Applying the Multilateral Instrument's Specific Activity Exemption

by Alfred Chan

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In this article, the author provides a guide to article 13 of the OECD's multilateral instrument, which attempts to combat efforts to artificially avoid creating a permanent establishment using the specific activity exemption. He examines the various options and reservations included in the article and considers how the choices that jurisdictions make interact with the choices made by their treaty partners.

The 2015 final report on action 7 of the OECD's base erosion and profit-shifting initiative, titled "Preventing the Artificial Avoidance of Permanent Establishment Status," reviews the definition of a PE as part of the OECD's effort to combat the use of some common tax avoidance strategies that companies use to circumvent the existing PE definition. The targeted avoidance strategies result in an entity shifting profits out of the country where the sales took place without making any substantive changes to the functions performed in that country. These strategies include:

- the use of commissionnaire arrangements to replace subsidiaries that traditionally acted as distributors;
- the splitting-up of contracts; and
- the exploitation of the specific exceptions to the PE definition in article 5(4) of the 2014 OECD model tax convention.

The third strategy is particularly relevant in the growing digital economy.

The action 7 final report changes the definition of PE in article 5 of the OECD model tax convention, which countries often use as the basis for tax treaty negotiations. The OECD also incorporated the changes in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which operates alongside existing tax treaties and modifies the text of some tax treaty provisions. In particular, article 13 of the MLI — "Artificial Avoidance of Permanent Establishment Status Through the Specific Activity Exemptions" — addresses some of the concerns identified in the action 7 final report.

I. Article 5(4) of the OECD Model

As part of the BEPS project, the OECD redrafted article 5(4) of the model tax convention, which establishes the specific activity exceptions, removing the phrase "of a preparatory or auxiliary character" from subparagraph (e). The goal was to ensure that all of the subparagraphs of article 5(4) would be subject to a "preparatory or auxiliary character" condition.

In contrast to the OECD's recommendations, policymakers in some countries have suggested that several of the activities referred to in subparagraphs (a) through (d) are intrinsically preparatory or auxiliary. To provide greater certainty for both tax administrations and taxpayers, these officials contend that those activities should not be subject to the condition that they be of a preparatory or auxiliary character. They argue that any concerns about the inappropriate use of these exceptions can be addressed using the anti-fragmentation rule, which the OECD added as article 5, paragraph 4.1, of the 2017 model tax convention.

Table 1. Text Structure of the Specific Activity Exception Article

2014 Model Tax Convention	2017 Model Tax Convention
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:	4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;	a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;	b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;	c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;	d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not listed in subparagraphs (a) to (d), provided that this activity **has a preparatory or auxiliary character**, or	e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is **of a preparatory or auxiliary character**.	f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e),
	provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is **of a preparatory or auxiliary character**.
	4.1 Paragraph 4 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 State and a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, 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.

Table 2. The Specific Activity Exception and Anti-Fragmentation Rule Under the MLI and Model Tax Conventions

MLI	2017 Model Tax Convention (see Table 1)	MLI	2014 Model Tax Convention (see Table 1)
Article 13	Article 5	Article 13	Article 5
(2)(a)	4(a) to (d)	(3)(a)	4(a) to (d)
(2)(b)	4(e)	(3)(b)	4(e)
(2)(c)	4(f)	(3)(c)	4(f)
(4)	4.1	N/A	N/A

A. Policy Choice

All members of the inclusive framework on BEPS must implement four minimum standards contained in action 5 (combating harmful tax practices), action 6 (preventing the granting of treaty benefits in inappropriate circumstances), action 13 (guidance on country-by-country reporting), and action 14 (making dispute resolution mechanisms more effective).

Preventing the artificial avoidance of PE status, including the specific activity exception, does not fall under the scope of the minimum standards. Accordingly, contracting jurisdictions that share different views on the preparatory or auxiliary condition are free to choose between the 2014 and 2017 versions of article 5, paragraph 4, in the model tax treaty convention.

A comparison of the two versions of article 5(4) is set out in Table 1.

B. The Anti-Fragmentation Rule

As the action 7 final report explains, paragraph 4.1 of article 5 in the 2017 model tax treaty is aimed at restricting the scope of article 5(4) to activities that have a preparatory and auxiliary character. In the absence of the anti-fragmentation rule, the OECD is concerned that it would be relatively easy to use closely connected enterprises to segregate activities that, when taken together, go beyond the specified threshold.

