

**EXPLANATORY MEMORANDUM TO**  
**THE DOUBLE TAXATION RELIEF (BASE EROSION AND PROFIT SHIFTING)**  
**ORDER 2018**

**2018 No. [XXXX]**

**1. Introduction**

- 1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.
- 1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

**2. Purpose of the instrument**

- 2.1 This Order brings into effect the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“the Arrangements”).

**3. Matters of special interest to Parliament**

*Matters of special interest to the Select Committee on Statutory Instruments*

- 3.1 The powers conferred by section 2 of the Taxation (International and Other Provisions) Act 2010 give effect to arrangements made with a territory outside of the UK with a view to affording relief from double taxation. Such arrangements have previously taken the form of bilateral treaties, generally referred to as Double Taxation Agreements or DTAs. The Arrangements given effect by this Order are multilateral in nature and will modify the application of DTAs already given effect by section 2 of the Taxation (International and Other Provisions) Act 2010. This is the first time that these powers will have been used to give effect to a multilateral arrangement.
- 3.2 DTAs will only be modified by these Arrangements if both the Government and the other jurisdiction give notice that they wish them to be “Covered Tax Agreements”. Such notice can be given at the time of signature, ratification or at any time subsequently. The list of provisional notifications made by Government at time of signature of the Arrangements can be found at the following link: <http://www.oecd.org/tax/treaties/beps-mli-position-united-kingdom.pdf>. Where the Government has listed a DTA as one that it wishes to be a Covered Tax Agreement, and either the other jurisdiction has not made the same notification, or is not a signatory to the Arrangements, the Arrangements will not modify that DTA until such time as the other jurisdiction either makes an equivalent notification, or signs and ratifies the Arrangements and makes such a notification.
- 3.3 Covered Tax Agreements are modified only to the extent of the provisions contained in the articles of the Arrangements. Most of these articles permit a jurisdiction to reserve against making the modification that it contains, or to make a reservation to preserve certain existing provisions in DTAs. The provisional list of reservations made by the Government on signature of the Arrangements can also be found at the following link: <http://www.oecd.org/tax/treaties/beps-mli-position-united-kingdom.pdf>. Where either signatory to a Covered Tax Agreement reserves against a

provision contained in the Arrangements, then the modification it provides for will not apply to that Covered Tax Agreement.

- 3.4 Jurisdictions cannot make additional reservations once they have notified the OECD that they have ratified the Arrangements. The Arrangements do though permit a jurisdiction to withdraw a reservation at any time. The withdrawal of a reservation will only have prospective effect.
- 3.5 The flexibility afforded to jurisdictions through the system of notifications and reservations means that DTAs may be modified in their application at any time following the entry into force of the Arrangements. However, the maximum possible extent of the modifications that may be made to a Covered Tax Agreement is limited to the provisions set out in the articles of the Arrangements.

#### *Other matters of interest to the House of Commons*

- 3.6 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and Northern Ireland.

### **4. Legislative Context**

- 4.1 The Order is being made to give effect in UK legislation to the Arrangements. The Arrangements are scheduled to the Order, and are thus given domestic legislative effect. The Order does not implement EU legislation.

### **5. Extent and Territorial Application**

- 5.1 The extent of this instrument is the United Kingdom.
- 5.2 The territorial application of this instrument is the United Kingdom.

### **6. European Convention on Human Rights**

- 6.1 The Financial Secretary to the Treasury, Mel Stride, has made the following statement regarding Human Rights:

“In my view the provisions of the Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018 are compatible with the Convention rights.”

