
Lund University

School of Economics and Management
Department of Business Law

# Reservations and Compatibility Clauses in the Multilateral Instrument: Overcoming New Interpretative Challenges

**by**

**Roberto Ramos Obando**

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**Supervisor: Cécile Brokelind**

**Examiner: Oskar Henkow**

Author's contact information:

E-mail: rramos.obando@gmail.com

Telephone number: +460736833955

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# Abstract

Adopted on November 2016, the Multilateral instrument for BEPS tax treaty measures (MLI) has come into play in the global tax treaty landscape. The MLI is a multilateral agreement that aims for a speedy implementation of the treaty measures agreed upon in the Base Erosion and Profit Shifting (BEPS) Project by allowing the modification of the bilateral double tax treaties (DTTs) without the need of individual negotiation of each treaty. In other words, it is a mass renegotiation of a 3000+ existing tax treaty network. In the following years, States enforcing the MLI will be confronted with new interpretative challenges arising from the interaction between both instruments, new taxation rules and different context. This investigation, focusing on the complex reservations system and compatibility clauses implemented by the MLI, provides a response on how the text of DTTs is actually modified by the MLI and its consequences on interpretation of DTTs in general.

# Abbreviation List

| | |
|---|---|
| **Art.** | Article |
| **BEPS** | Base Erosion and Profit Shifting |
| **DTT** | Bilateral Double Tax Treaties |
| **EU** | European Union |
| **GAAR** | General Anti-Abuse Rule |
| **ILC** | International Law Commission of the United Nations |
| **LOB** | Limitation of Benefits Provision |
| **MAP** | Mutual Agreement Procedure |
| **MLI** | Multilateral Instrument for BEPS tax treaty measures |
| **OECD** | The Organization for Economic Co-operation and Development |
| **PE** | Permanent Establishment |
| **PPT** | Principal Purpose Test |
| **UK** | United Kingdom |
| **UN** | United Nations |
| **USA** | United States of America |
| **USCIB** | United States Council for International Business |
| **VCLT** | 1969 Vienna Convention on the Law of Treaties |

# 1. Introduction

## 1.1. Background

Tax law needs to be understandable and transparent to every user. For this reason, elegance, brevity and clarity of expression are to be sought in the drafting of tax legislation, including tax treaties.[1] When these traits are met in the drafting process, the outcome should be one that is understandable to any person that wishes to be the subject of benefits granted by the tax treaty. Simultaneously, the purpose of the treaty should be clear from its preamble to discern the rationale of the rules.

Adopted on 24 November 2016, the Multilateral Instrument for BEPS tax treaty measures (MLI) is the Organization for Economic Co-operation and Development's (OECD) device to implement a new world post base erosion and profit shifting (BEPS).[2] It is a multilateral treaty whose objective is to bring together the world to apply a series of changes in their bilateral double tax treaty (DTT) network. The purpose of the MLI, as stated in its preamble, is to be a mechanism that will implement in a synchronized and efficient manner, the treaty-related BEPS measures against tax avoidance and evasion across the existing DTTs without the need to renegotiate each agreement.[3] In a nutshell, the MLI will coexist with the previously signed DTTs and will be implemented simultaneously. Pistone, an authority in international taxation, states that 'this project has the potential of turning into the apex of a complex system of true multilateralism in international tax law, bringing legal pluralism in line with a worldwide coordination in the exercise of taxing sovereignties across national borders'.[4]

Currently, Contracting States address two legal systems when solving international tax issues: their domestic law and DTT law. These legal systems must be regarded as autonomous with respect to each other which may lead to contrasting outcomes.[5] For example, in a hybrid mismatch arrangement, State A and State B may have different qualifications in their domestic laws for an item of income. Also, as a result of these qualifications, the rules in their DTT may exempt or exclude the item from taxation. Consequently, the item of income is not taxed in any country meaning there is a case of double non-taxation. This outcome is not averse to the overall purpose of DTTs – the avoidance of double taxation.[6] This situation is turned around with the entry into effect of the MLI. Article 5 of the MLI adjusts the DTT rules granting the exemption or exclusion from taxation to a credit method as in a 'switch-over' clause to avoid a situation of double non-

[1] Victor Thuronyi, Tax Law Design And Drafting (1st edn, IMF 1998), 74
[2] OECD, 'Action 15: A Mandate For The Development Of A Multilateral Instrument On Tax Treaty Measures To Tackle BEPS - Final Report' (OECD 2015), 15
[3] OECD, 'Multilateral Convention To Implement Tax Treaty Related Measures To Prevent BEPS' (OECD 2016), 1.
[4] Pasquale Pistone, 'Coordinating The Action Of Regional And Global Players During The Shif From Bilateralism To Multilateralism In International Tax Law' [2014] World Tax Journal, 9.
[5] M. Lang, 4. The interpretation of double taxation conventions in Introduction to the Law of Double Taxation Conventions (Second Revised Edition) (IBFD 2013), Online Books IBFD, 2-3.
[6] ibid 3.

taxation.[7] Therefore, the MLI supplements the existing DTTs, not the domestic legislation, for the sake of combatting tax planning strategies that exploit mismatches in tax rules.

As seen in the previous example, the incorporation of the MLI to the global tax treaty landscape may create legal uncertainty for national courts, legislators and taxpayers. National courts will find difficulties on interpreting and applying provisions in the MLI in conjunction with rules in DTTs and domestic law. Legislators will disagree on the status of the MLI in their national legal order whether they follow a monistic or dualistic view on the relationship between international agreements and domestic legislation. Moreover, the taxpayers' rights will be affected by the impact of the MLI provisions to the claim of tax treaty benefits.

For the success of the MLI, the OECD relies on the use of a complex system of reservations and compatibility clauses. These mechanisms introduce an unusual situation in the world of international tax law but not so uncommon in the universe of international public law. Multilateral treaties, such as the Agreement on Extradition between the European Union (EU) and the United States of America (USA)[8], provides examples of compatibility clauses providing rules for the application of the multilateral treaty in regard of bilateral treaties. However, opposite to extradition, most countries have adverse interests when it comes to tax law and its interpretation because it has a significant impact on a sensible matter - their tax revenue.