Paragraph 4.1 of article 5 applies to two types of cases. First, it applies when the nonresident has a PE in the source country, whether the nonresident directly sets up the PE or uses closely related entities to do so. Thus, the tax authority in the source country must determine whether the activities of the nonresident enterprise give rise to one or more PEs in the source country under article 5(4.1). Second, paragraph 4.1 also applies when the nonresident enterprise does not have a preexisting PE in the source country, but the combined activities of the nonresident and closely related enterprises result in a cohesive business operation that performs activities that are not merely preparatory or auxiliary in nature. In that case, the authorities should determine whether the activities of the enterprises give rise to one or more PEs in the source country under article 5(4.1).

II. Article 13 of the MLI

Article 13 of the MLI replicates the content of both the version of article 5 in the 2014 model tax treaty and the 2017 version.

Article 13(1) provides that "a Party may choose to apply paragraph 2 (Option A) or paragraph 3 (Option B) or to apply neither Option."

Article 13(2) corresponds to article 5(4) of the 2017 model tax convention, while article 13(3) corresponds to article 5(4) of the 2014 model tax convention, as set out in Table 2.

III. Legal Structure of Article 13

The legal structure of article 13 of the MLI shows the logic of how different provisions are related to one another. See Table 3.

Paragraph 5 is the compatibility clause for article 13. Paragraph 5(a) states that paragraph 2 (option A) or 3 (option B) will modify — that is, apply in place of — the equivalent language as it exists in a covered tax agreement (CTA), subject to any reservations made under article 13(6)(b).

Table 3. Structure of Article 13 of the MLI

	Article 13(1)			Opt-In Provision — Anti-Fragmentation Rule
	Option A	**Option B**	**Neither Option A nor Option B**	
Operative clause	Article 13(2)	Article 13(3)		Article 13(4)
Compatibility clause	Article 13(5): "(a) Paragraph 2 [Option A] or 3 [Option B] shall apply in place of the relevant parts of provisions of a Covered Tax Agreement that list specific activities that are deemed not to constitute a permanent establishment even if the activity is carried on through a fixed place of business (or provisions of a Covered Tax Agreement that operate in a comparable manner)."			Article 13(5): "(b) Paragraph 4 shall apply to provisions of a CTA (as they may be modified by paragraph 2 or 3) that list specific activities that are deemed not to constitute a PE even if the activity is carried on through a fixed place of business (or provisions of a Covered Tax Agreement that operate in a comparable manner)."
Reservation	Article 13(6)(b) allows the party to reserve the right for article 13(2) not to apply to its CTAs.			Article 13(6)(c) allows the party to reserve the right for article 13(4) not to apply to the CTAs.
Notification clause	Article 13(7): "Each Party that chooses to apply an Option under paragraph 1 shall notify the Depositary of its choice of Option. Such notification shall also include the list of its Covered Tax Agreements which contain a provision described in subparagraph a) of paragraph 5, as well as the article and paragraph number of each such provision. An Option shall apply with respect to a provision of a Covered Tax Agreement only where all Contracting Jurisdictions have chosen to apply the same Option and have made such a notification with respect to that provision."			Article 13(8): "Each Party that has not made a reservation described in subparagraph a) or c) of paragraph 6 and does not choose to apply an Option under paragraph 1 shall notify the Depositary of whether each of its Covered Tax Agreements contains a provision described in subparagraph b) of paragraph 5, as well as the article and paragraph number of each such provision. Paragraph 4 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 under this paragraph or paragraph 7."

Paragraph 5(b) modifies CTAs to apply paragraph 4 of article 13, subject to any reservations made under article 13(6)(c).

Paragraph 6 allows signatories to make reservations regarding article 13. Article 13(6)(a) provides that a party may reserve the right not to apply article 13, in its entirety, to its CTAs. Article 13(6)(b) provides that a party may reserve the right not to apply paragraph 2 (option A) to its CTAs that "explicitly state that a list of specific activities shall be deemed not to constitute a [PE] only if each of the activities is of a preparatory or auxiliary character." Article 13(6)(c) provides that a party may reserve the right not to apply paragraph 4 to its CTAs.

The MLI also specifies when the party must notify the depositary of a particular choice. Notification is required when a party reserves its right for an article or a provision within an article not to apply to its CTAs. Notification is also

Table 4. MLI Article 13 Positions for Select Jurisdictions

Jurisdiction	Entry Into Force	Article 13			
		Paragraph 6 (Reservations)			Paragraph 7 (Notification)
		a	b	c	
Australia	Jan. 1, 2019		Y		A
India	Oct. 1, 2019				A
Japan	Jan. 1, 2019				A
New Zealand	Oct. 1, 2018				A
France	Jan. 1, 2019				B
Ireland	May 1, 2019				B
Luxembourg	Aug. 1, 2019			Y	B
Singapore	Apr. 1, 2019			Y	B
Canada	Dec. 1, 2019	Y			
Finland	June 1, 2019	Y			
United Kingdom	Oct. 1, 2018				

required when a party wishes to give legal effect to the article or the provision of an article that it has chosen.

