry of Foreign Affairs of the People's Republic of China 2016](#)), and the top third country of the inbound direct investment², China is one of the major victims of BEPS. In the past four decades of market-oriented reform since the late 1970s, China's tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation.

In response to Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries of UN Committee of Experts on International Cooperation in Tax Matters, China clearly indicated, "China currently does not have a system which quantitatively analyzes the base erosion in our country. Yet, we do find, and it is obvious, that the major threat China faces is that many MNE groups have shifted their profits by means of tax planning and transfer pricing" ([UN n.d.](#)).

Without any exaggeration, almost all the highly speculative tax evasion and avoidance strategies and tactics have been widely used by MNEs doing business in China, including but not confined to hybrid mismatch arrangements, controlled-foreign-company (CFC), interest deductions, harmful tax practices, treaty shopping, artificial avoidance of permanent establishment (PE) status, manipulative transfer pricing, etc.

In particular, China has identified some most common BEPS practices and structures as the followings. First, MNE groups tend to adopt transfer pricing principles and methodologies in such intra-group dealings as purchase and sale transactions, financing transactions, equity transfer transactions and service provision transactions, in order to lower the profits of their subsidiaries in China. Second, MNE groups establish shell companies with no genuine economic substances in the low-tax jurisdictions and tax heavens to shift profits. As responses to the above mentioned BEPS concerns, China has enacted the general anti-avoidance rules and carry out TP audits to recover the taxes ([UN n.d.](#)).

Chinese tax authorities makes their judgment by auditing MNE groups' annual filing and reviewing their contemporaneous documentation, considering the profit levels of the industry and comparable companies, and performing functional analysis. They then make adjustments as necessary when their judgment is made. However, China has encountered two primary obstacles in assessing whether the appropriate amount of profit is reported in China and in ensuring that tax is paid on such profit. First, China is in lack of comparable companies. China's domestic legislation requires that the listed companies must make mandatory disclosures, but the unlisted companies are not required to make such disclosures. Therefore, it is unrealistic to find comparables from the over

² China has retained its top-three ranking in the 2017 edition of A.T. Kearney's Foreign Direct Investment Confidence Index as investors turn more optimistic about its economic prospects ([China Daily 2017](#)).

2000 listed companies in China. Second, some corporate taxpayers are often unwilling to provide the tax authorities with necessary information, such as resale prices, especially the business operation and profits throughout the supply chain. Their reluctance to cooperate increases the difficulties for the tax authorities to have a big picture in mind in their audits.³

As far as the most important BEPS action is concerned, China believes that TP-related actions are most important to it. China also considers BEPS Action 11 increasingly important, as China is dedicated to establish methodologies to collect and analyze data on BEPS, which is something developing countries should work hard on.⁴

To warrant sustainable growth and development, China has good reasons to share the priorities identified by OECD/G20 BEPS package, and to take a stronger and more coordinated stance in fighting against the excessive BEPS opportunist behaviors of MNEs that seek to avoid paying their fair share of taxes. Generally speaking, China has prioritized its efforts on the implementation of BEPS project in various aspects in the past years.

2.2. Active Participation in the Development of BEPS Project

China has been active in shaping the process of developing the BEPS package not only by and through the platform OECD/G20, but also by and through the UN Committee of Experts on International Cooperation in Tax Matters (the UN Tax Committee). As a subsidiary body of the Economic and Social Council, the UN Tax Committee is responsible for keeping under review and update, as necessary, the UN Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, and providing a framework for dialogue with a view to enhancing and promoting international tax cooperation among national tax authorities and assesses how new and emerging issues could affect this cooperation ([Financing for Development n.d.](#)). The current member from China is Ms. Xiaoyue Wang, the Director for Anti-avoidance Division, International Taxation Department, State Administration of Taxation (SAT) ([Economic and Social Council 2014](#)). The Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries was established at the ninth session of the UN Tax Committee in October 2013, aiming at communicating with officials in developing countries and ensure their views are fed into both the OECD/G20 BEPS project as well as the on-going United Nations tax cooperation work ([Committee of Experts on International 2014](#)). China has been closely working together with other countries in advancing the progress of the BEPS project, including but not confined to making submission to the Subcommittee questionnaire on how developing countries view and prioritize the BEPS project issues in 2014.

Although not a member of the OECD, China has been the key partner of the OECD since 2007.⁵ A Key Partner of the OECD plus a member of G20, China has contributed actively to the development of BEPS package. As Angel Gurría, the OECD Secretary-General indicated, China's unique perspectives and policy experience have enriched the work of the OECD, increased the relevance of our analyses and supported a more inclusive global policy debate in today's challenging global economic environment. Looking ahead, even stronger engagement of China with the OECD would help increase recognition of the country's reform progress and strengthen its role in global economic governance ([OECD 2016a](#)).

In 2013, Chinese President Xi Jinping attended the G20 Summit of St. Petersburg, and declared that, "China supports strengthening of multilateral collaboration on tackling tax avoidance, and is willing to make its contribution to the improvement of international tax governance mechanism" on

³ See China's reply to the BEPS Questionnaire of the UN Subcommittee, available at www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf.

⁴ See China's reply to the BEPS Questionnaire of the UN Subcommittee, available at www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf.

⁵ In May 2007, the Council, meeting at ministerial level, invited the Secretariat to strengthen OECD cooperation with Brazil, India, Indonesia, the People's Republic of China and South Africa through "Enhanced Engagement" programs. These Key Partners contribute to the OECD's work in a sustained and comprehensive manner ([OECD n.d.](#)).

the first session of the Eighth Summit of G20 leaders” ([Ministry of Foreign Affairs of the People’s Republic of China 2013](#)). G20 Leaders’ Declaration of September 6, 2013 acknowledged the urgency to address BEPS, tackle tax avoidance, and promote tax transparency and automatic exchange of information. In order to minimize BEPS, we call on member countries to examine how our own domestic laws contribute to BEPS and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions. We acknowledge that effective taxation of mobile income is one of the key challenges ([G20 Information Centre 2013](#)).

In 2014, President Xi Jinping attended the G20 Summit of Brisbane, and further supported the development of BEPS package. G20 Leaders’ Communiqué of 16 November 2014 declared, “Profits should be taxed where economic activities deriving the profits are performed and where value is created. We welcome the significant progress on the G20/OECD BEPS Action Plan to modernize international tax rules. We are committed to finalizing this work in 2015, including transparency of taxpayer-specific rulings found to constitute harmful tax practices. We welcome progress being made on taxation of patent boxes ([G20 Information Centre 2014](#))”.

Quickly following the publication of the BEPS package by OECD on 5 October 2015, SAT released the Chinese version of the BEPS package on its official website on 10 October 2015 ([State Administration of Taxation 2015a](#)). The translation of BEPS package is very helpful for the research and application of the BEPS packages in China.

In November 2015, President Xi Jinping attended the G20 Summit of Antalya, and co-adopted G20 Leaders’ Communiqué of 16 November 2015, which endorsed the package of measures developed under the ambitious G20/OECD BEPS project. The Communiqué stated that, “We, therefore, strongly urge the timely implementation of the project and encourage all countries and jurisdictions, including developing ones, to participate. To monitor the implementation of the BEPS project globally, we call on the OECD to develop an inclusive framework by early 2016 with the involvement of interested non-G20 countries and jurisdictions which commit to implement the BEPS project, including developing economies, on an equal footing ([G20 Information Centre 2015](#)).”

To be well prepared for the involvement at the level of OECD discussion on BEPS, the SAT set up both Leadership Group and Working Group on the G20 Tax Reform Project, and clarified the duties and working plans these two groups. More than 50 officials have deeply participated in the conferences, research activities and advice feedbacks on all relevant topics of BEPS project. The SAT also appointed its representative to the Steering Committee of the BEPS, working with other committee members on designing, supervising and reviewing the proposed BEPS actions. From 2013 through 2015, the SAT has participated 86 meetings relevant to the BEPS project, and submitted over 1000 pieces of position statements and proposals to the OECD. Many of the proposals have been adopted and reflected in the final BEPS package. China has made significant contributions to the recognition of core principles of the BEPS package and the successful completion of the BEPS project, and also effectively advocated for the developing countries and emerging economies ([State Administration of Taxation 2015a](#)).

On 11 May 2016, China hosted the 10th Forum on Tax Administration in Beijing, and attracted the Heads of 44 tax administrations in different jurisdictions. The Forum addressed the coordinated action required for the effective implementation of the G20/OECD international tax agenda, as well as the challenges related to building modern tax administrations. Wang Jun, the Commissioner of SAT, and Pascal Saint-Amans, the Director of OECD Centre for Tax Policy and Administration, attended the Forum.

In June 2016, the Inclusive Framework to Implement BEPS was established to allow OECD Member and Partner countries to discuss the BEPS issues on an equal footing. As an active member of the steering group and as the deputy chair for the Inclusive Framework, China is expected to play an important role in helping define and implement international tax policies.