### **7. Policy background**

#### *What is being done and why*

- 7.1 The Base Erosion and Profit Shifting (BEPS) Action Plan, which was developed by the OECD Committee on Fiscal Affairs (CFA) and endorsed by the G20 Leaders in September 2013, identified 15 actions to address BEPS in a comprehensive manner. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. More than a dozen developing countries have participated directly in the work and more than 80 non-OECD, non-G20 jurisdictions have provided input. Four of the 15 actions identified recommended changes to DTAs. The Arrangements allow jurisdictions to implement these changes in a timely and efficient manner without the need for bilateral negotiations on changes to individual DTAs.
- 7.2 The Arrangements enable all parties to meet the treaty-related minimum standards that were agreed as part of the BEPS package under Actions 6 (Preventing the Granting of

Treaty Benefits in Inappropriate Circumstances) and 14 (Making Dispute Resolution Mechanisms More Effective). The Arrangements also enable parties to implement recommendations for changes to tax treaties contained in the reports on Actions 2 (Neutralising the Effect of Hybrid Mismatch Arrangements) and 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). Copies of the reports can be found on the OECD's website at the following link: <http://www.oecd.org/tax/beps-2015-final-reports.htm>.

- 7.3 DTAs aim to eliminate the double taxation of income or gains arising in one country and paid to residents of another country. They do this by dividing the taxing rights that each treaty partner has under its domestic law over the same income and gains. They provide additional protection for taxpayers by specific measures combating discrimination in tax treatment. More generally, DTAs benefit the taxpayer by ensuring certainty of treatment and, as far as possible, by reducing compliance burdens. The purpose of the recommendations implemented by the Arrangements is to ensure that DTAs can only be used for their intended purpose and not to facilitate tax avoidance or evasion.
- 7.4 Action 2 of the BEPS report aims to neutralise the effects of hybrid mismatch arrangements. Hybrid mismatches occur when use is made of a hybrid financial instrument or a hybrid entity to reduce the corporation tax that would otherwise be payable. A hybrid financial instrument is one that is treated as producing a payment that is tax deductible in the country in which it is paid, but which is not treated as a taxable receipt in the recipient's country (or which is not very highly taxed). A typical example is an instrument treated as debt in one country but as equity in the other.
- 7.5 The Government does not intend to reserve against any of the Action 2 provisions that are applicable to the UK's DTAs, other than a provision in paragraph 2 of Article 3 of the Arrangements. While the Government agrees with the policy underlying this provision, the provision in the Arrangements differs in terms from the provision in DTAs that it would apply to and might, therefore, lead to uncertainty.
- 7.6 Action 6 of the BEPS report aims to prevent the granting of treaty benefits in inappropriate circumstances. It identifies treaty abuse as one of the most important concerns to address through the BEPS project. A common example of this abuse is "treaty shopping" where a resident of a country that is not a party to a treaty attempts to access the benefits it provides by the use of artificial or contrived transactions. For example, a resident of a low tax jurisdiction that does not have a tax treaty with the UK may attempt to limit the tax that the UK levies at source on interest by setting up a subsidiary in a country with which the UK does have a tax treaty and routing the loan through that subsidiary.
- 7.7 The Government intends only to reserve against those provisions in the Arrangements which are not part of the minimum standard and that it considers unnecessary because of its adoption of the Principal Purpose Test ("the PPT") through paragraph 1 of Article 7 of the arrangements. The Government is of the view that the mechanical tests introduced by those provisions could deny treaty benefits in circumstances that are not abusive and would not target any genuine avoidance structures more effectively than the PPT.
- 7.8 Action 7 of the BEPS report aims to prevent the artificial avoidance of Permanent Establishment ("PE") status. Under international tax rules, the profits of a company resident in one country can only be taxed in another country if its activities are carried

out through a permanent establishment (PE) situated there. To have a PE, the company must either carry out its activities through a “fixed place of business”, such as a shop, office or factory, or through a person (a dependent agent) who acts under instruction and is authorised to conclude contracts on the company’s behalf. Certain limited activities, such as storage of goods for delivery and purchase of goods, are generally deemed not to constitute a PE. In order to avoid the status of PE, some businesses employ tax avoidance strategies to circumvent the existing PE definition.

