ACTION ITEM 15: DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES

AN EXERCISE IN “POINT/COUNTERPOINT”

Implementation of many of the B.E.P.S. Action Items would require amending or otherwise modifying international tax treaties. According to the O.E.C.D., the sheer number of bilateral tax treaties makes updating the current treaty network highly burdensome. Therefore, B.E.P.S. Action Item 15 recommends the development of a multilateral instrument (“M.L.I.”) to enable countries to easily implement measures developed through the B.E.P.S. initiative and to amend existing treaties.\(^\text{54}\) Without a mechanism for swift implementation of the Action Items, changes to model tax conventions merely widen the gap between the content of the models and the content of actual tax treaties.

Discussion of Action Item 15 has centered on the following issues:

- Whether an M.L.I. is necessary,
- Whether an M.L.I. is feasible, and
- Whether an M.L.I. is legal.

In the spirit of these ongoing discussions concerning Action Item 15, we offer our commentary in a “point/counterpoint” format.

POINT:

**Action Item 15 is Impractical on its Face**

Of all the B.E.P.S. Action Items, Action Item 15 is subject to the highest degree of vagueness and ambiguity because agreement must be reached on other Action Items before drafting can begin on the M.L.I. To compensate for this ambiguity, the

O.E.C.D. addresses various methods by which an M.L.I. can come into effect. But in doing so, the O.E.C.D. highlights the main dilemma that is faced. The M.L.I. must be flexible so that countries are incentivized to sign. In addition, it must supersede all existing bilateral treaties not reflecting the terms of the M.L.I. in order to enhance effectiveness. These two principles naturally come into conflict: if the M.L.I. has mandatory terms and supersedes all existing bilateral treaties, it may not be attractive.

The main weakness of Action Item 15 is that this conundrum is not addressed. Due to the uncertainty inherent in the scope of the other Action Items, the O.E.C.D. often uses vague language to note economic principles. It is not clear that a country will wish to override all its bilateral treaties in order to achieve an uncertain result beyond the scope of its control.

The following is a list of criticisms of the various principles and ideas which the O.E.C.D. has mentioned in its recommendations:

23. **More Conferences v. Increased Efficiency**: The O.E.C.D. recommends holding a conference to negotiate the M.L.I. This conference would presumably occur after the other Action Items have been addressed. At the same time, the O.E.C.D. wishes for the M.L.I. to be implemented quickly. These two principles are somewhat in conflict. Inviting yet another negotiating conference will likely delay the implementation of B.E.P.S. measures through an M.L.I.

24. **Conflict between Efficiency and Sovereignty**: As indicated above, another conflict arises from the suggestion that a superseding clause should be placed in the M.L.I. to increase effectiveness. This proposal occurs prior to adoption of all the terms of the M.L.I. and is, in part, designed to encourage countries to assign power to override bilateral treaties in advance of the understanding what those overriding terms will look like. The O.E.C.D. suggests that the M.L.I. will be couched in so-called “soft language” to encourage cooperation. However, with the wide reach expected for B.E.P.S. legislation, countries will likely desire more clarity and less ambiguity.

25. **Problems without Solutions**: Often, the B.E.P.S. recommendations note problems but do not addressing solutions. For example, the report recommends that developing countries should be more involved in the implementation of the B.E.P.S. legislation. While a laudable point, the O.E.C.D. does not address how to involve developing countries, nor does it address whether developed countries would be encouraged to surrender economic sovereignty as a concession to developing country support. This conflict has not been resolved in other international arenas, such as climate change or the W.T.O. negotiations on agriculture. If the law of past performance holds true, loss of sovereignty may again be a stumbling block.

26. **Opt-In/Opt-Out and Competitiveness**: To calm fears that the signing of the M.L.I. will result in the breach of territorial and economic sovereignty, the O.E.C.D. recommends that the M.L.I. should be made “flexible” by including “opt-in” and “opt-out” clauses. Of course, countries will only opt in or opt out if to do so is in their best interest and will likely be wary of opting in and subjecting their economies to stringent standards, which would
render them unable to compete in the global marketplace unless other major economic players, like the U.S., also opt-in. Secondly, the O.E.C.D. may be of the view that once a country signs the M.L.I., opting out will not be politically easy.