In September 2016, China hosted the G20 Summit of Hangzhou. The close collaboration throughout China’s G20 Presidency in 2016 brought the role of China in implementing the BEPS project to a new

level. BEPS project was a highlighted priority in G20 Leaders' Communiqué of 4–5 September 2016. "We will continue our support for international tax cooperation to achieve a globally fair and modern international tax system and to foster growth, including advancing on-going cooperation on BEPS, exchange of tax information, tax capacity-building of developing countries and tax policies to promote growth and tax certainty. We welcome the establishment of the G20/OECD Inclusive Framework on BEPS, and its first meeting in Kyoto"; "China would make its own contribution by establishing an international tax policy research center for international tax policy design and research".⁶

In 2016, the OECD and the SAT jointly established a Multilateral Tax Centre in Yangzhou, the first tax center in a non-member country. The Centre, integrated into the OECD Network of MTCs, will continue to support a consistent implementation of BEPS outcomes for the benefit of developing countries.

To reflect and accommodate reasonable claims and suggestions from the local tax authorities, business community and the civil society, SAT communicates with the interested organizations and individuals on a regular basis. In addition to promoting the mutual understanding between the BEPS Working Group and the local tax authorities responsible for international tax law enforcement, the SAT has paid great attention to the opinions from the MNEs, domestic firms, accounting firms, tax consulting firms and universities. For instance, representatives from KPMG, PWC, EY, Deloitte Touche Tohmatsu Limited, Baker McKenzie, Microsoft (China), JD.Com Inc., Lenovo Group Ltd., Central University of Finance & Economy and Xiamen University were invited to participate the workshops on BEPS of 8 June of 2015 sponsored by the SAT. Zhang Zhiyong, the Deputy Commission of the SAT acknowledged the significance of the efficient communication channels between SAT and stakeholders ([State Administration of Taxation 2015b](#)).

The dialogues and interactions between the government and the private sector has enabled SAT to have a clear picture of the different concerns and expectations of taxpayers, consulting firms, and independent third parties for the purpose of making informed and feasible on shaping and implementing the BEPS project. Needless to say, the technical details of the BEPS package and the domestic rules and mechanism are also easy to be understood by the taxpayers and the professionals. The informed academia is also able to advise the government in choosing better policy alternatives in case of controversy.

China's active participation in the formulation of the BEPS package naturally leads to its efficient translation of BEPS package into domestic rules. In addition to successfully introducing some of its best practices into the BEPS package, China has opportunities to understand the positions and rationales of other jurisdictions. Thus, potential misunderstandings could be minimized in the process of bilateral or multilateral collaboration on implementation of the BEPS package.

2.3. Chinese Legal Framework Of Corporate Income Tax as it Relates to BEPS Implementation

The Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (ITLFEIFE) of 9 April 1991 created many measures providing tax relief for the purpose of boosting foreign investment. For instance, under Article 8 (1) of ITLFEIFE, any manufacturing enterprise with foreign investment scheduled to operate for a period of not less than ten years shall, from the year beginning to be profitable, be exempted from income tax in the first and second years and allowed a 50% reduction in the third through fifth years. However, the income tax exemption or reduction for enterprises with foreign investment engaged in the exploitation of resources such as petroleum, natural gas, rare metals, and precious metals shall be regulated separately by the State Council. Enterprises with foreign investment which actually operate for a period less than ten years, shall repay the amount of income tax exempted or reduced.

Although there are no exact statistics on the use of these provisions and their effectiveness, many foreign-funded enterprises and foreign enterprises benefited a lot from the tax holidays offered

⁶ G20 Leaders' Communiqué Hangzhou Summit, 4–5 September 2016 ([G20 2016](#)).

by the ITLEFIFE. However, most of the tax reliefs offered to the enterprises with foreign investment and foreign enterprises, were not available to Chinese domestic firms that were governed by the Interim Regulation on Corporate Income Tax promulgated by the State Council on 13 December 1993. The double tax standards and the tax reliefs only available to foreign firms were criticized by many domestic firms, especially private firms as discrimination against domestic firms. Theoretically speaking, the double tax standards were incompatible with the national treatments and fair competition requirements of globalized market economy. Therefore, it is necessary to terminate the double tax relief standards for domestic firms and foreign firms after China joined WTO in 2001.

The Corporate Income Tax Law (CITL), applicable to both domestic and foreign firms, was promulgated on 16 March 2007, and came into force as of 1 January 2008. The ITLEFIFE was repealed simultaneously as of 1 January 2008. To ensure smooth transitional period, Article 57 of the CITL declares, for the enterprises that were established prior to the promulgation of the CITL and enjoyed lower tax rates according to the provisions of the previous tax laws and administrative regulations, their income tax rates shall, according to the provisions of the State Council, be gradually transferred to the tax rate provided in the CITL within five years after the CITL is promulgated. The enterprises that have enjoyed the preferential treatment of tax exemption for a fixed term may, according to the provisions of the State Council, continue to enjoy such treatment after the promulgation of the CITL until the fixed term expires.

However, for those that have failed to enjoy the preferential treatment due to failure to make profits, the term of preferential treatment may be counted as of the year when the CITL is promulgated. The high- and new-tech enterprises that need the key support of the state newly established in the particular areas established by law for developing foreign economic cooperation and technological exchanges or in the areas where the State Council has provided for the implementation of the above mentioned special policies may continue to enjoy transitional preferential tax treatments, according to the specific measures to be formulated by the State Council. Other enterprises falling in the encouraged category as already determined by the State Council may enjoy the preferential treatment of tax reduction or exemption according to the provisions of the State Council.

Therefore, the implementation of BEPS package in China has to be conducted in the context of Chinese tax legal system based on the CITL and its subordinated regulations and guidances.

2.4. Taxpayers Rights and BEPS Implementation

All categories of taxpayers, including individuals, investors, small businesses, large businesses, tax-exempt organizations are most likely to be affected by the implementation of BEPS in different ways. For instance, the domestic firms might be able to acquire a level playing field to compete with the multinationals, as the multinational competitors will be forced to give up their over-speculative BEPS strategies as a comparative competitive advantage. Of course, the corporate taxpayers active in global trade and investment will be affected most among the taxpayers. Anyway, the traditional race to the bottom are expected to be reversed to some extent in terms of international tax planning.

Taxpayers in China enjoy a series of rights under the Law on the Administration of Tax Collection (LATC) of 2015. Article 8 of the LATC says, "Taxpayers and withholding agents shall have the right to inquire of the tax authorities about the tax laws and administrative regulations of the State as well as the information related to tax payment procedures. Taxpayers and withholding agents shall have the right to require the tax authorities to maintain confidentiality for the information of the taxpayers and withholding agents. The tax authorities shall maintain confidentiality for the information of the taxpayers and withholding agents in accordance with the law. Taxpayers shall, in accordance with the law, have the rights to apply for the reduction, exemption and refund of tax. Taxpayers and withholding agents shall have the right to statement and the right of defense to the decisions made by tax authorities; and shall have the rights to apply for administrative reconsideration, institute administrative litigation, ask for State compensation, etc. in accordance with the law. Taxpayers and

withholding agents shall have the right to bring charges against or make exposure of any tax authority or tax official for violation of laws or disciplines”.

The taxpayers’ rights are closely relevant to the implementation of BEPS in China, as the implementation of BEPS in China must be based on the rule of law, which is clearly recognized by Chinese Constitution and legal framework. This means that domestic tax statutes or regulations need to be reformed to reflect the outcomes of BEPS package, and that the anti-BEPS rules will be enforced in a transparent and fair way.

The taxpayers’ rights may influence with BEPS-related reforms in various ways. First, the taxpayers may propose the legislative or regulatory advice in the process of legal reform. According to Article 5 of Legislation Law of 2015, legislation shall represent the will of the people, carry forward socialist democracy, and in adherence to openness in legislation, ensure the people’s participation in legislative activities through various channels. Second, the taxpayers may claim their rights, including the right to information, the right of fair treatment and the right to judicial remedy if they disagree with the tax authorities on certain BEPS issues.

If the taxpayers are unsatisfied with the administrative decisions of the tax authorities in China, they are entitled to take legal actions to the courts of justice. Although the cross-border tax litigations were not so active as the international commercial disputes in the past years, the judicial remedy will be available to the corporate taxpayers including the MNEs unsatisfied with the special tax adjustment made by Chinese tax authorities.

3. Rigorous Responses to Mainly Domestic BEPS Action Items (Items 2–5)

3.1. Brief Introduction

The enactment of the CITL of 2007 and the abolishment of the ITLEFIFE of 1991 were identifiably already compatible with the purpose of the BEPS project, in particular, the single tax principle. The rules on special adjustments to tax payments in Chapter VI of the CITL are particularly compatible with the BEPS project.

China has also made numerous BEPS-related rule changes after and even before the publication of the BEPS package. The SAT has issued a series of regulations or guidances to implement BEPS, including but not confined to the General Anti-Avoidance Rule (GAAR), the Offshore Indirect Transfers Circular of 2015, Beneficial Ownership Circulars and the Outbound Payment Notice (2015). The GAAR can be invoked to prevent arrangements or transactions that result in the abuse of tax preferences, the abuse of tax treaties, the abuse of corporate forms and tax avoidance using tax heavens, and other arrangements without reasonable business purposes.