The way in which the reservations and compatibility provisions cover DTTs is crucial for the culmination of the BEPS Project. Great effort has been made by the OECD Member States and other members of the ad-hoc Group[9] to arrange clauses suitable to existing DTTs whether they follow the OECD or the United Nations (UN) Model Convention. It is a hit or miss situation for the OECD. If these provisions fail to be implemented correctly in the MLI, then a popular phrase may come to one's mind: 'What works for you may not work for me'.

## 1.2. Subject and Purpose

In the light of the disclosure of the text of the MLI and its explanatory statement in November 2016, times of uncertainty are coming. Academics have begun exploring the possible interpretative challenges that will be encountered in the swift implementation of the BEPS Project on DTTs through a complex multilateral convention. As Schwartz asserts, 'the BEPS Convention matrix raises an additional new task for the next few years, that is trying to decide what the text of a

[7] OECD (N 3) 5-7.
[8] 'Agreement On Extradition Between The European Union And The United States Of America' (2003) L 181, 19/07/2003 Official Journal of the European Union.
[9] The ad-hoc Group is a group of over 96 countries, including non-OECD countries, that was set up to develop the Multilateral Instrument through a series of negotiations starting on the 5th of November 2015.

specific treaty is as amended by the BEPS Convention'.[10] Therefore, the subject is aimed to examine in which ways will the complex system of reservations and compatibility clauses in the MLI transform the text of DTTs.

The purpose of this thesis is to overcome new interpretative challenges arising from the MLI by providing a detailed analysis on how the text of a DTT is actually modified by the MLI and its consequences on interpreting DTTs. A successful analysis would signify a step forward towards the creation of consolidated texts combining the MLI and existing DTT provisions. This examination would ease the implementation process of the MLI in every jurisdiction.

## 1.3. Method and Materials

This paper will follow the traditional legal dogmatic approach from an international law perspective. A systematic analysis of the provisions of the MLI, with the aid of the Vienna Convention on the Law of Treaties (VCLT), is conducted in this research. Other sources of law, such as international conventions and DTTs, contribute to the development of an internal perspective of the MLI. Soft law, specially the OECD materials on Action 15, plays an important role as it provides detailed explanations on the reasoning behind the subject under review.

Furthermore, scholarly articles and academic research provide valuable theoretical knowledge in relation to this paper. It is acknowledged in the tax community that interpretation of tax treaties is moving towards multilateralism. As a result, several researchers have contributed with accurate opinions on the interpretative challenges of the MLI. The author has compiled and analyzed these materials as of May 2017.

## 1.4. Delimitation

Even if deriving issues originating from the interpretation of the MLI provisions are commented, the detailed meaning of these provisions and their effectiveness on the combat against profit shifting and aggressive tax planning are not the focus of this thesis. The author does not assess on the correctness of the treaty-related BEPS measures. Instead, the author analyzes how these measures amend the text of DTTs. In addition, provisions on dispute resolution mechanisms in the MLI are not observed as they have a bearing on practicality concerning procedural rules.

Although the author pursues a semantic analysis of the MLI, the impact of this multilateral instrument on DTTs authenticated in official languages different to the authoritative languages of the MLI may not be examined thoroughly until national courts and tribunals establish case law on this topic or States apply unofficial translations of the MLI. Therefore, this thesis presents a limited

[10] Jonathan Schwarz, BEPS Multilateral Convention Unveiled, Kluwer Intl. Tax Blog (25 Nov. 2016), available at http://kluwertaxblog.com/2016/11/25/beps-multilateral-convention-unveiled (accessed 5 May 2017).

approach to multilingual tax treaties, focusing on the relation between the English version of the MLI with the English versions of DTTs as it has been estimated that in total over 80% of tax treaties have an English version.[11]

Also, only the relationship between the MLI and the existing DTTs is examined in this paper. The interaction between DTTs and domestic legislation has been widely discussed by several authors. Nonetheless, it is encouraged for researchers to continue this investigation by analyzing any interpretation effects of the MLI on national law.

### 1.5. Outline

The remainder of the paper is structured as follows. In the next chapter, the author illustrates an overview of the MLI, its legal nature and the different interpretative challenges arising from its implementation. Chapters 3 and 4 examine in depth the impact of reservations and compatibility clauses in the interpretation of the MLI and its relationship with existing DTTs. In Chapter 5, the author analyzes the need for a common interpretation of the MLI. Finally, Chapter 6 provides concluding remarks on the findings of this research.

## 2. The Multilateral Instrument (MLI)

### 2.1. General Remarks

The MLI is an unusual multilateral agreement better considered as 'a mass renegotiation of bilateral treaties on a limited range of issues and limited to a series of predetermined options'.[12] The MLI is an innovative treaty that aims for a speedy implementation of the treaty measures agreed upon in the BEPS Project by allowing the modification of bilateral tax treaties without the need for individual negotiation of each treaty. In a world with a 3000+ existing tax treaty network, the MLI seems as the only way to enforce the BEPS Project in a harmonized manner. Consequently, every DTT, regardless of its origin in the OECD or UN Model Convention, may be affected by the MLI.

The idea of a MLI as a solution to amend bilateral tax treaties did not come up from nowhere. During the past decade, several authors brought up new ideas on this subject. Avery Jones and Baker suggested the adoption of a multilateral agreement prepared by the OECD which would

[11] Stephane Austry and others, 'The Proposed OECD Multilateral Instrument Amending Tax Treaties' (2016) 70 Bulletin for International Taxation, 686.

[12] Jonathan Schwarz, Multilateral Negotiation of Bilateral Tax Treaties, Kluwer Intl. Tax Blog (21 Feb. 2017), available at http://kluwertaxblog.com/2017/02/21/multilateral-negotiation-of-bilateral-treaties (accessed 10 Mar. 2017).

serve as the framework for the amendments.[13] The framework agreement would only produce effects on the existing DTT if the individual pairs of States (both parties to a DTT) expressly declare their consent. This bilateral declaration, which includes information on the DTT and the particular provisions to be amended, serves the purpose of a multilateral convention while assuring the bilateral nature of a DTT.

Aside from the multilateral convention, other solutions to modify DTTs were developed as well. Innamorato proposed the use of 'multilateral single issue protocols' which would amend the existing tax treaty network.[14] These protocols would have an effect on the existing DTTs at the time of the ratification without the need of further bilateral declarations. In other words, the 'multilateral single issue protocols' would directly amend the text of the existing tax agreements.