27. **Transparency:** The annex allows for public access to the M.L.I. in a bid to increase both flexibility and transparency. Increasing transparency through public record access is a commendable objective, but there are few ways to interpret “public access” beyond offering to issue a treaty online with a comparison of the M.L.I. and other bilateral agreements. Most treaties are already issued online, rendering the objective moot. Action Item 15 does not address whether the actual conversations, concessions, and negotiations would be made available to the public at a later point in time, which may be of interest to domestic stakeholders and historians.

28. **Monitoring Implementation:** To enforce the provisions of the M.L.I., the O.E.C.D. desires to monitor whether countries are properly implementing B.E.P.S. legislation through the creation of a multilateral implementation board. This raises additional questions: who would sit on such a panel, and would an economically powerful country allow other member countries to decide the fate of its tax base? While the U.S. is a party to other international treaties where monitoring groups exist, the M.L.I. monitoring with other treaties. Moreover, the U.S. tax system has more at risk than others with regard to such a board. Any multilateral implementation board that encourages smaller countries to impose more tax on foreign members of a U.S.-based multinational group would reduce the U.S. tax base. While the U.S. eliminates double taxation through a foreign tax credit mechanism, most other countries eliminate double taxation through an exemption system. For them, increased tax in a foreign trading-partner country will not reduce revenue, especially if a bilateral transfer pricing agreement is not reached with that trading partner. Finally, the negotiations to determine which countries would sit on such a board may further delay the agreement coming into effect.

29. **Reservation:** Simply put, a reservation excludes a provision of the treaty from applying. A reservation is allowed so long as it is not prohibited by the M.L.I. The O.E.C.D. has indicated that the M.L.I. should allow for reservations only on “non-core” items. The O.E.C.D. has not identified core issues and non-core issues. The likelihood is that mostly core issues will be controversial. If this proves true, the ability to reserve will be limited to the inconsequential issues. The U.S. has already hinted that there are several issues where it may declare a “reservation” if it does not agree with the O.E.C.D. Some of these issues have been mentioned in a previous article, which can be seen by clicking here. Again, where an economically powerful country like the U.S. decides to opt out of several provisions, there is a likelihood that other countries will follow – rendering the clause in question effectively null in practice.

30. **Other Multilateral Agreements are Not Relevant to the M.L.I.:** A credible case has not been made that earlier multilateral agreements facing similar issues in relation to then-existing bilateral treaties are comparable to income tax treaties and the M.L.I. An income tax treaty embodies a careful set of compromises where specific countries negotiate to allocate the right to impose tax and to endeavor to prevent double taxation. The result is that
tax revenue flows into one country’s treasury but not to the treasury of the other country. In this scenario, the interests of the two states are adverse with regard to most matters other than those viewed to be purely administrative. Their interests and views are adverse in the same way that the interests of a buyer and a seller of property are adverse. Absent unusual circumstances, a seller typically believes the initial offering price for the property is too low and the buyer believes the final price is almost too high. Bilateral tax treaties reflect similar interests of the signatory states: (i) is each giving up too much tax revenue; (ii) is each state a capital importer or exporter; (iii) how will the treaty affect tax residents and the local economy? In comparison, the multilateral agreements currently in existence, and discussed below, have not been adopted in the context of adverse interests. Most countries have the same interest in extradition of purported criminals and the repatriation of minors abducted by one parent or the other. Whether the agreement is multilateral or bilateral, the issue is whether an acceptable procedure will be in existence to carry out the purpose of the treaty.