3.2. Responses to BEPS Action 2

The BEPS Action 2 Report “Neutralizing the Effects of Hybrids Mismatch Arrangements” is designed to fix the loopholes associated with the hybrid mismatch arrangements. On 22 August 2016, OECD releases discussion draft on branch mismatch structures under BEPS Action 2 Report (OECD 2016b). This discussion draft applies the analysis and recommendations set out in the Action 2 Report to mismatches that can arise through the use of branch structures. The discussion draft identifies five basic types of branch mismatch arrangements and sets out preliminary recommendations for domestic rules, based on those in the Action 2 Report, which would neutralize the resulting mismatch in tax outcomes.

China has been trying its best to address certain hybrid mismatch arrangements, to implement and apply hybrid mismatch rules in accordance with policy objectives of BEPS Action 2 Report. As debt and equity are treated differently for income tax purposes under current tax system, it is important to properly characterize a hybrid instrument. In order to determine accurately the tax treatment of hybrid mismatch, Bulletin Regarding Corporate Income Tax Treatments for Companies Engaging in

Hybrid Investments (SAT Bulletin 41 of 2013) was promulgated on 15 July 2013 by the SAT, pursuant to the CITL and its Implementation Regulations (CITLIR) ([State Administration of Taxation 2013](#)).

Hybrid investment is defined as a form of investment characterized by both equity and debt. The corporate income tax treatments stipulated in Bulletin 41 shall apply to hybrid investments meeting all of the following five conditions.

First, the recipient corporation of a hybrid investment (“target corporation”) should make regular interest payments (including minimum interest, fixed profit or fixed dividends) as agreed in investment contract/agreement. This means that the investment return of the hybrid investment is not dependent on the financial performance of the target corporation.

Second, the hybrid investments should either have a clear term of investment or specific investment conditions, and the target corporation must redeem the investment or repay the principal upon the expiration of the term of investment or the satisfaction of specific investment conditions.

Third, the hybrid investor may not have the ownership of the net assets of the target corporation.

Fourth, the hybrid investor should not have the right to elect or to be elected on governing bodies of the target corporation, including the general meeting of shareholders, the board of directors or the board of supervisors. This means that the hybrid investor shall be neither qualified to vote on the appointment and dismissal of directors, supervisors and senior executives, nor qualified to be elected as directors, supervisors and senior executives.

Fifth, the hybrid investor may not participate in daily production and management of the target corporation.

In case of payment of the interest, the interest income received by the hybrid investor from the target corporation, shall be recognized and included in taxable income for corporate income tax purposes on the day when the interest payment becomes due, the interest expense incurred by the target corporation, shall be recognized on the day when the interest payment becomes due and deductible for corporate income tax purposes according to the CITL, CITLIR and Article 1 of SAT Bulletin Regarding Certain Issues Related to Corporate Income Tax (SAT Bulletin 34 of 2011). In case of redemption of the investments, the difference between redemption price and investment cost shall be recognized as debt restructuring gain upon redemption and separately included in taxable income of the current period for corporate income tax purposes.

SAT Bulletin 41 of 2013 took effect on 1 September 2013. For tax cases on hybrid investment already settled before its enforcement, no adjustments should be made, although the unsettled cases should be governed by SAT Bulletin 41.

However, the SAT has not issued further special rules on hybrid mismatch arrangements after the release of the BEPS package in October 2015. According to the BEPS Action 2 Report, China is expected to undertake internal periodic review of the operation of hybrid mismatch rules as necessary to determine whether they are operating as intended, and make information about hybrid mismatch exchange procedures available to taxpayers. This author kindly recommends the SAT to comprehensively update its hybrid mismatch rules including those arising through the use of branch structures in the near future.

3.3. Responses to BEPS Action 3

According to the BEPS Action 3, it is a minimum standard for the countries to undergo periodic OECD monitoring of CFC rules. Although Action 3 does not contain any rules or prescriptions relating to CFCs, this is an important item.

Article 45 of CITL provides for the general principles on identification of the CFCs by clarifying that, with regard to an enterprise that is established by a resident enterprise, controlled by a resident enterprise, or by a Chinese resident who is located in a country (region) where the actual tax burden is obviously lower than the tax rate as prescribed in paragraph 1 of Article 4 of this Law, if the profits are not distributed or are distributed partially for a cause that is not a reasonable business operation,

the portion of the aforesaid profits attributable to this resident enterprise shall be included in its incomes of the current period.

Chapter VIII of the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation) (Circular 2 of 2009) released by the SAT deals with the CFCs in details from Article 76 through Article 84. The CFC refers to a foreign enterprise which is formed in a country (or region) where the actual tax rate is lower than 50% of the tax rate set out in Article 4 (1) of the EITL and is controlled by a resident enterprise or by a resident enterprise and Chinese individual residents and whose profits are not distributed or are distributed in a reduced amount for reasons other than reasonable needs for business operation.⁷

The term “control” refers to a substantive control in terms of shares, capital, business operation, purchase and sales, etc. Control in shares means that a single Chinese resident shareholder directly holds or indirectly in a multilayered structure holds at least 10% of the voting shares of a foreign enterprise in any day of a taxable year, and the Chinese resident shareholders shall jointly hold at least 50% of the shares of the foreign enterprise. If the Chinese resident shareholders hold shares indirectly in a multilayered structure, their shareholding proportion shall be computed by multiplying the shareholding proportions at all layers. If the shareholding proportion in a middle layer exceeds 50%, the proportion shall be treated as 100% in calculation.⁸

The taxation authority shall summarize and examine the information on overseas investment declared by a Chinese resident enterprise shareholder, and serve a Notice of Confirmation of a Chinese Resident Enterprise Shareholder of a Controlled Foreign Enterprise on the Chinese resident enterprise shareholder of the controlled foreign enterprise. If the Chinese resident enterprise shareholder meets the taxation conditions as prescribed in Article 45 of the CITL, the taxation authority shall levy tax on it according to the relevant provisions.⁹

If the Chinese resident enterprise shareholder has already paid any enterprise income tax overseas for the current-period income deemed as from dividend distribution, it may be entitled to a tax credit according to the relevant provisions of the CITL or tax agreement.¹⁰

If the Chinese resident enterprise shareholder is able to provide information to prove that its CFC meets any of the following conditions, the profits of the foreign enterprise that are not distributed or the deficit when the profits are distributed in a reduced amount may not be deemed as distributed dividends and not be included in the current-period income of the Chinese resident enterprise: (i) It is an enterprise formed in a non-low tax rate country (or region) as specified by the SAT; (ii) its incomes are mainly derived from its active business activities; or (iii) its total annual profits are less than 5 million RMB.¹¹

In 2015, the SAT published the updated discussion draft of Circular 2 for the purpose of soliciting public opinions ([State Administration of Taxation 2015c](#)). Chapter 10 of the new draft has more detailed requirements on the CFCs from Article 114 through Article 125. However, this new draft has not been finalized yet by the end of June 2017.

3.4. Responses to BEPS Action 4

As far as the BEPS Action 4 is concerned, Article 46 of the CITL of 2007 offers the thin capitalization rule based on a fixed debt/equity ratio, by clarifying that the interest disbursement for any debt investments and equity investments, which an enterprise accepts from its affiliates, in excess of the prescribed criterion shall not be deducted in the calculation of the taxable amount of income. As the

⁷ Article 76, Circular 2 of 2009.

⁸ Article 77, Circular 2 of 2009.

⁹ Article 79, Circular 2 of 2009.

¹⁰ Article 82, Circular 2 of 2009.

¹¹ Article 84, Circular 2 of 2009.

thin capitalization is closely connected with the interest deduction, Article 46 could be considered a general article on limiting base erosion involving interest deductions.

Pursuant to Article 46 of the CITL, Article 119 of CITLIR defines the term “debt investment” as the financing which an enterprise directly or indirectly obtains but has to repay the principal and pay interest or has to make compensation by any other means in the nature of interest payment. The debt investment obtained by an enterprise from any related party shall include: (i) Debt investment a related party provides through an unrelated third party; (ii) debt investment an unrelated third party provides which is guaranteed by a related party that assumes several and joint liabilities; (iii) any other debt investment indirectly obtained through any related party in the nature of obligation assumption. The term “equity-based investment” refers to the type of investment which an enterprise accepts for which it does not have to repay the principal and pay interest and the investor holds ownership over the net assets of the enterprise.

According to the authorization of Article 119 of CITLIR, Chapter IX of the Circular 2 of 2009 deals with the standards for identification of thin corporations in details from Article 85 through Article 91.

China has not issued further new detailed regulations to implement the recommended approach by the BEPS Action 4, based on a fixed ratio rule which limits an entity’s net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA) by the end of 2016. However, generally speaking, the current regulations on thin capitalization function well in China.

The BEPS Action 4 requires the countries to undergo periodic OECD monitoring of interest deduction limitation rules according to a process to be determined.¹² As China takes the BEPS package very seriously, China is expected to collaborate with the OECD on the monitoring process.