The development of the MLI culminated in the creation of an independent multilateral agreement that resembled more closely to Avery Jones' and Baker's proposal. The approach taken in the MLI is not one of an amending protocol which would directly alter the text of the existing DTTs but instead will be applied alongside these DTTs, modifying their application in the process.[15] Therefore, their close interaction requires an in-depth analysis to observe in which way is the wording of DTTs impacted by the MLI as they are both regarded as autonomous agreements.

However, the MLI should not be regarded as a regulatory framework. Article (Art.) 30 of the MLI establishes that its provisions do not intend to affect the right of the States to carry out subsequent modifications to their DTTs.[16] The Explanatory Statement affirms this by stating that 'the Convention is not intended to freeze in time the underlying agreement and that Contracting Jurisdictions may of course decide to further amend the underlying agreement after it has been modified by the Convention'.[17]

In addition, some of the treaty measures developed in the BEPS Project and implemented through the MLI are multilateral by nature, facilitating their coexistence with existing DTTs. The BEPS actions include tax treaty related measures that address different topics such as hybrid mismatch arrangements, treaty abuse, artificial avoidance and dispute resolution.[18] As illustrated in the Final Report of the OECD on Action 15, issues regarding the triangular cases involving permanent establishments (PE) in Third States and treaty abuse in inappropriate circumstances may only be incorporated efficiently in a MLI as they involve various treaty shopping arrangements in their

[13] John Avery Jones and Philip Baker, 'The Multiple Amendment Of Bilateral Double Taxation Conventions' (2006) 60 Bulletin - Tax Treaty Monitor IBFD, 21.
[14] Caterina Innamorato, 'Expeditious Amendments To Double Tax Treaties Based On The OECD Model' (2008) 36 Intertax, 123.
[15] OECD, 'Explanatory Statement To The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion An Profit Shifting' (OECD 2016), 3.
[16] OECD (N 3) 42.
[17] OECD (N 15) 10.
[18] OECD (N 3) 1.

DTT network.[19] At the same time, the MLI may impose provisions with a bilateral nature to level the playing field in each State's treaty network. This means that the MLI sets minimum standards in their provisions to enhance the level of commitment of each country in the fight against tax avoidance and tax evasion.

## 2.2. Interpretation of the MLI

Ensuring a consistent interpretation and application of the MLI will facilitate the implementation process for every Signatory State. The MLI is an international agreement with the underlying purpose of combatting double non-taxation or reduced taxation through tax evasion and tax avoidance. As an international agreement, its interpretation should follow the interpretation rules found in the VCLT and the maxims of international law.

In Art. 31, the VCLT establishes as a general rule that treaties should be interpreted in good faith according to the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.[20] Art. 31(2) adds that the context of the treaty includes, aside of its preamble, text and annexes, any agreement between the parties in connection with the treaty as well as any instrument made in connection to the treaty and accepted by the parties.[21] Art. 33 calls upon interpreters to take into account subsequent agreements between the parties concerning the interpretation of the provisions, subsequent practices in the application of the treaty or any relevant rules of international law applicable to the treaty.[22] Art. 31(4) indicates that a special meaning shall be given to a term if established by the parties. According to Art. 32, recourse may be had to supplementary means of interpretation including the preparatory works of the treaty and the circumstances of its conclusion as a way of confirming the result obtained by the interpreter from the application of Art. 31.[23] Lastly, Art. 33 refers to the interpretation of treaties authenticated in two or more languages.[24]

The treaty text of the MLI is the starting point of the interpretative process as it is regarded as the expression of all the signatory parties to the Convention. Based on the principle of good faith, the grammatical interpretation of its text should not lead to any absurd results.[25] Good faith, supported by the principle of effectiveness, requires that the interpretation of a treaty that is more in line with the object and purpose is preferred to an interpretation that disregards its letter and spirit.[26] In the case of the MLI, an outcome of the interpretative process may not be a situation that the treaty related BEPS measures are trying to combat.

[19] OECD (N 2), 24-25.
[20] 'UN Vienna Convention On The Law Of Treaties' [1969] IBFD, 10.
[21] ibid.
[22] ibid.
[23] ibid.
[24] ibid.
[25] J. G. Starke, An Introduction To International Law (11th edn, Butterworths 1977), 434-438.
[26] ibid.

By its very nature, the ordinary meaning of the terms has to be established in its own text as the MLI stands on its own legal footing. In conformity with Art. 31(2)(a) of the VCLT, the context for the purpose of a treaty shall include 'any agreement relating to the treaty which was made between the parties in connection with the conclusion of the treaty'. It is logical to the complexity of the MLI for it to be accompanied by an Explanatory Statement. In theory, this instrument would fall in the category of an agreement as stated in Art. 31(2)(a) as it was adopted simultaneously to the conclusion of the MLI, making it binding context.

The OECD had the chance to give a clear legal basis to the Commentaries in the Explanatory Statement in order to avoid an ongoing debate in the same fashion as the relationship between the OECD Model Convention and its commentaries.[27] Nonetheless, the OECD did not seize this opportunity and decided to keep a confusing situation for the MLI interpreters. The Explanatory Statement sets out its own status by making clear its intention to clarify the operation of the MLI to modify DTTs but not to address the interpretation of the underlying BEPS measures.[28] Subsequently, the Explanatory Statement considers that its substantive provisions should be interpreted in accordance with the rules established in Art. 31 of the VCLT and declares that the object and purpose of the MLI is to implement the tax treaty-related BEPS measures.[29]

Furthermore, the text of the Explanatory Statement was prepared by 'participants in the ad hoc Group', 'negotiators' and 'members of the ad-hoc Group' that may not be presumed as parties of the MLI.[30] For example, the ad-hoc Group is a group of over 96 countries, including non-OECD countries, that was set up to develop the Multilateral Instrument but it is still unknown if each of these countries will sign the MLI. Also, the participation of the non-OECD countries in the drafting of the MLI and in the decision-making bodies was constricted to a consultative role.[31] For that reason, it cannot be said in *stricto sensu* that these participants are the same parties in the context of the VCLT. However, this circumstance should not diminish the role of the Explanatory Statement in establishing the context of the treaty in accordance with Art. 31(2)(a) of the VCLT.