In conclusion, much of the uncertainty and vagueness of Action Item 15 results from timing. Negotiations on the other action plans have yet to begin. Once those negotiations are completed, prospects for a successful M.L.I. may be clearer. Nonetheless, the O.E.C.D. will encounter significant challenges in determining the proper balance between effectiveness and flexibility. Many commentators across the world have suggested that U.S. agreement to the M.L.I. is key to its effectiveness. Others believe that whether or not an M.L.I. is agreed upon, Action Item 15 has achieved its goal of motivating consensus to action.

COUNTERPOINT:

The M.L.I. is Both Feasible and Necessary Given the Current Geopolitical and Macroeconomic Environment & Precedent Exists Under International Law

Although objections exist to the feasibility of the M.L.I. due to its complexity and the derogation of sovereignty for the signatory nations, a multilateral approach is a practicable way to streamline implementation of the B.E.P.S. action plans. The Annex of Action Item 15 provides a toolbox of theoretical options that may be utilized to develop the M.L.I. into a vehicle for the implementation of B.E.P.S. measures. According to the Annex, these tools are based upon three principles:

- The M.L.I. can implement B.E.P.S. measures and modify the existing bilateral treaties;
- The M.L.I. can provide for flexibility in the parties’ level of commitment; and
- The M.L.I. can ensure transparency and clarity for all stakeholders.

These principles derive from the success of their ongoing existence in other multilateral treaty instruments in international public law. If these same principles and tools are used in the creation of the B.E.P.S. M.L.I., it should be feasible for the O.E.C.D. to create an instrument that respects sovereignty, is created legally, and achieves its goal.
The M.L.I. would not terminate any part of the pre-existing network of bilateral treaties, but instead, would try to achieve a concurrent and cohesive application of the provisions of the instrument and the bilateral treaties as they relate to B.E.P.S. There have been several situations in which states have implemented multilateral conventions to introduce common international rules and standards, thus harmonizing the network of bilateral treaties. These conventions rely on tools of international law to achieve their goals, namely, (i) compatibility clauses, (ii) flexibility of provisions, and (iii) transparency and clarity. However, it is not clear that there are many multilateral treaties that have as their principal purpose the override of a host of bilateral treaties.

**Compatibility Clauses**

The Annex cites the use of compatibility clauses (or “conflict clauses”) to explicitly define the relationship between the multilateral instrument and the existing bilateral treaties. These have been used in several other agreements in which the provisions of a multilateral instrument have superseded the provisions of an existing network of bilateral treaties.

A multilateral agreement can supersede provisions of a bilateral treaty covering the same specific subject matter, as can be seen in the *European Convention on Extradition* (1957)[55] and the *European Convention on the Repatriation of Minors* (1970).[56]

It may also grant an exception to the general principal that the provisions of the multilateral instrument supersede those of prior agreements. Certain treaties stipulate that “more favorable” provisions of a bilateral treaty existing at the time of conclusion will not be affected.[57] Others go a step further and indicate which provisions are added to the bilateral agreements or which provisions are modified and how.[58]

A compatibility clause can also modify the provisions of a pre-existing treaty insofar as they differ from or are incompatible with the provisions of the multilateral agreement. These can be seen in treaties such as the *European Convention on the Suppression of Terrorism* (1977).[59] In some cases, any difference in the provisions can invoke this type of compatibility clause. However, in other cases, it requires inconsistency or incompatibility between the provisions.

Furthermore, a compatibility clause may provide for the supremacy of the multilateral agreement over existing treaties on the condition that the rights and obligations of other treaties are not affected to the extent they are compatible with the multilateral agreement.

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55 *European Convention on Extradition* (1957), Article 28(1).
57 See *International Convention of the Protection of the Rights of All Migrant Workers and Members of their Families* (1990), Article 81(1).
59 *European Convention on the Suppression of Terrorism* (1977), Article 8(3).
the multilateral agreement. Such a variation can be seen in the *European Convention on Mutual Assistance in Criminal Matters* (1959).  