3.5. Responses to BEPS Action 5

According to the BEPS Action 5, it is a minimum standard for the countries to modify existing IP regimes to use nexus approach, and to use agreed grandfathering rules if modification will include transition rules. Additional four prescriptions of the BEPS Action 5 are, to adopt procedures to inform the OECD Harmful Tax Practices Forum if tax benefits are provided to specified IP assets, to adopt measures to monitor and gather data on companies benefitting from regimes to promote development in disadvantaged areas, to adopt procedures to spontaneously exchange statistical information with respect to specified IP-related rulings, and to adopt procedures to spontaneously exchange statistical information with respect to cases of insufficient IP-ruling related data gathering and exchange.¹³

Under Article 28 of CITL, the corporate income tax on important high-and-new-tech enterprises that are necessary to be supported by the state shall be levied at the reduced tax rate of 15%. Such preferential regime on reduced rate for advanced technology enterprises in China is considered not harmful by the review process of the FHTP.¹⁴

4. Responses to Mainly Treaty-Based Action Items (Items 6–7)

4.1. Responses to BEPS Action 6 on Treaty Shopping

According to the BEPS Action 6, it is a minimum standard for the countries to include a principle purpose test (PPT) alone or combined with a limitation on benefits (LOB) provision, or a LOB provision combined with a specified anti-conduit rule. Additional three prescriptions of the BEPS Action 6 are, adopting anti-abuse rules to address tax avoidance strategies addressed throughout the Action Plans, including an express statement about a common intention to eliminate double taxation without

¹² Action 4 Report, p. 13.

¹³ Action 5 Report, pp. 67–68.

¹⁴ Action 5 Report, p. 64.

creating double non-taxation or treaty shopping opportunities and including a saving clause to preserve domestic taxation of residents subject to specified exceptions.¹⁵ Another relevant prescription from the BEPS Action 2 is to address hybrid mismatches in accordance with revisions to OECD Model Article.¹⁶

Several bilateral tax treaties China signed in the process of developing the BEPS package have incorporated the LOB provision required by the Action 6. For instance, the Agreement between China and Chile for the Avoidance of Double Taxation and the Protocol thereto were formally signed in Santiago, Chile on 25 May 2015. The two parties have completed the required domestic legal procedures for the entry into force of the Agreement and the Protocol thereto. The Agreement and the Protocol thereto have come into force on 8 August 2016, and applies to income obtained on and after 1 January 2017. In addition to the LOB provision, this Agreement also introduced the PPT and the rule on identification of the existence of PE in triangular situations.

The similar approach was also taken in the Agreement between China and Russia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and the Protocol thereto and the Protocol Amending this Agreement formally signed in Moscow respectively on 13 October 2014 and 8 May 2015, and came into force on 9 April 2016.

Of course, not all the bilateral tax treaties have adopted the approach recommended by Action 6. However, as China has promised to implement the Action 6 as minimum standard, it is likely for China to comprehensively adopt the approach of the Action 6 by updating its bilateral treaties based on the new Multilateral Instrument required by the Action 15 in the near future.

To optimize the administration of non-resident taxpayers' enjoyment of the treatment under tax agreements, the SAT issued Bulletin on Issuing the Measures for the Administration of Non-Resident Taxpayers' Enjoyment of the Treatment under Tax Agreements (Bulletin 60 of 2015) on 27 August 2015.

Where non-resident taxpayers are eligible for the treatment under tax treaties, they may, when filing tax returns, or when withholding agents make withholding declaration, enjoy the treatment under agreements at their own discretion and be subject to the follow-up administration by tax authorities.¹⁷

Where, under the circumstance of withholding at source or designated withholding, non-resident taxpayers deem that they are eligible for the treatment under agreements, and need to enjoy the treatment under agreements, they shall take the initiative to put forward the request to withholding agents, and provide withholding agents with the relevant report forms and materials as prescribed in Article 7 of Bulletin 60. Where such documents are complete, and the information filled in the relevant report forms meets the requirements for enjoying the treatment under agreements, withholding agents shall withhold taxes in accordance with the provisions of agreements, and forward the relevant report forms and materials to the competent tax authorities while making withholding declaration. Where non-resident taxpayers fail to put forward the request for enjoying the treatment under agreements to withholding agents, or the materials provided for withholding agents or the information filled in the relevant report forms fail to meet the requirements for enjoying the treatment under agreements, withholding agents shall withhold taxes in accordance with the provisions of domestic tax laws.¹⁸

Although the tax authorities will give up their traditional power of prior approval on the treaty treatment or benefit, they will closely follow-up the non-resident taxpayers' enjoyment of the treaty benefit under agreements, and accurately execute tax agreements, so as to prevent the risks of treaty shopping. Therefore, such reform is both taxpayer-friendly and efficient.

¹⁵ Action 6 Report, p. 10.

¹⁶ Action 2 Report, pp. 139–43.

¹⁷ Article 3 of Bulletin 60.

¹⁸ Article 6 of Bulletin 60.

Where the competent tax authorities find in the process of the follow-up administration that the general rules on anti-tax avoidance in tax agreements or domestic tax laws shall apply, the general anti-tax avoidance investigation procedures may be initiated.¹⁹

A recent development of the restraint mechanism for the non-resident taxpayers is the credit evaluation and disclosure system. The competent tax authorities shall maintain credit archives for non-resident taxpayers' improper enjoyment of the treatment under agreements, and take corresponding follow-up administration measures.²⁰

4.2. Responses to BEPS Action 7 on Permanent Establishment (PE)

The 2015 BEPS Report on Action 7 aims at preventing the artificial avoidance of PE status, and provides for changes to be made to Article 5 of the Model Tax Convention ("MTC"), so as to prevent artificial avoidance of PE status through use of commissionaires, fragmentation of activities and abuse of independent agent status.²¹ On 4 July 2016, the OECD published the Discussion Draft of Additional Guidance on the Attribution of Profits to PE.

China has shown great interest in tightening the regulation of the PE, and has directly endorsed the criteria for identifying the PE in the draft Report of Action 7 in the bilateral treaty with Chile signed on 25 May 2015, almost five months before the finalization of BEPS package in October 2015. However, it remains to observe whether similar approach will be followed in its subsequent treaties with other countries in the future.

Considering the fact that the SAT previously promised to support the PE definition in the BEPS package, it is expected that China will introduce this definition in most, if not all, of its bilateral treaties by multilateral automatic treaty modification based on the Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting of 2016 in the future. As some contracting countries are low tax jurisdictions, such as Luxembourg, the Netherlands, Ireland and Singapore, the modification of the bilateral treaties between China and those low tax jurisdictions will have huge impacts on the corporate structure and tax planning of the MNEs.

China has traditionally attributed the profit to PE based on the verification of the profit rate, instead of the AOA. Therefore, China has to decide whether and/or to what extent it is willing to implement the full AOA after the Additional Guidance on the Attribution of Profits to Permanent Establishments is finalized in the future. It is expected that the national information exchange and data analysis systems will help China identify the PE in the future.

Paragraph 1 of Article 5 (PE) of the tax agreements signed by China prescribes that: The term "PE" refers to a fixed place of business through which the business of an enterprise is wholly or partly carried out. Paragraph 4 of Article 5 prescribes that: The term "permanent establishment" shall not include the fixed business place established solely for of the enterprise itself to carry out any other activity of a preparatory or auxiliary nature.

To clarify the terms "business" and "preparatory or auxiliary" and other PE issues, the SAT released the Bulletin on the Relevant Issues about the Determination of Permanent Establishments in Tax Agreements (Bulletin No. 35 of 2006) on 14 March 2006.²² The term "business" refers to both business operations and common business operations conducted by NPOs. The following principles shall be followed when determining "preparatory or auxiliary" activities: (i) Whether the fixed base or place only provides services to its head office or whether it has any business relation with any other entity; (ii) whether the business nature of the fixed base or place is in line with that of its head office; and (iii) whether the business operations of the fixed base or place are an important part of those of its head office. If the fixed base or place not only provides services to its head office but also has

¹⁹ Article 22 of Bulletin 60.

²⁰ Article 23 of Bulletin 60.

²¹ Action 7 Report, p. 9 et seq.

²² CLI.4.75564(EN).

business relations with any other entity, or its business nature is in line with that of its head office and its business operations are an important part of those of its head office, the activities of such fixed base or place shall not be regarded as preparatory or auxiliary.

In the past years, China has paid great attention to the regulation of the service PE. The term “PE” in tax treaties encompasses that “the furnishing of services, including consultancy services, by an enterprise of a Contracting State through employees or other personnel in the other Contracting State, provided that such activities continue for the same project or a connected project for a period or periods aggregating more than six months within any twelve-month period.”

The SAT clarified the determination of the PE of foreign enterprises providing services within China and the Attribution of profits to PE in its reply to Jiangsu Tax Authority on 19 July 2016.²³ First, if a foreign enterprise without PE sends its employees to provide services, including consultancy services, for a connected project within China for more than six months within any twelve-month period, the PE shall be identified. Second, if a project lasts for several years and if the employees assigned by the foreign enterprise provide services more than six months, but other employees assigned by this foreign enterprise provide services not more than six months, the existence of PE shall be determined. This PE is based on all services which the foreign enterprise provides for the relevant project rather than the services provided in a certain period. Third, for a foreign enterprise which has a PE providing services for a certain project through its employees within China, the profits sourced from such project shall be taxed as the profits of the PE.