The Explanatory Statement addresses the operation of the MLI but provides limited direction on the substantive or technical tax meaning of the implemented changes to the DTTs' distributive clauses.[32] The only exception is the extensive technical explanation of the new arbitration

[27] For analysis on this issue, see Sjoerd Douma and Frank Engelen, The Legal Status Of The OECD Commentaries (1st edn, IBFD 2008); Ulf Linderfalk and Maria Hilling, 'The Use Of OECD Commentaries As Interpretative Aids - The Static/Ambulatory–Approaches Debate Considered From The Perspective Of International Law' (2015) 1 Nordic Tax Journal, 34-59.
[28] OECD (N 15) 2.
[29] ibid.
[30] ibid.
[31] Irma Mosquera, 'Legitimacy And The Making Of International Tax Law: The Challenges Of Multilateralism' (2017) 7 World Tax Journal, 16.
[32] P.J. Hattingh, The Multilateral Instrument from a Legal Perspective: What May Be the Challenges?, 71 Bull. Intl. Taxn. 3/4 (2017), Bulletin for International Taxation IBFD, 7.

proceedings.[33] Concerning the substantive provisions, the Explanatory Statement remits the lector to the BEPS Final Reports which, at first glance, do not have a binding context as they were prepared by a smaller group of countries than the ad-hoc Group. Whenever the Explanatory Statement follows this practice, ambiguity is produced as shown in the following example:

> Art. 4 – Dual Resident Entities - Paragraph 1
> 49. Paragraph 1 modifies the rules for determining the treaty residence of a person other than an individual that is a resident of more than one Contracting Jurisdiction, and is *based on the text of Article 4(3) of the OECD Model Tax Convention produced in paragraph 48 (page 72) of the Action 6 Report*, which reads as follows:
> 3. Where by reason of the provisions of paragraph 1 a person…[34]

Instead of providing a technical commentary, the Explanatory Statement makes a direct reference to the Action 6 Report. In so doing, the Explanatory Statement attributes importance to the BEPS Final Reports on the interpretation of the MLI provisions.[35] This synergy may elevate the status of the BEPS Final Reports to binding context when interpreting the MLI. As it seems, interpreters must refer to the Explanatory Statement to determine the object and purpose of the MLI and to the Reports to find the ordinary meaning of the terms in the MLI.

## 2.3. Symmetric and Asymmetric Provisions

Symmetry implies that the application of a provision by any of the parties of the treaty will lead to the same outcome. In terms of symmetry, the provisions in the MLI can be divided in two categories: symmetric and asymmetric provisions.[36] The symmetric provisions, which form the majority of the MLI, are more straightforward in application as they only present one way of application of which scope may only be modified by the reservations made by each party. Art. 6 of the MLI is a good example of a symmetric provision:

> Article 6 – Purpose of a Covered Tax Agreement
> 1. A Covered Tax Agreement shall be modified to include the following preamble text: 'Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements

[33] OECD (N 15), 55-65
[34] ibid, 14.
[35] Luis Eduardo Schoueri and Ricardo Galendi Junior, 'Interpretative And Policy Challenges Following The OECD Multilateral Instrument (2016) From A Brazilian Perspective' (2017) 71 Bulletin for International Taxation, 2.
[36] Other authors have categorized the provisions of the MLI according to their susceptibility to reservations. This categorization will be further discussed in Chapter 4. See also Piergiorgio Valente, 'BEPS Action 15: Release Of Multilateral Instrument' (2017) 45 Intertax, 219-228.

> aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions),' (…)
> 4. A Party may reserve the right for paragraph 1 not to apply to its Covered Tax Agreements that already contain preamble language describing the intent of the Contracting Jurisdictions to eliminate double taxation without creating opportunities for non-taxation or reduced taxation, whether that language is limited to cases of tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in the Covered Tax Agreement for the indirect benefit of residents of third jurisdictions) or applies more broadly.[37]

In Art. 6 of the MLI, the party does not have any discretion in the application of the provision but instead it is obliged to modify the existing DTT as instructed by the words 'shall be modified'. Then, the party may only diminish its obligation through the use of a reservation as indicated in Paragraph 4 of the same article. As will be discussed in the next Chapter, the MLI safeguards the symmetry of its provisions through its complex reservations system unless provided otherwise.[38]

On the contrary, the asymmetric provisions of the MLI give discretion to the parties on their way of application. Asymmetric clauses are not a new feature in the world of international taxation as they can be observed in Art. 23 of the 2014 OECD and 2011 UN Model Convention on the methods of elimination of double taxation. This type of provisions may be seen in Arts. 5, 7 and 13 of the MLI.

For example, Article 13 of the MLI regarding the artificial avoidance of the PE status provides three options to the Contracting State on how to apply this provision. Both Option A and Option B preserve the exceptions for activities described in Art. 5(4) on activities of preparatory or auxiliary character found in the 2014 OECD or 2011 UN Model Convention. However, Option A has a different approach as it preserves the exceptions to these activities but to make them subject to the condition that the activity be of a preparatory or auxiliary.[39] *Au contraire*, Option B ensures that those exceptions will apply irrespectively of whether the activity is of preparatory or auxiliary nature.[40] Option C is applying neither Option A nor Option B. If a Contracting State chooses Option A while the other Contracting State chooses Option B, the asymmetrical decisions conclude in the non-application of the provision in its entirety. This is illustrated in Paragraph 7 of Art. 13 which states that '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'.

[37] OECD (N 3) 8.
[38] The reservation system in the MLI is examined in Chapter 3 of this thesis.
[39] OECD (N 15) 42.
[40] ibid, 43.

## 2.4. Flexibility in the MLI

The BEPS Final Report on Action 15 acknowledges that the MLI must provide flexibility in the level of commitment of the Contracting States.[41] In brief, this means that the MLI can provide flexibility when the parties do not agree, for reasons of tax policy or lack of commitment towards the partner jurisdiction, on implementing certain provision.

The MLI may achieve flexibility through different tools such as:[42]

a) The discretion given to the States to choose their existing tax treaties that will be modified by the MLI;
b) The inclusion of asymmetric provisions in which the Contracting States can choose different alternatives on their form of application;
c) The use of flexible wording, such as 'may', in the design of the provisions;[43]
d) The formulation of reservations to the provisions of the MLI; and,
e) The use of compatibility clauses that preserve the effectiveness of provisions in the existing tax treaties.

