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International Tax Update – Multilateral Instrument

On 7 June at the OECD in Paris, then Minister for Finance, Michael Noonan T.D. signed the Multilateral Instrument ("MLI") on Ireland's behalf, along with 67 other jurisdictions. The MLI provides a mechanism for countries to transpose Base Erosion and Profit Shifting ("BEPS") recommendations into their existing bilateral tax treaties. What follows below is a brief summary of some of the main aspects of the MLI of relevance to corporate treasurers in Ireland and in particular Irish entities involved in intergroup lending.

Some of the BEPS recommendations are considered to be "minimum standards" which countries have committed to, while others are recommended best practices that countries can choose to adopt. One such minimum standard is Article 7 of the MLI, being the Prevention of Treaty Abuse. This addresses concerns that double tax treaties could be used to make available treaty benefits in unintended circumstances. Optionality is given to support the different approaches permitted under the minimum standard namely the adoption of a principal purpose test ("PPT") or a PPT supplemented with simplified limitation on benefits rules ("LOB").

All 68 jurisdictions (i.e. including Ireland) have opted to include the PPT within their double tax agreements. Twelve however have also chosen to apply the simplified LOB rules – these are Argentina, Armenia, Bulgaria, Chile, Colombia, India, Indonesia, Mexico, Russia, Senegal, Slovak Republic and Uruguay. The position where different countries have chosen different rules is complex but broadly speaking the simplified LOB should not apply to an Irish treaty unless Ireland in future agrees to it.

In terms of what the PPT actually is, the wording to be introduced by the MLI to Covered Tax Agreements (broadly all tax treaties with Ireland other than the USA) is as follows:

> "Notwithstanding any provisions of a Covered Tax Agreement, a 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 the Covered Tax Agreement."

The PPT is therefore a type of general anti-avoidance rule within a treaty itself. As with any general anti-avoidance, the PPT creates additional uncertainty and requires increased analysis of a transaction pre-implementation to ensure it does not fall foul of such anti-avoidance. In particular, pure conduit financing arrangements without commercial substance (e.g. where a financing company has been introduced in order to borrow and on-lend funds in order to rely on the favourable double tax treaty between the lending and borrower country to mitigate withholding taxes on interest) would likely not qualify for treaty benefits once the MLI is ratified into treaties.

The specific BEPS report (Article 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) would no doubt in future be relevant to interpret how the PPT applies. The BEPS report states that it must be reasonable to conclude that one of the principal purposes of an arrangement or transaction was to obtain the benefits of the tax treaty. As can be seen, the treaty benefit does not have to be the sole or dominant purpose to fall foul of the PPT; if one of the principal purposes is obtaining the treaty tax benefit it would be sufficient for the benefit to be disallowed. Furthermore, it states that a purpose will not be a principal purpose when it is reasonable to conclude that obtaining the tax treaty benefit was not a principal consideration and would not have justified entering into any transaction or arrangement that has resulted in that benefit.

In this regard, an example is used in the BEPS report to illustrate the analysis required to determine whether a transaction, with specific reference to treasury operations, would be impacted by the PPT:

The example postulates the scenario where a group is considering establishing a regional company to provide group services to other subsidiaries, and specifically refers to financing and treasury services. After reviewing a number of possible locations, it decides to establish this regional company in State "R". In other words, the example is close to the situation where a group decides to establish a group treasury function in Ireland (say, Irish FinCo). The example further states that the decision is mainly driven by the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation treaty network of "R" (Ireland in our example), including its tax treaties with certain jurisdictions where related parties of FinCo are based.

In this example, the BEPS report suggests that merely reviewing the effects of the double tax treaties of a country on future payments by the related parties to Irish FinCo would not enable a conclusion to be drawn about the purposes for the establishment of this company in Ireland. It states that assuming the group treasury function in, say, Ireland, including the making of decisions necessary for the conduct of its business, constitute a real business through which it exercises substantive economic functions, using real assets and assuming real risks, and provided that business is carried on in Ireland through its own personnel located here, it would not be reasonable to deny the benefits of the treaties concluded between Ireland and the other States. This should be the case unless there are other facts which would indicate that the Irish company has been established for other tax purposes or unless the Irish company enters into specific transactions to which the PPT would otherwise apply.

There are a number of non-tax reasons for setting up a treasury function in Ireland. To name but a few, these include a common law legal system, the only English speaking Eurozone country (and soon only English speaking EU country), time-zone proximity to key markets and air connections to Europe and the US, the youngest population in the EU and a leading country in the world for availability of financial skills (including a deep pool of experienced corporate treasurers), and a well-developed and internationally understood corporate insolvency procedures. As such, under the PPT, provided the making of decisions necessary for the conduct of the treasury operations occurs in Ireland and substantive economic functions are carried on in Ireland through personnel located here, it should be clear that Irish treaty benefits should continue to apply to interest and other income received from abroad.

The introduction of the PPT (and other items from the MLI) will become binding on Ireland on foot of the ratification of the MLI in Irish law. Ireland's tax treaties will be amended where both Ireland and the relevant treaty partner have fully ratified the convention in their domestic law. The ratification process will determine when the changes will have affect for each treaty. This will depend on a number of factors but likely will be from 2019 onward.

As mentioned above, twelve countries have opted to include the supplementary simplified LOB rules in their treaties. The LOB rules are detailed and complex but one particular point to take note of is that the simplified LOB contained in the MLI contains the same change that is included in the proposed changes to the Ireland / USA Double Tax Agreement that seeks to specifically address concerns about group financing and cash pooling. Specifically, it excludes "providing group financing (including cash pooling)" from constituting an "active conduct of a trade or business" with the result that obtaining double tax treaty relief for interest payments on intergroup loans would be even more difficult where the borrower is tax resident in a country where the LOB rule applies. It would be prudent for Irish financing companies that have advanced intergroup loans to group companies tax resident in the twelve countries mentioned above to take note of the LOB rules contained in the MLI. This is to determine if any withholding taxes or other adverse tax impact will arise should the LOB become operational in treaties between Ireland and such countries. As mentioned above, however, the LOB rules should only apply if Ireland in future specifically agree to it because at present Ireland has not opted for the simplified LOB to apply to any of its treaties.

In conclusion, corporate treasurers in Ireland should take note of the PPT in particular and review their intergroup loan portfolio to determine those instances where double tax treaty relief is currently being relied on to mitigate foreign withholding taxes on interest payments. If reliance is currently being placed on Irish double tax treaties to reduce such withholding taxes, it should be considered whether suitable substance is present in Ireland to support a position that the new PPT rule should not adversely impact the Irish financing company's ability to avail of treaty benefits. It is worth pointing out again that the PPT is aimed primarily at tax driven conduit financing arrangements. While the PPT will give rise to a level of uncertainty and greater transactional analysis in future before intercompany loans are advanced, there are a number of strong commercial non-tax reasons to support the establishment of corporate treasury operations in Ireland which should greatly mitigate the risk of denial of treaty benefits.

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