IV. Article 13: Country Survey

As of September 26, 35 jurisdictions have confirmed their MLI positions by depositing an instrument of ratification with the OECD depositary. Among them, 14 contracting jurisdictions have chosen to adopt option A under article 13(2); six adopted option B under article 13(3); and 15 chose neither option.

Table 4 shows the MLI positions of 11 selected contracting jurisdictions based on information from the MLI database's Matrix of Options and Reservations, which the depositary maintains in accordance with article 39 of the MLI.

In accordance with article 13(6)(a), Canada and Finland have opted out of the entire article 13. Under article 13(7), Australia, India, Japan, and New Zealand have notified the depositary that they adopt option A under article 13(2). France, Ireland, Luxembourg, and Singapore have chosen to adopt option B under article 13(3). The United Kingdom has chosen neither option.

both of which are at odds with the option A — are

A. Jurisdictions Adopting Option A

1. Notification

Australia deposited its instrument of ratification with the OECD on Sept. 26, 2018. India and Japan made the same choice as Australia in electing for option A under article 13(2) and giving matching notifications under article 13(7). Therefore, article 13(2) (option A) shall apply in place of the previously existing provisions in the Australia-India and Australia-Japan CTAs.

Similarly, option A under article 13(2) shall apply in place of the relevant parts of the provisions of the India-Japan, India-New Zealand, and Japan-New Zealand CTAs that list specific activities that are deemed not to constitute a PE even if the activity is carried on through a fixed place of business. Table 5 contains an option A matrix for these countries.

2. Reservation

In accordance with article 13(6), Australia has reserved its right for option A of article 13(2) not to apply to its CTA with New Zealand.

Subparagraphs (e) and (f) of paragraph 7 of article 5 of the Australia-New Zealand CTA — reproduced below:

Table 5. Option A Matrix

	Australia	India	Japan	New Zealand
Australia		Y	Y	N
India	Y		Y	Y
Japan	Y	Y		Y
New Zealand	N	Y	Y	

7. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

. . . .

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e) of this paragraph,

provided that such activities are, in relation to the enterprise, of a preparatory or auxiliary character.

Australia also reserved the right for article 13(2) not to apply to the Australia-Finland and Australia-South Africa CTAs.

B. Jurisdictions Adopting Option B

Focusing on Singapore, option B shall apply in place of the relevant portions of the France-Singapore, Ireland-Singapore, and Luxembourg-Singapore CTAs. In each case, both parties to the CTA made matching notifications under article 13(7).

Article 13 does not provide contracting jurisdictions with the ability to reserve the right for option B not to apply to its CTAs under article 28(1), which explicitly lists the provisions for which a party can make a reservation.

C. Jurisdictions That Adopt Neither Option

As Table 4 shows, Australia adopts article 13(2) (option A), while the United Kingdom does not adopt either option A or option B. Therefore, article 13(2) shall not apply to the Australia-United Kingdom CTA because of an asymmetrical choice of options. Likewise, article 13(2) shall not apply to the India-U.K. CTA, the Japan-U.K. CTA, and the New Zealand-U.K. CTA.

There is a similar result in the Ireland-United Kingdom CTA. Ireland adopts article 13(3) (option B), and the United Kingdom adopts neither option A nor B. Therefore, article 13(3) shall not apply on ground of an asymmetrical choice of options. Likewise, article 13(3) shall not apply to the France-U.K. CTA, the Luxembourg-U.K. CTA, and the Singapore-U.K. CTA.

Both Canada and Finland also chose neither option A nor B. However, applying article 13(6)(a), both Canada and Finland reserved the right for the entirety of article 13 not to apply to their CTAs. Therefore, the provisions of the PE articles in the Canada-U.K. and the Finland-U.K. CTAs will not be subject to any modification by the compatibility provision of the MLI.

V. Opt-In Provision

A. Article 13(4): The U.K. Perspective

Article 13(4) is an opt-in provision. It operates independently from article 13(1), subject to any reservation made and with the requirement of notification.

