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UK ratifies the OECD’s Multilateral Instrument – Practical Impact and Timing of Implementation

On 23 May 2018, the United Kingdom ratified the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, otherwise known as the ‘Multilateral Instrument’ ("MLI"). The ratification was effected by the Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018 (S.I. 2018/630). On the same date, HM Treasury published a detailed explanatory memorandum, describing the impact of the MLI for the UK’s treaties and the options which the UK has chosen.

Background
The MLI is part of the coordinated response to the OECD’s recommendations arising from its Base Erosion and Profit Shifting (“BEPS”) project. The BEPS project seeks to identify and eliminate certain cross-border tax arrangements which it considers artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity. The MLI enables participating jurisdictions to implement recommended changes to double taxation agreements ("DTAs") in an efficient way, without bilateral negotiations between jurisdictions on individual DTAs. The issues addressed by the MLI include treaty abuse, hybrid mismatch arrangements, and permanent establishment avoidance.

The modifications applicable to the UK’s DTAs will be those notified as applying to applicable DTAs both by the UK and the relevant counterparty jurisdiction (so-called “Covered Tax Agreements”). The UK’s provisional list of notifications was made at the time of signing the MLI, and in April 2018 the government published draft amendments. The final list of notifications is expected to be submitted to the OECD on deposit of the MLI ratification instrument.

Practical impact
The UK’s ratification of the MLI takes the UK one step closer to the introduction of a general principal purpose test ("PPT") in relevant DTAs. The general PPT can operate to deny treaty benefits (such as a reduced withholding tax rate on interest under the relevant DTA) if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the relevant 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 DTA. The PPT is generally expected to be applicable to the UK’s DTAs in relation to withholding tax from 1 January 2019, depending on the timing of deposit with the OECD of the ratification instrument by the relevant counterparty jurisdiction. The PPT will be relevant to structures already in existence when the PPT becomes effective, as there is no ‘grandfathering’ provision.
This means that, for example, in an existing investment structure in which 'UK source' interest is payable to a Luxembourg creditor company, under the current version of the UK/Luxembourg DTA the Luxembourg creditor may expect that the interest could be paid gross (with the rate of UK withholding tax effectively reduced from 20% to nil), provided that it is tax resident in Luxembourg and beneficially owns the interest. Once the PPT is effective for the purposes of the UK/Luxembourg DTA (potentially from 1 January 2019), the PPT will be an additional requirement to be satisfied and its application may lead to a denial of treaty relief in respect of these ongoing interest payments. In practice, this may focus more attention on the rationale for such entity’s role in the structure and the substance of the entity claiming treaty benefits.

Other measures announced by the government include the adoption of an ‘anti-fragmentation’ rule, so as to prevent the fragmentation of activities in order to avoid the creation of a permanent establishment under a Covered Tax Agreement, and the adoption of provisions to improve the mechanism for jurisdictions to resolve disputes regarding the application of DTAs.

**Timing**

The MLI will enter into force in the UK on the first day of the month following a three calendar month period from the date the ratification instrument is deposited with the OECD. The date of entry into force of the MLI in the UK will determine the date from which changes to the UK’s DTAs as a result of the MLI will be applicable. Assuming the UK deposits the ratification instrument with the OECD prior to 30 September 2018, the MLI will enter into force in the UK in 2018.

This means that the provisions of the MLI in respect of withholding tax will apply to the UK’s Covered Tax Agreements with effect from 1 January 2019, where the counterparty jurisdiction has also ratified the MLI and deposited the instrument with the OECD prior to 30 September 2018.

In respect of other taxes, the MLI will apply to the UK’s Covered Tax Agreements from the date falling at least 6 calendar months after the later of the date that the MLI enters into force in the UK or in the counterpart jurisdiction (unless a shorter period is notified).

The timing of the application of the MLI to each of the UK’s Covered Tax Agreements, therefore, will depend on the date on which the relevant other jurisdiction ratifies the MLI and deposits the ratification instrument with the OECD. Other countries that have, to date, ratified the MLI include Malta, Serbia, Slovenia, Poland, Jersey, the Isle of Man, and Austria. No EU jurisdiction other than Malta, Slovenia, Poland or Austria has so far publicly announced its ratification of the MLI.

**Updated DTAs**

The government has also stated that it intends to publish consolidated texts of the UK’s bilateral DTAs reflecting how the MLI will affect each one in accordance with the positions taken by the UK and other participating jurisdictions. This will be an important practical step, as currently the anticipated changes are contained only in the draft list of proposed notifications.
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