Some may argue that a single instrument would be unable to address complex situations where there are several variations of scope, wording, and paragraph numbering between bilateral treaties. However, there are precedents in which compatibility clauses address these issues and do so by identifying the provisions to be modified using a specific description, which then removes the necessity to refer to a certain provision or paragraph number in the bilateral treaties.

It is also possible for the compatibility clause to describe the exact effect of its provisions on those bilateral treaties through the inclusion of terms such as “in place of,” “in addition to,” or “in the absence of.” For example, a multilateral agreement may include a clause which allows parties to take on further commitments with another party on the condition that the subsequent agreements can only confirm, supplement, extend, or amplify the provisions of the multilateral agreement. Alternatively, it may take the opposite approach and state that any subsequent agreements may not contradict the provisions or purpose of the treaty. Both mechanisms are used in treaties that are currently in effect and allow for parties to prepare and commit to further objectives in their own time.

The M.L.I. could draw from other multilateral instruments and their compatibility clauses in the following ways:

1. **Negotiable Start Date**: Allowing for the participating states to negotiate the date when the M.L.I. would come into force would allow the states to maintain sovereignty. Such a provision has been implemented in the *Convention of Mutual Administrative Assistance in Tax Matters* (1988). It is also possible to provide for different dates with regard to different provisions of the treaty, if necessary. Doing so can reduce complications for those parties with differing tax years. It can also provide for an allowable time gap for a party joining at a later time.

2. **Accompanying Commentaries**: Also, to ensure consistency in interpretation and implementation of the multilateral agreement, many treaties are accompanied by commentaries that are agreed to by all parties and that provide background information and guidance as a supplement to the provisions. A discussion between the parties on implementation of the M.L.I. will allow for ease of monitoring with regard to practical implementation. Additionally, if desired by the parties, more specific questions can be addressed by providing for mechanisms such as

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62 See *European Convention on Extradition* (1957), Article 28(2).
63 See *Convention on International Civil Aviation* (1944), Article 83.
64 Article 28(2).
66 See id., Article 24(3).
consultation procedures in the M.L.I. These mechanisms exist in most bilateral treaties to resolve any difficulties that may arise.⁶⁷

3. Use of Amendments: Finally, to preserve the sovereignty of individual states when implementing the M.L.I., the states may agree to future amendments of the M.L.I. – but only those to which they have consented.⁶⁸

In sum, there are many examples of compatibility clauses in existing multilateral agreements that have prevailed without challenge. The multiple variations in these clauses allow them to be flexible and invoked where and when they are necessary. Such clauses allow for the pre-existing treaties to endure while addressing only those areas that are in conflict with the new provisions of the multilateral instrument. Also, the obligations previously agreed upon by the treaty partners are not affected. This has clearly been shown to be successful when used in multilateral agreements.

Flexibility of Provisions

Where certain tax policies cannot be harmonized among the parties, it is possible to provide flexibility in the level of commitment the parties are prepared to undertake. Flexibility of provisions supports the idea that parties maintain their sovereignty in choosing to be part of the M.L.I.

Flexibility in the level of commitment can apply to the substance of specific provisions or it can depend on the partner jurisdiction. Also, a multilateral agreement could allow for the parties to implement a specific regime among themselves, if certain conditions are met through the use of a disconnection clause. Such clauses have been used in treaties with the European Union.

1. Opt-out Mechanisms: Types of flexibility mechanisms that can be implemented are opt-out mechanisms, opt-in mechanisms, or a choice between provisions. The opt-in and opt-out mechanisms are commonly used devices in treaties that allow flexibility and are standard in treaties developed within several international organizations.