A frequently cited PE case was reported by China Tax News. In this case, a parent corporation incorporated in Singapore, X corporation, established an equity joint venture of auto making in China, Y corporation. X corporation sent several groups of employees to provide technological instructions and post-sale services for the projects of Y corporation in China. Beijing Tax Authority found that X corporation had 51 PEs by sending employees providing services for more than 183 days between January 2012 and December 2015 in China. Y corporation disagreed by arguing that the employees of X corporation stayed less than 183 days, and therefore no PE would be constituted, and that the employees’ income were paid outside the territory of China, therefore the employees of X corporation not obligated to pay individual income tax in China²⁴.

The methodology for calculating the period of 183 days in aggregation has been reflected in many tax treaties signed by China and other contracting parties, and will play significant role in frustration of the strategies of abusive splitting-up of contracts. It is expected that China will be more actively in identifying the PE with the help of information sharing and regulatory collaboration between and among Chinese domestic government agencies and international counterparts.

The growth of E-Commerce and new business models in the digital economy poses serious challenges for applying the definition of PE to the world of e-commerce. China expressed its concern about the challenge and significance on the taxing the corporate income deriving from e-commerce in its comments on the UN Subcommittee on Base Erosion and Profit Shifting. “The development of the digital economy increases the online transactions. How to tax these transactions remains a difficulty for tax administrations. The action plans should consider how to tackle the challenges of digital economy on the existing tax systems and the revenue base (UN n.d.)”.

While the OECD approach is to treat service income as business income under Article 7, the source State has no taxing rights unless the service income is attributed to a PE situated therein. The UN Model, however, grants greater taxing rights to the source State through the inclusion in Article 5 of a deemed service PE provision (Art. 5 (3) (b)), which is based on a time threshold (i.e., 183 days in any 12-month period) concerning the service activities within a Contracting State.²⁵

²³ No. 694 [2006] of the State Administration of Taxation, 19 July 2006, CLI4.78110(EN).

²⁴ See http://www.ctaxnews.net.cn/html/2016-10/21/nw.D340100zgswb_20161021_1-05.htm.

²⁵ See China Comments to BEPS, <http://www.un.org/esa/ffd/tax/Beps/index.htm>.

As one of the basic features of the modern global economy is that a physical presence may no longer be required for the conduct of business, it is very common for a large range of cross-border services, such as design, engineering, financial consultancy, advertising to be performed from remote locations. In our opinion, it should be possible to devise a workable PE threshold that does not depend on physical presence but on a de minimis amount of sales of goods and services into a taxing jurisdiction.²⁶

5. Responses to Transfer Pricing Measures (Items 8–10 and 13)

5.1. General Requirements of BEPS Action Items 8–10 and 13

BEPS Action Items 8–10 and 13 focus on areas of concern involving transfer pricing, and aims at bringing about rule changes involving the treatment of intangibles, of risks and capital, and of other high-risk transactions, as well as improving new “country-by-Country” (CbC) reporting requirements. It is a minimum standard for the countries to adopt CbC reporting procedures for three-tiered reporting system of master file, local file, and CbC reports and to adopt international agreements and procedures to automatically exchange CbC reports.²⁷

Additional Prescriptions include undergoing periodic OECD monitoring of CbC implementation,²⁸ revising allocation rules to attribute risks to related parties on the basis of control and financial capacity,²⁹ revising allocation rules to prevent legal ownership as sole determinant of source of income attributed to intangibles,³⁰ revising allocation rules to attribute value to companies that perform important functions,³¹ limiting non-controlling companies to risk-free return or less on financial transactions,³² limiting values attributed to group synergy to companies contributing to synergistic benefits³³.

5.2. The Legal Framework of Transfer Pricing and TP Documentation in China before the Release of BEPS Package in 2015

Chapter 6 of the CITL, under the title “Special tax adjustments”, provided the legal foundations of transfer pricing and TP documentation in China, including the authorization of tax authorities to adjust the tax, the arm length principle, cost contribution agreements (Article 41), advance pricing arrangements (APA, Article 42), annual report on the related transactions, adjustment methodology, CFCs (Article 45), thin capitalization (Article 46), and general anti-tax avoidance (GATA, Article 47), etc. Chapter 6 of the CITLIR further defined the terms used by Chapter 6 of the CITL in details.

For instance, Article 43 of CITL imposed the TP documentation requirements in China. When an enterprise files its annual corporate income tax returns with the tax authority, it shall enclose an annual report on the related party transactions. When the tax authority investigates into the related party transactions, the enterprise and its affiliates, as well as other enterprises relevant to the affiliated transactions under investigation, shall provide the pertinent documents.

Article 36 of the LATC also authorized Chinese tax authorities to make reasonable adjustments in case of the receipt or payment of charges or fees which are not priced at arm’s length prices and results in a reduction of the taxable income.

Pursuant to the CITL, the CITLIR and the bilateral tax treaties on the avoidance of double taxation, the SAT released the Measures for the Implementation of Special Tax Adjustments

²⁶ For these proposals see, e.g., (Avi-Yonah 1997, 2016; Avi-Yonah and Xu 2016).

²⁷ Action 13 Report, pp. 9–10.

²⁸ Action 13 Report, pp. 10, 23.

²⁹ Actions 8–10 Reports, p. 10.

³⁰ Actions 8–10 Reports, p. 10.

³¹ Actions 8–10 Reports, p. 10.

³² Actions 8–10 Reports, p. 11.

³³ Actions 8–10 Reports, p. 11.

(for Trial Implementation) of 2009 (Circular 2), which represents the most comprehensive and significant regulation in addressing the transferring pricing and TP documentation in China before the release of the BEPS package in 2015.³⁴

5.3. Overview of the Transfer Pricing and CbC Reporting Changes in China

To effectively implement the BEPS package in China and to comprehensively update the existing Circular 2, the SAT released a Discussion Draft of a Circular on Implementation Measures for Special Tax Adjustments (“Discussion Draft”) in September 2015, ranging from Action 3 (CFC rules), Action 8–10 (Aligning TP outcomes with value creation) to Action 13 (TP documentation and CbC reporting) in details ([State Administration of Taxation 2015c](#)). Compared with 13 chapters and 118 articles in Circular 2, there are 16 chapters and 168 articles in the Discussion Draft of 2015.

Although the long-expected new single version of Circular 2 has not been finalized yet, a series of patches have been made to replace the substantial part of Circular 2. For instance, Article 69 of Circular 2 was replaced by the SAT Bulletin 45 of 16 June 2015.³⁵ Chapters 2–3, Articles 74 and 89 of Circular 2 were replaced by the SAT Bulletin 42 on Matters concerning Improving the Administration of Affiliation Reporting and Contemporaneous Documentation of 29 June 2016. Chapter VI of the Circular 2 was replaced by the SAT Bulletin 64 on the Issues Concerning Improving the Administration of Advance Pricing Arrangements of 11 October 2016. Chapters 4–5, 10–11 of the Circular 2 were repealed by the SAT Bulletin 6 on Improving Administration of Special Tax Investigation and Adjustment and Mutual Agreement Procedures of 17 March 2017 ([State Administration of Taxation 2017a](#)).

Following the release of the aforesaid Bulletins, the majority of innovative institutional arrangements proposed in the 2015 Discussion Draft have been produced as a series of separate items. It is likely that the remaining parts of the Discussion Draft will also be released as piecemeal documents, rather than as a single comprehensive regulation. As a result, the existing valid parts left in Circular 2 are only Chapter 7 (cost sharing agreements) except Articles 69 and 74 annulled by Bulletin 42, Chapter 8 (CFC), Chapter 9 (thin capitalization) except Articles 89 annulled by Bulletin 42, and Chapter 10 (general anti-avoidance).

Bulletin 45 of 2015, Bulletins 42 and 64 of 2016, and Bulletin 6 of 2017 have not only substantially updated the transfer pricing specific clauses of Circular 2, but also basically reflected the final results of the BEPS package, especially Actions 8–10, and Action 13. As China has totally endorsed the underlying standards on transfer pricing, BEPS project enhances has substantially promoted the convergence of transfer pricing standards between China and other countries.

5.4. TP Documentation Requirements of Bulletin 42 of 2016

The CbC report and contemporaneous documentation are one of the four minimum standards of the BEPS package. To implement the BEPS Action 13, the SAT released Bulletin 42 of 2016, which fundamentally updated the previous requirement for contemporaneous documentation under Chapter 2, Chapter 3, Article 74 and Article 89 of Circular 2, and the requirement for annual reporting of related party transactions under Circular No. 114³⁶.

As the first step of the SAT to localize OECD/G20 BEPS Project recommendations into domestic legislation, Bulletin 42 introduced the three-tiered framework of comprehensive related-party transactions reporting and improved the existing contemporaneous documentation, based on Circular 2. Bulletin 42 established ambitious TP compliance requirements at two levels: (i) RPT Forms, including three forms/tables of CbC report; and (ii) three-tiered contemporaneous documentation, including master file, local file and special file. As the CbC report is incorporated in the RPT Forms of

³⁴ No. 2 [2009] of the SAT (Guoshuifa [2009] No. 2).