Even if it is intended for the MLI to apply to the maximum number of existing DTTs, States may incorporate or exclude specific DTTs from its scope. Art. 2 of the MLI states that a DTT covered by the MLI must be in force between the parties and each party must have made a notification to the Depositary (the Secretary General of the OECD) listing the DTT as an agreement to be covered by the MLI.[44] Therefore, the MLI is not a straitjacket that automatically incorporates the whole tax treaty network of a country.[45] As of now, States may implement the MLI to any number of their existing DTTs without any political sanction if they do not cover existing DTTs that do not fulfill the BEPS minimum standards. This issue should be solved on a political level as it is needed for Signatory States to have a similar level of commitment in the playing field.

The built-in flexibility in the MLI will establish unevenness in the global tax treaty landscape.[46] Aside from establishing their covered DTTs, States can make use of opt-out reservations that will create a broad range of possibilities in the new wording of DTTs as modified by the MLI through compatibility clauses. The problems of interpretation arising from the complex reservations system and compatibility clauses will be the subject of the following chapters.

[41] OECD (N 2) 41.
[42] ibid, 42-49.
[43] See, for example, Art. 9(4) of the MLI.
[44] OECD (N 3) 2.
[45] Hattingh (N 32) 4.
[46] ibid, 5.

# 3. Reservations

## 3.1. General Remarks

Until now, reservations have played a minor role in international taxation. In the international tax world, reservations display a disagreement, by an OECD country, concerning the provisions of the OECD Model Convention.[47] Still, since 1997, non-members have also been allowed to express their disagreements with certain aspects of the OECD Model Convention.[48] Anyhow, these kinds of reservations merely indicate a negotiating position of the States regarding certain provisions in the OECD Model.[49] As reservations to a non-binding instrument, their importance for the interpretation of tax treaties is limited. They may be used by the interpreters to confirm the existence of a State's pre-established intention that departs from the example in the OECD Model.[50] However, during the drafting process, Contracting States may ignore their reservations and it would not affect the Commentaries' interpretative relevance.

Reservations in the OECD Model should not be confused with reservations to treaties. As a starting point, in Art. 3.1(d), the VCLT defines a reservation as a:

> […] unilateral statement, however phrased or named, made by a State, when signing, ratifying, accepting, approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State.[51]

From this definition, which has been confirmed in the recent UN's Guide to Practice on Reservations to Treaties[52], several characteristics of the reservation may be distinguished. First, reservations are unilateral statements which means that they are introduced individually by a State with the intention of protecting specific interests in relation to norms expressed in the treaty.[53] Second, reservations are formal statements that have to be formulated in writing so that all interested parties become aware of their existence.[54] Lastly, reservations have an impact on the operation of the norms by excluding or modifying the legal effect of provisions in a treaty.[55]

[47] Jacques Sasseville, 'The Role And Evolution Of Reservations, Observations, Positions And Alternative Provisions In The OECD Model', Departures from the OECD Model and Commentaries (1st edn, IBFD Publications 2014), 3.
[48] Alberto Vega and Ilja Rudyk, 'Explaining Reservations To The OECD Model Tax Convention: An Empirical Approach' (2011) 4 InDret, 4.
[49] Hattingh (N 32) 5.
[50] Alberto Vega, 'The Legal Status And Effects Of Reservations, Observations And Positions To The OECD Model', Departures from the OECD Model and Commentaries (1st edn, IBFD Publications 2014), 42.
[51] UN Vienna Convention on the Law of Treaties (N 20) 5.
[52] UN, 'Guide To Practice On Reservations To Treaties' (United Nations 2011).
[53] Frank Horn, Reservations And Interpretative Declarations To Multilateral Treaties (1st edn, Swedish Institute of International Law 1988), 44.
[54] ibid.
[55] ibid, 45.

According to the latter characteristic, which differentiates reservations from any other unilateral statement, the objective of a reservation is to alter the scope or operation of the norm itself, not to change the wording of the provisions.

In addition, Arts. 19 to 23 of the VCLT also regulate reservations. Article 19 allows States to formulate reservations unless: a) they are prohibited by the treaty; b) the treaty provides that only specified reservations may be made, which is the case of the MLI[56]; or, c) when the reservation is incompatible with the object and purpose of the treaty. In virtue of the inclusion of specified provisions in the MLI and the clear statement on the object and purpose of the Convention, theoretically, States should not have any difficulties on depositing valid[57] reservations that would produce a reciprocal legal effect.

A valid reservation modifies the reserving State's rights and obligations under the treaty with respect to the objectionable provision.[58] In the MLI, a reserving State formulates excluding reservations to free itself from the obligation of applying the treaty-related BEPS measures to their existing DTTs. How does a reservation affects vis-à-vis the other treaty partner? The legal effects of a reservation should be observed from two sides of the same coin. With regards to the legal effects of reservations, Art. 21(1)(a) of the VCLT declares that:

> A reservation […] modifies for the reserving State in its relations with that other party (the accepting State) the provisions of the treaty to which the reservation relates to the extent of the reservation; and modifies those provisions to the same extent for that other party in its relations with the reserving State.[59]

Horn asserts that the immediate effect of reservations is advantageous to the reserving State because they delimit the correlate rights of the other parties and widen their obligations.[60] He demonstrates the logic behind this statement through the following graph:[61]

[56] Art. 28 of the MLI states that no reservations may be made except those expressly permitted by the treaty.
[57] For the purpose of this thesis, a valid reservation is one the does not preclude the reserving State of becoming a party to the treaty.
[58] Jean Koh Peters, 'Reservations To Multilateral Treaties: How International Legal Doctrine Reflects World Vision' (1982) 23 Harvard International Law Journal, 71.
[59] UN Vienna Convention on the Law of Treaties (N 20) 10 – See also Article 28(3) of the MLI which extracts the unaltered provision of the VCLT.
[60] Horn (N 53) 92.
[61] ibid.