1. Notifications

Focusing on the U.K. perspective, both Australia and the United Kingdom have chosen to apply the anti-fragmentation rule under article 13(4) to their CTAs using article 13(5)(b), and notified the OECD depositary as article 13(8) directs. Therefore, article 13(4) shall apply to the Australia-United Kingdom CTA.

As Table 4 shows, the United Kingdom has concluded CTAs with numerous jurisdictions including India, Japan, New Zealand, France, and Ireland, all of which have given notification regarding the adoption of the anti-fragmentation rules. Therefore, article 13(4) shall apply in the absence of any applicable reservations.[1]

2. Reservations

For the Canada-U.K. and Finland-U.K. CTAs, article 13 shall not apply because Canada and Finland have reserved the right for the entire article 13 not to apply to the CTAs, in accordance with article 13(6)(a).

Both Luxembourg and Singapore reserve the right for article 13(4) not to apply to their CTAs, a position that article 13(6)(c) allows. Therefore, article 13(4) shall not apply to the Luxembourg-U.K. and the Singapore-U.K. CTAs.

3. Principle of Reciprocity

One party to the Luxembourg-U.K. CTA has made reservation under article 13(6)(c), and the other party has not. As a result, article 13(4) shall not apply to the Luxembourg-U.K. CTA. The same holds for the Singapore-U.K. CTA.

To illustrate the legal point, it is useful to look at paragraph 3 of article 28 (reservations) of the MLI, which replicates article 21(1)(a) and (b) of the 1969 Vienna Convention on the Law of Treaties. Article 28(3) reads:

> Unless explicitly provided otherwise in the relevant provisions of this Convention, a reservation made in accordance with paragraph 1 or 2 shall:
>
> a) modify for the reserving Party in its relations with another Party the provisions of this Convention to which the reservation relates and to the extent of such reservation; and
>
> b) modify those provisions to the same extent for the other Party in its relations with the reserving Party.

Article 28(3) contains two principles. First, unless explicitly provided otherwise, a reservation made on a unilateral basis will not only have an effect on the CTA between the reserving party and the other contracting party, but also have an effect on all other CTAs that a contracting party has nominated in accordance with paragraph (1)(a) of article 2 (interpretation of terms) or paragraph 5 of article 29 (notifications) of the MLI. The main exception to this rule is that a reservation to apply the arbitration articles under Part VI of the convention require acceptance under article 28, paragraph 2 of the MLI. Second, unless explicitly provided otherwise, a reservation for an article (or a portion of an article) is reciprocal. That is, a reservation does not work only one way: In general, a reservation shall apply symmetrically to both parties.

4. Withdrawal or Replacement of Reservation

However, article 13(4) would apply to the Luxembourg-U.K. CTA (or Singapore-U.K. CTA) if Luxembourg (or Singapore) later chose to withdraw its 13(6)(c) reservation as permitted under article 28(9) of the MLI, which reads:

> Any Party which has made a reservation in accordance with paragraph 1 or 2 may at any time withdraw it or replace it with a more limited reservation by means of a notification addressed to the Depositary.

Note that the United Kingdom is not permitted to make additional reservation to bring it in line with Luxembourg (or Singapore), except for the situation described under MLI article 29(5) (notifications):

> A Party may extend at any time the list of agreements notified under clause ii) of subparagraph a) of paragraph 1 of article 2 (Interpretation of Terms) by means of a notification addressed to the Depositary. The Party shall specify in this notification whether the agreement falls within the scope of any of the reservations made by the Party which are listed in paragraph 8 of article 28 (Reservations). The Party may also make a new reservation described in paragraph 8 of article 28 (Reservations) if the additional agreement would be the first to fall within the scope of such a reservation.

[1] *See* HMRC, "Tax Treaties" (July 28, 2014) (providing links to the synthesized texts of the MLI provisions and the relevant tax treaties between the United Kingdom and treaty partners).

Table 6. Matrix of Article 13(4) Extracted From Table 4

	France	Ireland	Luxembourg	Singapore	United Kingdom
France	-		N	N	
Ireland		-	N	N	
Luxembourg	N	N	-	N	N
Singapore	N	N	N	-	N
United Kingdom			N	N	-
Note: N = representing reservation made under article 13(6)(c).					

Likewise, Luxembourg (or Singapore) cannot replace the 13(6)(c) reservation with the full reservation under article 13(6)(a). Article 28 of the MLI only works in one direction for making changes to the scope of the reservation. The reason is that when a party withdraws or replaces it with one that is more limited in scope, it will be moving closer to the full adoption of the MLI — not moving away from it.