³⁵ No. 45 [2015], SAT ([State Administration of Taxation 2015d](#)).

³⁶ Document No. 114 [2008], SAT.

2016, China has developed four-tiered standardized approach (master file, local file, special file and CbC report).

Any resident enterprise subject to tax levied on auditing accounting books and non-resident enterprise with establishments or offices in China subject to corporate income tax levied on an actual basis, should report its related-party transactions in a fiscal year by filling the annual report forms on related-party transactions (RPT Forms), along with the annual corporate income tax return, by May 31 of every fiscal year.³⁷

Bulletin 42 recognizes five types of related-party transactions: (i) Transfer of the right to use or ownership of tangible assets, including commodities, products, buildings and structures, means of transportation, machinery equipment, tools and instruments; (ii) transfer of financial assets, including accounts receivables, notes receivables, other receivables, equity investment, debt investment, and the assets formed by derivative financial instruments; (iii) transfer of the right to use or ownership of intangible assets, including patent right, know-how, trade secrets, trademark right, brands, list of clients, sales channels, franchised rights, government licensing, and copyright; (iv) accommodation of funds, including all types of long-and short-term loans (including capital pool of the group), guarantee expenses, all types of prepayments with accrued interest, delayed receipts and payments; (v) trading of services, including market investigation, marketing planning, agency, design, consulting, administration, technical services, contracted R & D, maintenance, legal services, financial management, auditing, recruitment, training and centralized procurement.³⁸

Under Article 11 of Circular 2 and Circular 114, there were nine old RPT Forms. To enhance the global transparency of the BEPS picture of the MNE group, Bulletin 42 increased the lengths of RPT Forms to 22 items, including: Reporting entity information form (compulsory); annual summary form on related party transactions (compulsory); related party relationship form (compulsory); transfers of ownership in tangible assets form; transfers of ownership in intangible assets form; transfers of rights to use tangible assets form; transfers of rights to use intangible assets form; financial assets transaction form; financing form; related party services form; equity investment form; cost contribution agreement form; outbound payment form; overseas related party information form; financial analysis form of annual affiliated transactions between enterprises (unconsolidated); financial analysis form of annual affiliated transactions between enterprises (consolidated); form on the global allocation of income, taxes and business activities; list of entities within the multinational group; and additional information. The last three forms on the CbC report should be prepared in both Chinese and English.

Given the fact that not every table/form in the 22 RPT Forms is mandatory for the taxpayer to file, and given the different thresholds for the taxpayers to prepare certain forms, this author speculate that, although some MNEs need to file all the RPT forms, most taxpayers will be only required to file not more than nine forms as before the release of Bulletin 42. The SAT also expressed the same idea ([State Administration of Taxation 2016](#)).

As envisaged by the BEPS Action 13 Report, the CbC report will provide annually the amount of revenue, profit before income tax, income tax paid and accrued, number of employees, stated capital, retained earnings, tangible assets, business activities of each entity of the MNE group in each tax jurisdiction. Following the model legislation of the BEPS Action 13 Report, Bulletin 42 made it mandatory for large MNEs to file the CbC report in three forms/tables, as part of RPT Forms of 2016, for the purpose of disclosing the global allocation of the income, taxes paid and economic activity among countries.

In the past decades, Chinese tax authorities have complained about the difficulties in acquiring the full global picture of MNEs' value-creating activities and profit allocations. With the help of the CbC Report, tax authorities will obtain a preliminary understanding of the allocation of a MNE's

³⁷ Article 1 of Bulletin 42, Article 54 of the CITL.

³⁸ Article 4 of Bulletin 42.

profits around the globe, the distribution of the entities/jurisdictions engaging specific activities along an MNE's value chain, and the relevant tax positions for each of the tax jurisdictions. Of course, the authentic, accurate and complete CbC report will also help the MNEs to demonstrate their compliance with the arm's length principle on their transfer pricing activities. Therefore, CbC report will benefit both the tax authorities and the taxpayers.

The primary reporting entity is the ultimate holding company of the MNE group with annual consolidated group revenue in the immediately preceding fiscal year of not less than 5.5 billion RMB, roughly equivalent to the threshold of Euro 750 million as specified under the BEPS Action 13 Report. The ultimate parent entity is able to consolidate the financial statements of all constituent entities under its umbrella, while its own financial statements cannot be consolidated by any other enterprises. The secondary reporting entity is the constituent entity nominated or designated by the MNE group to file the CbC Report.³⁹

Chinese tax authorities may also request a taxpayer under special tax investigation to provide a CbC report in any of the following circumstances: (i) The MNE group has not provided a CbC report to any country; (ii) although the MNE group has provided a CbC report to another country, China has not established the information exchange mechanism on the CbC report with that country; or, (iii) despite the fact that the MNE group has provided the CbC report to another country with such mechanism with China, China has not successfully obtained the CbC report.⁴⁰

Bulletin 42 requires qualified taxpayers to prepare the CbC report by completing three specified forms/tables under the BEPS Action 13 Report, including: (i) Overview of allocation of income, taxes and business activities by tax jurisdiction; (ii) list of all the constituent entities of the MNE group included in each aggregation per tax jurisdiction; and (iii) additional information.

As recommended by the BEPS Action 13 Report, the first CbC Reports would be filed by 31 December 2017. For MNEs with a fiscal year ending on a date other than 31 December, the first CbC Reports would be required to be filed later in 2018, twelve months after the close of the relevant MNE fiscal year, and would report on the MNE group's first fiscal year beginning after 1 January 2016. Thus, inter-government exchange mechanism is expected to be ready for the exchange of the first CbC Reports.

In response to the three-tier structure for transfer pricing documentation as set out in BEPS Action 13, Bulletin 42 restructured the contemporaneous documentation into a three-tier structure, including master file, local file and special file. The qualified taxpayers should prepare and file contemporary documentation on related party transactions in the fiscal year at the request of the tax authority.⁴¹ As each file has its own filing thresholds, it is possible for one taxpayers to file two or three of the contemporaneous documents.

5.5. Bulletin 6 of 2017 on the Special Tax Investigations and Adjustments

To further streamline and improve the transparency and predictability of transfer pricing investigations undertaken by Chinese tax authorities, SAT released its long-awaited Bulletin on Special Tax Investigations, Adjustments and Mutual Agreement Procedures ("Bulletin 6") on 28 March 2017, as another step in converting the BEPS Actions 8–10 Reports into domestic regulations on transfer pricing. Bulletin 6 was effective from 1 May 2017, and replaced Chapters 4, 5, 11 and 12 of Circular 2, Circular 188, Circular 363, Bulletin 54 and Bulletin 16.

Bulletin 6 not only reflects the outcome of the BEPS Actions 8–10 Reports, but also consolidates previous regulations and existing practices on transfer pricing. It is expected that the introduction of Bulletin 6 will greatly improve the predictability, reliability and transparency of transfer pricing

³⁹ Article 5 of Bulletin 42.

⁴⁰ Article 8 of Bulletin 42.

⁴¹ Article 10 of Bulletin 42.

investigations by clarifying the focus points and the rationale of Chinese tax authorities, standardize the transfer pricing investigation practices, and indirectly force the corporations to take initiatives on voluntary and honest self-adjustments.

Embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions, interpreted by OECD's Transfer Pricing Guidelines, the arm's length principle (ALP) is re-emphasized by the BEPS package. To help tax authorities and taxpayers evaluate transfer prices between associated enterprises, and to prevent double taxation, China also uses the ALP as the cornerstone of transfer pricing rules. Article 37 of Bulletin 6 authorized tax authorities to "make adjustments to the full amount of payments made to overseas related parties that have performed no function, assumed no risk or carried out no substantive activities, which are not in compliance with the arm's length principle".

Article 4 of Bulletin 6 listed 9 categories of target corporations with the risk features to be investigated by tax authorities: (i) Enterprises with significant amount or substantially multiple types of related-party transactions; (ii) enterprises with longtime losses, low profitability or fluctuating profitability; (iii) enterprises with profit levels lower than average levels of the same industry; (iv) enterprises whose profit levels do not match their functions performed and risks assumed, or whose shared benefits do not match their allocated costs (CCA); (v) enterprises that transact with related parties in low tax jurisdictions (tax havens); (vi) enterprises that fail to file their related-party transaction reporting forms or to prepare contemporaneous documentation; (vii) enterprises whose related-party debt-to-equity ratio exceeds the standard ratio (thin capitalization); (viii) enterprises incorporated in a jurisdiction where the effective tax rate is lower than 12.5%, controlled by Chinese tax resident companies, or by Chinese tax resident companies and Chinese nationals, having either failed to distribute profits or reduced the distribution of profits without reasonable business needs (CFC); (ix) enterprises who engage in tax planning schemes or tax arrangements that lack reasonable business purposes (general anti-avoidance, GAA).