Opt-out mechanisms are frequently used and can be limited to a defined period of time.⁶⁹ The use of reservations allows for the possibility to opt out of certain provisions of a treaty and is done when a unilateral declaration is made by a state when signing, ratifying, accepting, approving, or acceding to a multilateral agreement, and it purports to exclude or to modify the legal effect of certain provisions of the agreement. To prevent parties from opting out of core provisions, the M.L.I. could allow for the formulation of

⁶⁹ See International Labour Convention No. 63, Concerning Statistics of Wages and Hours of Work (1938), Article 2(1).
reservations only on certain provisions, as was done in the *Convention on Mutual Administrative Assistance in Tax Matters* (1988).\(^{70}\)

2. **Alternate Provisions:** Another mechanism to allow for flexibility that has been used in the past involves choosing between alternative provisions. Parties could be given the choice between alternative provisions or a list of provisions from which they would select a defined minimum, as in the *European Social Charter* (1961) or the *Bali Agreement on Trade Facilitation* (2013). Opt-in mechanisms allow parties that are ready to do so to commit to pursue the objectives of the treaty. This can be achieved by opting into added commitments that go beyond an outlined set of minimum commitments required by the multilateral treaty. The parties can be offered the option to accept being bound by specific provisions by making a unilateral declaration. Alternatively, the parties may add optional protocols to the instrument at the same time the main treaty is adopted or at a later date.\(^{71}\)

3. **Flexible Wording:** The level of commitment can also be defined by the wording of the provisions and by the types of obligations contained in the provisions. The use of "will," "shall," and "must" can be used to achieve core objectives of the treaty, and more flexible wording can be used for more desirable objectives that are not necessarily required to achieve the main objective, such as "may" or "as appropriate." These more flexible terms can be found in many treaties, such as the *Convention of Mutual Administrative Assistance in Tax Matters* (1988)\(^{72}\) or in the *United Nations Convention on the Law of the Sea* (1982).\(^{73}\)

**Transparency and Clarity**

Considering the complexity of the current network of bilateral tax treaties, it is important that a high level of transparency and clarity exists regarding the commitments undertaken by the parties and for all those involved and affected. Mechanisms are available to ensure clear and publicly accessible information. The objectives of the multilateral treaty can be achieved based on the law of treaties and existing precedents in international law. Focus on the following points is necessary.

1. **Publications:** To ensure clarity and transparency, there should be a publication of consolidated versions of bilateral treaties on publicly accessible databases. Further, an M.L.I. depository is imperative for receiving and maintaining information, notifications, and communications relating to the treaties. A viable option would be to require written
notifications to the depository by the parties involved, setting out the effect on the bilateral treaty, as it was done for the Agreement on Extradition between the European Union and the United States of America (2003). As is common practice, opt-out measures are communicated to the depository, which then notifies all the parties to the treaty and can, upon request, notify other groups of all or certain communications. This same mechanism can be used for opt-in or choice-of-alternative measures.

2. **Translation:** Multilateral agreements are only negotiated and signed in a limited number of languages for practical purposes. Although it may not be possible to have official texts of the M.L.I. in all relevant languages, they may be translated at a later time. This has been done to universal human rights treaties, and the translations did not create major difficulties.

In conclusion, the many objections attacking the feasibility of the M.L.I. can be addressed by mechanisms that have been successfully used in other multilateral agreements currently in existence in public international law. Those agreements have been implemented and utilized predominantly without challenge over the many years they have been existence. Although instituting the B.E.P.S. initiative will be a complex and expansive undertaking, all concerns have already been addressed by past instruments and can be minimized by much the same mechanisms in previous cases.

**POINT & COUNTERPOINT:**

**Treaty Provisions at Issue**

The question raised by the Action Item 15’s M.L.I. concept is whether or not the existing bilateral treaty network is equipped to deal with many different factors that may arise in today’s global market. The treaty provisions at issue focus on a world where different countries have different standards, where each country is entitled to create its own standard, and where the disparity between standards can lead to the mismatching of tax results. The overriding question is whether the M.L.I. addresses real or imagined issues.