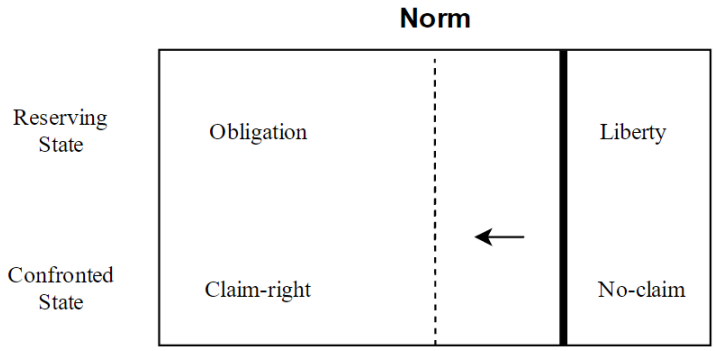


Figure extracted from Frank Horn's Reservations and Interpretative Declarations to Multilateral Treaties (1988).

The State that formulates a reservation wants to diminish the obligations created by the reserved provision. The reserving State will have more liberty on its actions as it is not bound to comply with any obligations. Consequently, the confronted or accepting State has no power to claim any rights over the reserved obligations. In other words, a reserved provision will produce no legal effects on any of the parties unless there is an objection to it.

The figures of acceptance and objections are foreseen in the MLI as they are important features of reservations in public international law. Art. 20 of the VCLT establishes rules on these subjects without defining their concepts. As Pellet suggests, the words 'acceptance and 'objection' should be interpreted according to their ordinary meaning which implies they have opposite meanings that leads to different effects.[62]

Acceptance by the parties to the treaty of the reservations made by a State is a condition for the validity of the reservation. Most of the time, it arises from the absence of objections made by the other parties in the treaty.[63] In the case of the MLI, tacit acceptance to reservations is observed in Art. 28(2)(b) which states:

> Reservations made under subparagraph a) are subject to acceptance. A reservation made under subparagraph a) shall be considered to have been accepted by a Party if it has not notified the Depositary that it objects to the reservation by the end of a period of twelve calendar months beginning on the date of notification of the reservation by the Depositary or by the date on which it deposits its instrument of ratification, acceptance, or approval, whichever is later.[64]

This provision follows the standards of implied or tacit consent in Art. 20(5) of the VCLT. It can be said that the provision does not only clarify the notion of consent but it also operates as a subtle

[62] Alain Pellet and Daniel Müller, 'Reservations To Treaties: An Objection To A Reservation Is Definitely Not An Acceptance', The Law of Treaties Beyond the Vienna Convention (1st edn, Oxford University Press 2011), 38.
[63] ibid.
[64] OECD (N 3) 38.

restraint on the power of States to oppose reservations at will.[65] The twelve months threshold impedes a State to present an objection whenever it desires to. Albeit, this practice would not be of importance if incompatible reservations are considered void *ab initio*, such that no objection is necessary and the failure to act within the time threshold cannot be treated as tacit acceptance.[66]

Together with the acceptance of reservations, objections are also discerned in Art. 28(2)(b) of the MLI. Objections are oppositions to the reservations formulated by a State. Under Art. 21 of the VCLT, if a non-reserving State objects a reservation without denying the reserving State's status as a party to the treaty, then the provisions to which the reservation relates do not apply between the two States to the extent of reservation.[67] In contrast to the effect of an acceptance, the effect of an objection hinders the modification of the provision for both States.

In summary, three sets of bilateral relations might be created:[68]

a) Between the reserving States and the accepting States, causing an alteration of the original terms by the reservation;
b) Between all the non-reserving States, maintaining the original terms; and,
c) Between the reserving States and the objecting states, resulting in the inapplicability of the reserved provisions to the extent of the reservation.

## 3.2 Reservation System in the MLI

### 3.2.1. Types

The MLI introduces a complex system of reservations in virtue of flexibility. As previously mentioned, Art. 28(1) of the MLI provides an extensive list of the permitted reservations to the treaty. These specified reservations, also called opt-out reservations, are excluding in nature as they absolve the reserving States to comply with a positive obligation (the application of a provision) .[69]

However, the Contracting States may only opt out of a provision entirely if the provision does not reflect a minimum standard. The minimum standards encompass model provisions to prevent treaty abuse, standardized country-by-country reporting, peer review process to address harmful tax practices and an agreement to secure progress on dispute resolution. [70] In this regard, the only

[65] Peters (N 58)103.
[66] Edward T. Swaine, 'Reserving' (2006) 31 The Yale Journal of International Law, 317.
[67] ibid, 319.
[68] ibid, 312.
[69] The only example in the MLI where it allows the reserving State to modify, instead of excluding, the provision is Art. 4(3)(e).
[70] OECD, 'Background Brief - Inclusive Framework On BEPS' (OECD 2017), 7.

Arts. of the MLI that reflect a minimum standard are Art. 6 (Purpose of a Covered Tax Agreement), Art. 7 (Prevention of Treaty Abuse) and Art. 16 (Mutual Agreement Procedure).

Moreover, reservations are specifically designed for each substantive provision in the MLI.[71] There is not a specific pattern on the permitted reservations but, in most cases, they leave the reserving State the right to neglect the entire or part of the provision. The following examples may illustrate how this reservation system works:

> Article 5 – Application of Methods for Elimination of Double Taxation (Asymmetric provision)
> 8. A Party that does not choose to apply an Option under paragraph 1 may reserve the right for the entirety of this Article not to apply with respect to one or more identified Covered Tax Agreements (or with respect to all of its Covered Tax Agreements).
> 9. A Party that does not choose to apply Option C may reserve the right, with respect to one or more identified Covered Tax Agreements (or with respect to all of its Covered Tax Agreements), not to permit the other Contracting Jurisdiction(s) to apply Option C.
>
> Article 10 – Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions (Symmetric provision)
> 5. A Party may reserve the right:
> a) for the entirety of this Article not to apply to its Covered Tax Agreements;
> b) for the entirety of this Article not to apply to its Covered Tax Agreements that already contain the provisions described in paragraph 4;
> c) for this Article to apply only to its Covered Tax Agreements that already contain the provisions described in paragraph 4.[72]

Both symmetric and asymmetric provisions are subject to reservations in different terms. Each reservation has been tailor-made for each provision as a result of the negotiations in the development of the instrument. Nonetheless, the general rules on reservations are applicable regardless of any specific characteristics related to the type of provision (if it is symmetric or asymmetric) or the inclusion of special practices (e.g. rules that will only apply to provisions that serve as minimum standards).

[71] OECD (N 15) 4.
[72] OECD (N 3) 3-6.