Under Article 4 of Bulletin 6, both residents and non-residents shall be subject to investigation. This is likely to happen in the cases involving CFC or GAA issues. Tax authorities may deal with non-residents either directly or through a resident related party. According to the interpretation of SAT, the legal basis for the investigation of the foreign tax residents is the CIT ([State Administration of Taxation 2017b](#)). Such a legal basis should be Article 43 of the CITL, which said, "When the tax organ investigates into the affiliated transactions, the enterprise and its affiliates, as well as other enterprises relating to the affiliated transactions under investigation, shall provide the pertinent materials according to the relevant provisions". Article 114 (2) of the CITLR further referred the term "other enterprises relating to the related transaction under investigation" to those enterprises that are similar to the enterprise under investigation in the contents and pattern of production and business management.

The special tax adjustment is generally not applicable to wholly domestic related party transactions. Based on the approach of Article 30 of Circular 2, Article 38 of Bulletin 6 provides that, "as a general principle, no special tax adjustment shall be made with respect to the transaction between domestic affiliates whose actual tax burdens are the same, provided the transaction has not directly or indirectly decreased the overall tax revenue of China".

The process of special tax investigation would be generally launched in case of the failure of appropriate self-adjustment of the taxpayers. Therefore, Bulletin 6 encourages the taxpayers to take initiative to adjust its transfer pricing on its own. Tax authorities may also remind the taxpayers of any taxation risk in question, based on verification of the RPT reporting, administration of the contemporaneous documentation and monitoring of corporate profit level. When taxpayers choose to self-adjust, they should file the newly introduced "Special Tax Adjustments Self-Payment Form".⁴²

Tax authorities shall initiate special tax investigations in cases where taxpayers request tax authorities to confirm the principles and methods of the transfer pricing. Despite any self-adjustments

⁴² Article 3 of Bulletin 6.

by taxpayers, tax authorities may use their discretion to initiate a special tax audit process if they deem the self adjustment is insufficient.

Based on the presumption that there would be profits attributable to LSAs, Bulletin 6 requires Chinese tax authorities to analyze LSAs such as the cost savings and market premiums, and select appropriate and reasonable transfer pricing methods to determine LSAs' contribution to profits, where the comparable corporation and investigated corporation operate in different economic conditions.⁴³ Chinese tax authorities have long emphasized the significance of LSAs, and endeavored to ensure Chinese taxpayers are compensated for LSAs that allow the MNE group to earn higher profits. The significance of LSAs' impact on transfer pricing analysis has been expressly recognized by Bulletin 42 and Bulletin 64. For instance, the LSAs requirement is reflected in the local file documentation as the factors affecting transfer pricing and profits in the value chain under Bulletin 42.

Consistent with the OECD Guidelines, Article 111 of the CITLIR recognized the comparable uncontrolled price method (CUP), the resale price method (RPM), the cost-plus method (CPM), the transactional net margin method (TNMM), the profit split method (PSM), and other methods in compliance with the arm's-length principle. Article 16 of Bulletin 6 continues to authorize the tax authorities to choose one of the above-mentioned reasonable transfer pricing methods, based on the comparable analysis, to analyze the related party transactions. The detailed guidance of Bulletin 6 on the methods generally reflected the positions of the OECD Guidelines.

Article 22 of Bulletin 6 introduced three frequently used asset valuation methods, including cost, market and income, to support transfer pricing analysis of the transactions of either individual pieces of corporate assets, including intangible assets, or entire corporate assets as a whole.

This Article also introduced a broad language "Other methods in compliance with the arm's length principle" as to include any other reasonable methods that comply with the arm's length principle, and can appropriately reflect the principle that profits should be taxed where economic activity takes place and where value is created. The broad wording of "other methods" will offer necessary discretion and flexibility for tax authorities to employ any reasonable methods available to reflect the principle that profits should be taxed where economic activity takes place and where value is created, for the purpose of fair and reasonable special tax adjustment.

The controversial term value contribution allocation method (VCAM) or value chain apportionment method introduced in Article 35 of Discussion Draft of 2015, which was considered akin to formulary apportionment by some, has been dropped from Bulletin 6. Some consultants interpreted this major change as a response to criticisms made by commentators on the Consultation Draft (EY n.d.). This author argues that the silence of Bulletin 6 on VCAM does not imply that VCAM will never be used by Chinese tax authorities. Quite contrary, the term "Other methods in compliance with the arm's length principle" is broad enough to empower Chinese tax authorities to directly or indirectly use the VCAM or similar terms when necessary.

A further good example is the GVCAM advocated by the Jiangsu Provincial Office of SAT. Based on the practice of transfer pricing investigation, APA and consensus with some MNEs, Jiangsu Office urged the MNEs to change their mindset and try a new transfer pricing method based on the analysis of global value chain. GVCAM can be divided into three steps: (i) Collecting sufficient information including the Group's master file, CbC report, commercial databases, internal financial data, etc. The subsidiaries should strengthen intra-group communication and to promote full understanding of the substance of relevant information; (ii) analyzing the operation and profit of the group value chain, clarify the functions and relevant undertakers on the value chain, and identify the core elements in value creation, such as intangibles, fixed assets, personnel and market; (iii) allocating the total profit on the value chain to different function bearers according to a set of core indicators (such as assets, sales, expenses, costs, etc.) to ensure that the allocation match the functions performed

⁴³ Article 27 of Bulletin 6.

and the risks assumed by these parties on the value chain (Jiangsu Provincial Office, Sat 2016). As Jiangsu is one of the economic power houses with active operations of MNEs in China, it is likely that other Chinese tax authorities would follow Jiangsu's pioneer model. The reason is very simple.

5.6. Transfer Pricing of Intangible Property Transactions

Different from the traditional unilateral approach to the payment of royalties paid by Chinese enterprises to the oversea affiliates, Bulletin 6 introduced the bilateral approach to the payment of royalties between Chinese enterprises and their affiliates, including the payment received by Chinese corporations from their oversea affiliates. As the new rules on transfer pricing of intangible property transactions covers both transferors and transferees of intangibles, Chinese tax authorities will give enough attention to the BEPS risks associated with intangibles transactions between the members of China-based MNE groups. Therefore, it is essential for China-based MNE groups to ensure the arm's length nature of the royalties received by Chinese taxpayers from their oversea affiliates as licensees of intangibles. It is expected that there will be serious discussions on the BEPS risk associated with the royalty received by Chinese taxpayers from their offshore affiliates. Of course, Chinese tax authorities will not weaken their priority focus on the traditional BEPS risks arising from the payment of the royalties from Chinese corporations to their oversea affiliates.

In addition to duplicating the five functions (DEMPE) outlined by the BEPS Actions 8–10 Reports and OECD Transfer Pricing Guidelines, Bulletin 6 identifies "Promotion" of intangibles as another key function for the purpose of "DEMPEP" analysis. As Chinese tax authorities will conduct six-function (DEMPEP) analysis of the intangibles transactions under the new rules, the value contribution by and through marketing and promoting activities undertaken by Chinese companies will be appropriately rewarded. This innovation further reinforced Chinese traditional emphasis on the huge value of marketing and promotion efforts in attracting Chinese consumers to buy international brands at the price of generous premiums.

The DEMPEP analysis depends on different facts and circumstances, including business models of the MNE group and intangibles natures of the related party transactions. However, Bulletin 6 is silent on further quantification and weighting of the performance of various contribution in considering the arm's length adjustment of income related to intangible property between and among various members of the MNE group. The necessary discretion should be controlled by rule of law especially the due process of law, so as to strike a good balance between sophisticated taxpayers and tax authorities in the process of arm's length analysis of transfer pricing of intangibles transactions.

To warrant the predictability of tax audit and adjustment, the SAT would be well advised to develop detailed guidance based on Chinese specific circumstances and the BEPS Actions 8–10 Reports in the future. Neither ignorance of the significant functions of design and control, nor ignorance of the significant functions of exploitation and promotion is rationale and convincing without regard to the facts and circumstances in specific individual cases in question.

Under Bulletin 6, an entity that merely owns the legal ownership of intangible assets, but has not contributed towards the value creation of the intangible assets, should not be entitled to any benefit arising from the exploitation of such intangible assets.⁴⁴ Such position reflected the recommendations of the BEPS Actions 8–10 Reports, which indicates that, "For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible"; "Legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles".⁴⁵

⁴⁴ First paragraph, Article 30 (2) of Bulletin 6.

⁴⁵ Actions 8–10 Reports, pp. 10, 64.

Under Bulletin 6, an entity that has merely funded intangible development activities but has not performed any DEMPEP functions or assumed any risks in the creation and exploitation of intangible assets, should only be entitled to a reasonable financing return.⁴⁶

Under Bulletin 6, tax authorities may conduct special tax adjustment on the royalties received or paid as a result of intangibles licensing transactions, in case of the failure of timely adjustment by the taxpayer on one of the following situations: (i) The value of intangible assets have changed fundamentally; (ii) an adjustment mechanism on royalty for comparable transactions between unrelated parties would have been in place, pursuant to usual and normal business practices; (iii) the functions performed, risks assumed and assets used by the enterprise and its related parties have changed during the course of the exploitation of intangible assets; (iv) the enterprise and its affiliates have not been appropriately compensated for the ongoing DEMPEP of intangibles.⁴⁷ These rules are generally consistent with recommendations under the BEPS Actions 8–10 Reports, although discussions there are much more detailed.