1. **Multi-country Disputes:** The goal of an article on Mutual Agreement Procedure (“M.A.P.”) in a bilateral income tax treaty is to resolve disputes between the two countries that are parties to the bilateral agreement. The M.A.P. provision in the O.E.C.D. Model Convention provides guidance for a taxpayer where taxation in accordance with the provisions of a treaty is at issue. The M.A.P. provision establishes rules for two countries to follow with the goal of resolving the dispute. Action Item 15’s position is that the M.A.P. needs to be improved to address issues where more than two countries are stakeholders and where international arbitration outside the protocols of the treaty itself may be appropriate. Perhaps this reflects a view that where major economies and global financial institutions are called upon to bail out the banking systems of other countries with failing

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74 Article 3(2).
economies, the major economies and the global institutions have an interest in the collection of tax in the countries receiving support.

2. **Dual Residency**: Action Item 15 suggests that it would be more efficient for countries in a bilateral context to address these issues on a case-by-case basis that reflects an anti-abuse structure in effect across the existing bilateral tax treaty network. In the residence article of the O.E.C.D. Model Convention, the proper residence of a dual-resident corporation is the state in which the corporation’s place of “effective management” is situated. An entity may have more than one place of management, but it can only have one place of effective management at any one time. Action Item 15’s position is that the M.L.I. can be used to create factors that control the manner in which this issue is resolved.

3. **Linking Rules**: Hybrid mismatching has created double non-taxation or low taxation in many instances. The O.E.C.D. is concerned about the commitment of many countries to make the required changes in domestic laws to eliminate the abuse. The M.L.I. would address potential gaps in domestic legislation and existing treaty provisions – an attractive goal for the O.E.C.D.

4. **Profit Shifting**: The standard by which the existence of a permanent establishment is determined can vary in application from country to country. This disparity can result in the shifting of profits to countries that impose tax at a lower rate or that permit tax to be deferred indefinitely. These so-called “triangular situations” may be outside the scope of a bilateral treaty if taxation in a given jurisdiction is not addressed in identical fashion by treaties or domestic law in all three countries. The M.L.I. will define permanent establishment in a consistent way that can provide flexibility for countries to tailor tax policy in a way that achieves compatible domestic policies. This could be accomplished while ensuring consistency and coherency for all multinational taxpayers.

5. **Treaty Shopping**: The M.L.I. could be used to prevent treaty shopping. Bilateral treaties give specific tax benefits, which are provided on reciprocal basis to appropriate taxpayers. Treaty shoppers seek to obtain treaty benefits by effectively using a treaty resident that channels income to a head office in a low tax jurisdiction having no comprehensive income tax treaty in effect. The M.L.I. might be appropriate as a backstop to the limitation on benefits provisions, such as those now in place in virtually all U.S. income tax treaties.

**CONCLUDING POINTS**

An M.L.I. could be beneficial if it quickly and efficiently address B.E.P.S. However, an M.L.I. is not possible without O.E.C.D. countries and associate countries committing to the cause, even if that means possibly giving up some sovereignty. In addition, the M.L.I. is, as of now, dependent on proposed rules that have been discussed and approved in general terms but lack the finer details which provide the proper context for the M.L.I.
The issue is one of balancing principle versus practicality. Many countries rely on multinational business structures to generate commercial activity, employment, and related tax revenues. The creation of the M.L.I. and its effect on a given multinational enterprise is yet to be demonstrated by consensus. If it is true that taxation is the core right of a given country and that a country can impose laws as its government sees fit, an M.L.I. that infringes upon this right will be resisted. This is especially true for the associate countries and other developing countries. This would not be a problem if a consensus is reached among all countries, including those with adverse interests. However, it is not clear that consensus has been reached.

On the other hand, if it is true that the provisions at issue with the bilateral treaty network cannot be amended in a timely manner and the risk of continued B.E.P.S. is too great, consideration of the M.L.I. is appropriate. The M.L.I. could address gaps that are created between bilateral agreements and domestic laws while co-existing with agreements already in place. It would be aligned with a country’s given right to exercise its taxation authority. Whatever the size or shape of the M.L.I., a country’s fundamental right to tax will not be changed. The right to tax includes the right to forbear from taxing.

We anticipate that a draft M.L.I. will be forthcoming in 2015. The points and counterpoints that will be addressed or deferred remain to be seen.