### 3.2.2. Application of Reservations and Impact on Interpretation

Whenever a Contracting State formulates a reservation in the MLI, there will be an effect on the wording of the modified provision in the DTT as a consequence of the legal effects of reservations in combination with the bilateral nature of DTTs. On this subject, Hattingh argues there may be several ways to interpret the amendment of the existing DTTs:[73]

a) A clause in the DTT will only be amended as displayed in the MLI if both Contracting States make the identical reservation permitted for in the MLI. This situation requires the reservations to match and, as Hattingh points out, provisions in the MLI may be silent or explicit in this respect. For that reason, this approach disregards the modification of the provision if only partial agreements have been reached between a reserving State and a Contracting State. or,
b) Only the words in common between a reserving State and an accepting State should provide the modifications of the DTT between them. This way of interpreting amendments is more congruent to the flexibility of the MLI as it establishes the text of the MLI that will be considered to change the DTT text, according to the decisions taken by the parties.

Under the latter approach, four sets of outcomes will arise from the effects of the reservations in the MLI on the text of a DTT:[74]

1. If there are no reservations between the parties, the text of the MLI applies strictly in the DTT.
2. If one State formulates a reservation and the other accepts it, the reserved part of the MLI text will be excluded from the text in the DTT.
3. If both States formulate the same reservations, the reserved parts of the MLI text are omitted by the parties in the DTT.
4. If both States formulate different reservations, the reserved parts of the MLI text are not taken into consideration in the DTT.

By way of illustration, the following chart shows how to determine the final text of the MLI provisions under different circumstances:

[73] Hattingh (N 32) 4-5
[74] For the purpose of this comment, the author refers to reservations of an excluding nature.

| Text of the Provision (e.g. Article 3 - Transparent Entities) | Reservations Formulated | DTT Text as modified by the MLI |
|---|---|---|
| 1. For the purposes of a Covered Tax Agreement, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting Jurisdiction shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction.<br><br>2. Provisions of a Covered Tax Agreement that require a Contracting Jurisdiction to exempt from income tax or provide a deduction or credit equal to the income tax paid with respect to income derived by a resident of that Contracting Jurisdiction which may be taxed in the other Contracting Jurisdiction according to the provisions of the Covered Tax Agreement shall not apply to the extent that such provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction. | No reservations are formulated. | The entire text in Art. 3 of the MLI will be applied strictly in the DTT. |
| | State A reserves the entirety of the Article. (Reservation in Art. 3(5)(a))<br><br>State B accepts the reservation. | The entire provision will not apply between the Contracting States. |
| | Both States reserve paragraph 1 not to apply to the treaty. (Reservation in Art. 3(5)(b)) | Paragraph 1 is omitted but paragraph 2 is taken into consideration in the DTT text. Paragraph 2 represents the only common text in between the Contracting States. |
| | State A reserves paragraph 1 not to apply to the treaty. (Reservation in Art. 3(5)(b)).<br><br>State B reserves paragraph 2 not to apply to the treaty. (Reservation in Art. 3(5)(f)) | Both paragraphs are not taken into consideration in the DTT text as they are reserved by both Contracting States in different formulations. In this case, the legal effect will be the same as if there was a reservation for the entire provision. |

Due to the flexibility of the MLI, a provision may follow specific rules on reservations. For example, Art. 7 of the MLI proposes the use of a Principal Purpose Test (PPT) or Simplified Limitation of Benefits Provision (LOB) Clause to prevent treaty abuse. In this particular provision, the MLI allows the Contracting States to reserve their right to adopt it if they decide to meet the

minimum standards through a mutually satisfactory solution. Consequently, this reservation leads to the non-application of the entire Art. To such degree, regardless of specific rules, the way in which reservations operate in order to filter the final text of a provision is consistent throughout the MLI.

It is visible how reservations may impair the uniformity of the DTT text depending on the States' formulations of reservations. As can be seen from the chart above, a MLI provision can be excluded in part or entirely. After Contracting States determine the text of the MLI to be excluded or not, then the parties may apply it to their existing DTTs. By way of explanation, a reservation to the MLI may be seen as modifier of another modifier (the MLI provision itself), having an impact on the text of the DTT.

# 4. Compatibility Clauses

## 4.1. General Remarks

The MLI serves as a new layer of content which will be applicable to thousands of DTTs in the international tax treaty network. Therefore, it is important to know not only to which DTTs the MLI will be applicable but also to observe to which extent it will alter their text. Compatibility clauses are in charge of determining how the MLI interacts with the existing DTTs after reservations have been formulated. This stage of the interpretation process should define how the text of a specific treaty is amended by the MLI.

In 1966, the International Law Commission of the United Nations (ILC) defined a compatibility clause as:

> … a clause intended to regulate the relation between the provisions of the treaty and those of another treaty or of any other treaty relating to the matters with which the treaty deals. Sometimes the clause concerns the relation of the treaty to a prior treaty, sometimes its relation to a future treaty and sometimes to any treaty past or future.[75]

The use of compatibility clauses as instruments of clarification between treaties is common in international agreements. In the absence of general hierarchy of treaties, compatibility clauses dictate the interaction between newly adopted instruments and existing agreements as their

[75] International Law Commission of the United Nations, 'Report Of The Of The International Law Commission On The Work Of Its Eighteenth Session, 4 May - 19 July 1966, Official Records Of The General Assembly, Twenty-First Session, Supplement No. 9 (A/6309/Rev.1)' (UN 1966), 214.

provisions overlap and may potentially contradict each other.[76] Examples of this practice can be observed from early to modern treaties such as:

- Art. 26 of the European Convention on Mutual Assistance in Criminal Matters[77]
- Art. 8(3) of the European Convention on the Suppression of Terrorism[78]
- Art. 311(2) of the United Nations Convention on the Law of the Sea[79]
- Art. 3(1) Agreement on Extradition between the European Union and the United States of America[80]

The wording of compatibility clauses in multilateral agreements varies as a consequence of the drafting process that is subject to political interests and objectives.[81] The States involved in the drafting process may alter the temporal element of these clauses in favor of an existing or new treaty. In that respect, compatibility clauses can be divided into three categories:[82]

a) Clauses giving priority to existing or later treaties – which explicitly provide primacy to earlier or later treaties or state that the treaty should not be considered incompatible to pre-existing or future norms;
b) Clauses claiming primacy over later treaties – which provide primacy over later treaties or prohibit the conclusion of future incompatible agreements; and,
c) Clauses claiming priority over existing treaties – which establish that provisions in the treaty have primacy over existing norms.