Tax authorities are expected to pay particular attention to whether the value of the licensed intangibles has declined since the royalty was initially established, whether price adjustment clauses are commonly found in uncontrolled comparable transactions, whether the related parties have changed their functions as well as assets and risks have changed, and whether the transferee or the licensee has performed further additional DEMPEP functions for which it has not been reasonably and fairly compensated.

The core spotlight of Article Bulletin 6 is the recognition of the principle of benefit commensurate with the royalty rate. Bulletin 6 declares that the royalty paid or received for the transaction of intangibles should match the economic benefits generated by the intangibles for the enterprise or its affiliates. If the royalty does not match the economic benefit derived to the enterprise or its affiliates, and thus result in a reduction in the taxable gross income or taxable income of the enterprise or its related party, tax authorities may initiate special tax adjustment on such royalty. Assuming the licensed intangibles have generated no economic benefit, and assuming the transactions are not arm's length, tax authorities may make adjustments up to the full amount of the royalties paid. Assuming an enterprise pays a royalty to a related party that merely has the ownership of the intangibles, and assuming the royalties are not arm's length, tax authorities may make special adjustments up to the full amount of the royalty.⁴⁸

These rules have reinforced the substance principle reflected in the BEPS package and the recommendations of the BEPS Actions 8–10 Reports, including "legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles, and associated enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration".⁴⁹ The substance principle requires the magnitude of royalty specified in the contracts to be commensurate with the economic benefit in substance, and thus ensures arm's length pricing.

5.7. Transfer Pricing of Intra-Group Service Transactions

Articles 34–36 of Bulletin 6 are designed to determine the nature and level of the arm's length in related party service transactions, based on Article 4 of Bulletin 16 and existing enforcement practice, and inspired by the internationally accepted and OECD sanctioned "benefits test".

As indicated by the BEPS Actions 8–10 Reports, there are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided.

⁴⁶ Second paragraph, Article 30 (2) of Bulletin 6.

⁴⁷ Article 31 of Bulletin 6.

⁴⁸ Article 32 of Bulletin 6.

⁴⁹ Actions 8–10 Reports, p. 64.

The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle.⁵⁰

Following the same line of thinking, Article 34 of Bulletin 6 introduces two interrelated principles for the transfer pricing of intra-group service transactions to follow: The benefit principle and the ALP. First, the related-party services should be beneficial to the service recipient. Second, the service fee paid or received should be arm's-length. In case of the failure to satisfy the two interrelated requirements, a special tax adjustment shall be made.

To determine whether intra-group services have been rendered, the second paragraph of Article 34 of Bulletin 6 introduces benefits test recommended by the BEPS Actions 8–10 Reports. The arm's length related party service transactions should be beneficial service transactions that are priced according to business practices and fair prices for transactions conducted between unrelated parties in the same or comparable circumstances. The term "beneficial service" is defined as the service activity, which is able to deliver direct or indirect economic benefit to the recipient, and which an independent enterprise would have been willing to pay for or would have performed the activity in-house for itself, in the same or comparable circumstances.

The first paragraph of Article 34 of Bulletin 6 authorizes tax authorities to make a special tax adjustment by disallowing the deduction of the service fee, where an enterprise pays the service fee to its related parties for services that are not beneficial.

Although Bulletin 6 has not provided any detailed documentation requirements on the intra-group service transactions, it will be very helpful for the recipient and the provider of services to prepare and maintain genuine and reliable documents, including the books and records, to support the existence of beneficial services and the compliance of the ALP. It is irresponsible for the taxpayers and the tax consultants to wait for the SAT guidance before preparing the documents. The rationale is that the burden of proof on the compliance of the ALP is on the shoulder of the parties to intra-group service transactions, instead of the tax authorities.

Article 35 of Bulletin 6 listed 6 categories of non-beneficial intra-group service: (i) Duplicative services (services that has already been procured or carried out by the enterprise itself); (ii) shareholder activities (services that is carried out to exercise control, management and supervision of the enterprise with a view to protecting the investment interests of a direct or indirect investor); (iii) services that benefit solely from being part of the group (service not specifically carried out for the recipients, although the enterprise has obtained an incidental benefit by belonging to a particular group); (iv) services that have already been compensated in another related party transaction; (v) services that are irrelevant to the functions performed or risks assumed by service recipients, or do not meet the business needs of the service recipients; (vi) any other services that cannot bring direct or indirect economic benefit to the service recipient, or that an independent enterprise would have been unwilling to pay for or would not have performed the activity in-house for itself.

Based on the BEPS Actions 8–10 Reports, Article 36 of Bulletin 6 introduced the direct and indirect charging methods for related party services, except for the elective, simplified approach introduced by the BEPS Actions 8–10 Reports for low value-adding intra-group services of Chapter VII of the Transfer Pricing Guidelines. The elective, simplified approach specifies a wide category of common intra-group services which command a very limited profit mark-up on costs, applies a consistent allocation key for all recipients for those intra-group services, and provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.⁵¹ The reason is that SAT has long considered all intra-group service transactions are highly risky.

Article 36 of Bulletin 6 requires the reasonable pricing methods to be selected based on the consideration of the concrete content and features, the functions, risks, cost and expense undertaken by

⁵⁰ Actions 8–10 Reports, p. 144.

⁵¹ Actions 8–10 Reports, p. 14.

the service provider, the benefits and market circumstances of the recipient, the financial situation of the transactions parties, and the pricing level of comparable transactions. Where the direct “reasonable cost” is unavailable, the indirect “apportioned cost” shall be identified based on the match between the benefit enjoyed by the recipient and the outcome of the apportionment. Compared with the Discussion Draft, Article 36 of Bulletin 6 deleted the language “plus an arm’s length mark-up” on calculating a service fee.

The impact of Article 36 of Bulletin 6 is that the ALP will be actively applied to the intra-group service transactions, and the MNE groups have to reflect and readjust their existing unreasonable transfer pricing policies correspondingly. For example, where an overseas affiliate has outsourced all of the service that it used to provide to a corporate taxpayer in China, the outsourcing affiliate may not charge the Chinese taxpayer for the service provided by external unrelated parties any more.

6. Conclusions

As indicated above, China has actively participated in both developing and implementing the BEPS project. China’s tax base has been seriously eroded by aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or substantially reduced taxation.

In the first three earlier decades since the late 1970s, China had received more inbound foreign direct investments including advanced technologies and intangibles than the outbound investment of Chinese investors. However, as China started to implement the “Going-out” strategy in the 21st century, in particular the initiative of “one belt and one road” (OBOR), more and more China-based corporations are increasingly active in outbound investment and intangibles export overseas. In response to the new scenario of increasingly accelerated globalization of China-based MNE groups, China has to take a very holistic approach to deal with the BEPS challenges from different perspectives, including domestic action items (items 2–5), treaty-based action items (items 6–7) and transfer pricing measures (items 8–10 and 13).

In the post-BEPS era, China is expected to implement the BEPS project in a more consistent and coherent way, and will take whatever measures necessary to guarantee the successful implementation of the BEPS package in collaboration with the global community. That is why the SAT has quickly translated many minimum standards and recommendations of BEPS project into domestic regulations.

China has been one of most active countries in endorsing its international obligation created under the BEPS project. For instance, on 7 June 2017, China joined other 67 jurisdictions in Paris for the official signing ceremony for a new multilateral tax instrument (MLI).⁵² China signed the MLI not only by itself, but also on behalf of the Hong Kong Special Administrative Region of the People’s Republic of China. China and other 47 Signatories agreed to modify their 47 bilateral treaties among the existing 102 bilateral treaties China entered with 102 contracting countries (OECD 2017c).

In China, the bilateral treaties prevail over the domestic law. For instance, Article 91 of the LATC of 2015 states that, “If the provisions of the relevant tax treaties or agreements concluded between the People’s Republic of China and foreign countries are in conflict with the provisions of this Law, the relevant matters shall be handled in accordance with the treaties or agreements”. Article 58 of the CITL declares that, “Where any provision in a tax treaty concluded between Chinese government and a foreign government is different from the provisions in the CITL, the provision in the treaty shall prevail”. Despite the controversial debate of the legal effect of the tax treaties, the SAT tends to argue that the tax treaties are not only legally binding on the governments of the contracting

⁵² (OECD 2017a); see also (OECD 2017b) (listing the 68 jurisdictions, plus eight other countries that intend to sign soon). The Signatories include the major OECD and EU members (except for the US), China and India, as well as many important treaty shopping jurisdictions (e.g., the Netherlands and Mauritius) and tax havens (e.g., Singapore and Hong Kong).

parties, but are also directly applicable to the taxpayers (State Administration of Taxation n.d.). Therefore, we believe that China will implement the BEPS project in a serious manner.

Of course, the implementation of BEPS project might invite new uncertainty both for taxpayers and for administrators during the short transitional period between the articulation and the implementation of the action plans. It is also possible for some taxpayers to design new tax planning strategies of regulatory arbitrage in the transitional period, in order to avoid the application of both traditional norms and new norms. The Chinese government could address the new challenges by modernizing its tax governance with the help of big data and big analysis of its own domestic information platform and the international information sharing system.

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