- 7.9 The Government intends to adopt the “anti-fragmentation” rule under paragraph 4 of Article 13 of the Arrangements, which prevents the fragmentation of activities to avoid the creation of a PE. The Government does not intend to adopt the other provisions in Article 13 (changes to the rules on specific activity exemptions), and to reserve against those in Articles 12 and 14 of the Arrangements. None of these provisions is part of a minimum standard. As is recognised in the BEPS report on Action 7, the anti-contract splitting rule in Article 14 is not necessary where a jurisdiction has adopted the PPT. Parallel work is being undertaken by the OECD on the attribution of profits to PEs that would be found under the provisions of Article 12 and the changes to the specific activity exemptions in Article 13. The initial conclusion of this work is that little or no additional profit would be attributed to these “new” PEs compared to that which jurisdictions can already tax under existing international rules. The PE rules play an important role in providing certainty and cost savings for both businesses and governments by setting a threshold below which a company’s activities in another country are not taxable there. In the absence of any additional profits to attribute, the Government does not believe that the case has been made to remove some of the certainty provided by the current rules. The Government will, however, continue to monitor the work of the OECD on profit attribution and will review its position should the conclusions change.
- 7.10 Action 14 of the BEPS report aims to make dispute resolution mechanisms between jurisdictions more effective. It is important for businesses that disputes are resolved without unnecessary delay and double taxation thereby avoided. The Mutual Agreement Procedure (“MAP”) is a mechanism for jurisdictions to resolve disputes on the application of DTAs which might otherwise result in double taxation. Action 14 aims to strengthen the effectiveness of the MAP process by introducing a minimum standard to resolution procedures which ensures that the MAP procedure be fully implemented in good faith and that MAP cases be resolved in a timely and efficient manner. The Government will adopt all of the provisions contained in the arrangements.
- 7.11 The Government also intends to apply the optional provisions under Part VI of the Arrangements regarding mandatory binding arbitration for MAP disputes. These provisions provide a guarantee for taxpayers that disputes will be resolved and double taxation avoided. This provision is welcomed by business.

### *Consolidation*

- 7.12 HMRC will make available consolidated texts of its bilateral DTAs which explain how the MLI will affect each one in accordance with the positions taken by the Government and the other jurisdiction in the MLI.

## **8. Consultation outcome**

- 8.1 As part of the BEPS project, the OECD consulted widely on its proposed actions to tackle BEPS.
- 8.2 HMRC consulted with external stakeholders including business, trade representative bodies and non-governmental organisations on its proposed reservations under the Arrangements.
- 8.3 Business and trade representative bodies broadly welcomed the UK's approach to the Arrangements though some NGOs considered that the Government should apply all provisions and make no reservations. Reasons for the Government's intended reservations are explained above.

## **9. Guidance**

- 9.1 HMRC has a Double Taxation Relief Manual available online for taxpayers seeking guidance on claiming relief available under DTAs.
- 9.2 Once the modifications made by the Arrangements take effect, the manual will be updated to include relevant guidance on the effect of the Arrangements on the UK's DTAs.
- 9.3 The OECD has published an explanatory statement on the MLI and guidance on the provisions contained in the Arrangements can be found in the relevant BEPS reports.

## **10. Impact**

- 10.1 The impact on business, charities or voluntary bodies is negligible. The provisions of the Arrangements do not introduce new tax burdens; rather, they ensure that relief from UK tax under DTAs is only granted in circumstances where it was intended.
- 10.2 There is no impact on the public sector.
- 10.3 A Tax Information and Impact Note has not been produced for this instrument as it modifies the effect of DTAs. DTAs impose no obligations on taxpayers, rather they seek to eliminate double taxation and fiscal evasion.

## **11. Regulating small business**

- 11.1 The legislation applies to activities that are undertaken by small businesses.
- 11.2 No specific action is proposed to minimise regulatory burdens on small businesses.
- 11.3 The legislation applies only to activities of small businesses if they have used DTAs to artificially reduce their tax burden. No special approach to small business is therefore necessary.

## **12. Monitoring & review**

- 12.1 HMRC will consider on an ongoing basis whether developments in other tax jurisdictions and developments in UK domestic legislation will require the withdrawal of reservations or the inclusion of further Covered Tax Agreements.

## **13. Contact**

- 13.1 Tom Matthews at the HM Revenue and Customs Telephone: 03000 585 476 or email: tom.o.matthews@hmrc.gsi.gov.uk can answer any queries regarding the instrument.