B. Article 13(4): A Non-U.K. Perspective

Focusing on France, article 13(4) shall apply to the France-Ireland CTA because both parties have made the same choice and given the notification under article 13(8). Article 13(4) also applies to the France-U.K. CTA for the same reason.

Article 13(4) shall not apply to either the France-Singapore or the Ireland-Singapore CTAs because asymmetrical choices exist between the parties to the respective CTAs.

VI. Decision Tree and Nodes on Article 13

A. Main Provision: Specific Activity Exception

The logic of article 13(1) can be explained using a decision tree model as follows.

The first node asks whether a party (contracting jurisdiction) to the MLI reserves the right for the entire article 13 not to apply to its CTAs under article 13(6)(a):

(1) If the party reserves its right under article 13(6)(a), node 1 ends.

(2) If the party does not reserve its right, node 2 starts, and the party may choose to apply option A, option B, or to apply neither option under article 13(1):

(a) If option A (article 13(2)) is chosen, does the party reserve the right under article 13(6)(b) for the MLI provision not to apply to the relevant CTAs? If any reservation applies, then go to node 3.1.

A. If a reservation under article 13(6)(b) is made, option A does not apply, and node 3.1 ends here.

B. If that reservation is not made, option A applies. Next, have all the parties given notice of the same provision under article 13(7)? If notification is required, then go to node 4.

(I.) If notification is given, option A applies and node 4 ends.

(II.) If not, option A does not apply and node 4 ends.

(b) If option B (article 13(3)) is chosen, does any reservation apply under article 28? If no reservation clause applies, check whether the parties are required to give notification under article 13(7). If yes, go to node 3.2.

A. If notification is given, option B applies, and node 3.2 ends.

B. If it is not given, option B does not apply, and node 3.2 ends.

(c) A party adopts neither option A nor B.

B. Opt-In Provision: Anti-Fragmentation Rule

As an opt-in provision, article 13(4) operates independently from article 13(1). Equally, the logic of article 13(4) can be explained as follows.

The first node (node 1) asks whether a party reserves the right for the entire article 13 not to apply to its CTAs under article 13(6)(a).

(1) If yes, node 1 ends here.

(2) If no, the party may opt for article 13(4). If the party does so, the decision moves to node 2, which checks whether the party adopting article 13(4) reserves the right for it not to apply to its CTAs under article 13(6)(c).

(a) If yes, the node 2 ends here.

(b) If the party has not reserved the rights, then article 13(4) shall apply. In this case, check whether the party has given notification under article 13(8) in order for the opt-in provision to have legal effect. Then move to node 4, the final node.

A. If notification is given, article 13(4) shall apply, and node 4 ends.

B. If notice is not given, article 13(4) does not apply, and node 4 ends.

VII. Conclusion

From a policy perspective, certainty and clarity are of great concern to tax administrations and taxpayers alike in matters of international taxation. The rules that contracting jurisdictions use to allocate taxing rights between source and residence jurisdictions certainly fall under the scope of certainty. The appropriate allocation depends in large part on how the countries define PE status, which in turn depends on *inter alia* the applicability of the specific activity exception. Whether the specific activity exception applies depends on several factors including:

- whether a specific activity is subject to the preparatory or auxiliary condition;
- whether a specific activity is of preparatory or auxiliary character; and
- whether (allegedly) separate activities constitute complementary functions that, combined, form a cohesive business operation.

Adding to the uncertainty regarding the allocation of taxing rights, the ever-evolving world of information and communication technology continues to influence traditional business models and processes in ways that will alter the common understanding of what constitutes a preparatory or auxiliary function in defining PE status. The status quo is that contracting jurisdictions have different views on the issues discussed herein and cannot reach a consensus. Therefore, article 13 of the MLI offers contracting jurisdictions options in the form of alternative provisions leading to different outcomes.

From a technical perspective, article 13 provides three options in article 13(1), three opt-out provisions (reservations) in article 13(6), and one opt-in provision in article 13(4). A party is permitted to withdraw a reservation or replace it with one that is more limited in scope, but cannot shift its position in the opposite direction for preexisting CTAs after confirming its initial position.

As this article demonstrates, opt-in provisions and alternative provisions are similar in that both are subject to any reservations a party may make. But there are fundamental differences between the two. An opt-in provision only applies if both parties opt in and make matching notifications. Thus, an opt-in provision gives rise to the same outcome for both parties because it must be applied symmetrically. In contrast, the adoption of an alternative provision may result in different outcomes since it can be applied asymmetrically. ■