In general, compatibility clauses in the MLI follow the spirit of the latter category. Clauses claiming priority over existing treaties are reaffirmations of the *lex posterior* principle.[83] Applied in a strict manner, these type of clauses derogate the provisions in the earlier treaty.[84] They can also be applied in a lighter form by stating that the clauses will not affect the existing rights and obligations deriving from existing international agreements.[85] In any way, if the earlier treaty is

[76] Nele Matz-Lück, 'Treaties, Conflict Clauses', Max Planck Encyclopedia of Public International Law (Online edn, Oxford University Press 2015), 1.
[77] European Convention On Mutual Assistance In Criminal Matters (1st edn, Council of Europe Publication 1959).
[78] European Convention On The Suppression Of Terrorism (1st edn, Council of Europe Publications 1977).
[79] United Nations, United Nations Convention On The Law Of The Sea (1st edn, United Nations 1982).
[80] 'Agreement On Extradition Between The European Union And The United States Of America' (N 8).
[81] Jan Wouters and Bart De Meester, 'The UNESCO Convention On Cultural Diversity And WTO Law: A Case Study In Fragmentation Of International Law' (2008) 42 Journal of World Trade, 32.
[82] Matz-Lück (N 76) 3. See also International Law Commission of the United Nations, 'Fragmentation Of International Law: Difficulties Arising From The Diversification And Expansion Of International Law, Finalized By Martti Koskenniemi' (United Nations 2006), 135-138.
[83] Panos Merkouris, Article 31(3)(C) VCLT And The Principle Of Systemic Integration (1st edn, Brill Nijhoff 2015), 190.
[84] Matz-Lück (N 76) 3. See Article 311(1) United Nations Convention on the Law of the Sea as an example.
[85] See also Art. 22 of 'Convention On Biological Diversity' (UN 1992).

not terminated by the Contracting States, then this treaty applies to the extent that its provisions are compatible with those of the later treaty in conformity with Art. 30(3) of the VCLT.

If compatibility clauses have worked out in several international agreements, there should be a positive rate of success for their inclusion in the MLI. For this reason, the OECD has been enthusiastic on their inclusion in the MLI since the beginning of its drafting process. However, several commentators in the public discussion indicated that problems, ranging from the extensive worldwide treaty network to the differences in languages, would affect the practicality of a compatibility clause.[86] As the United States Council for International Business (USCIB) encapsulated in its technical comments, 'the use of compatibility clauses to implement the BEPS outcomes creates the possibility of real confusion for both taxpayers and tax administrations in trying to identify and apply the treaties that will be modified by the MLI'.[87]

## 4.2. Compatibility System in the MLI

### 4.2.1. Entry into force, Notifications and Compatibility Clauses

Before venturing into the compatibility clauses, it is important to give an overview on how the MLI enters into force for a State. To join the MLI, States must sign and deposit a ratification, acceptance or approval instrument with the Depositary.[88] Then, the MLI shall enter into force three months after the deposit of the fifth instrument of ratification, acceptance or approval.[89] After the deposit of the fifth instrument, for each new Signatory, the MLI will enter into force three months after the deposit of its instrument of ratification, acceptance or approval.[90] Throughout this process, Contracting States are able to inform the Depositary about different subjects including:

a) Existing DTTs covered by the MLI;
b) Formulation of reservations;
c) Notifications reflecting the choices made on asymmetric provisions; and,
d) Notifications regarding which specific provisions in the covered DTTs are within the scope of the compatibility clauses for each provision of the MLI.

The latter notifications ensure the clarity about the existing provisions that will be superseded or modified by the MLI.[91] Ideally, every Contracting State will identify these provisions and link them to the correct Art. in the MLI. If done correctly, a compatibility clause may be applied

[86] Caroline Silberztein and Jean-Baptiste Tristram, 'OECD: Multilateral Instrument To Implement BEPS' [2017] International Transfer Pricing Journal – IBFD, 352
[87] OECD, 'Comments Received On Public Discussion Draft - Action 15: Development Of A Multilateral Instrument To Implement The Tax Treaty Related BEPS Measures' 226.
[88] OECD (N 15) 76-83.
[89] ibid.
[90] ibid.
[91] ibid, 5.

transparently without having any interpretation issue on which Art. of the existing DTT will be altered.

In the same fashion as the Agreement on Extradition between the EU and the USA, compatibility clauses in the MLI address complex situations. In these clauses, a variety of details can be found such as the prevailing MLI provision. Also, due to the different terminology and wording of DTTs, the language of compatibility clauses describes in general terms the type of provisions of DTTs that will be modified by the MLI.[92]

The Explanatory Statement enlists and describes the type of compatibility clauses found in the MLI along with its form of application based on the Contracting States' notification.[93] Compatibility clauses in the MLI are divided into four types:

1. Provision of the MLI applies 'in place of' an existing provision of a covered DTT;
2. Provision of the MLI 'applies to' or 'modifies' an existing provision of a covered DTT;
3. Provision of the MLI applies 'in the absence of' an existing provision of a covered DTT; and,
4. Provision of the MLI applies 'in place of or in the absence of' an existing provision of a covered DTT.

Where a MLI provision applies only 'in place of' an existing provision, the MLI provision replaces an existing provision if one is present in the covered DTT, and is not applicable if there is no existing provision.[94] The notification establishes the MLI provision will apply only in cases where all Contracting States make a notification with respect to the existing provision of the covered DTT.[95]

Where a MLI provision 'applies to' or 'modifies' an existing provision, the MLI provision changes the application of an existing provision without replacing it.[96] For this reason, it can only apply if there is an existing provision in the covered DTT. The notification establishes that the MLI provision will apply only in cases where all Contracting States make a notification with respect to the existing provision of the covered DTT.[97]

Where a MLI provision applies only 'in the absence of' an existing provision, the MLI provision will apply only in cases where the Contracting States notify the absence of an existing provision

[92] Nathalie Bravo, 'The Multilateral Tax Instrument And Its Relationship With Tax Treaties' (2016) 7 World Tax Journal, 297.
[93] OECD (N 15) 6.
[94] ibid.
[95] ibid.
[96] ibid.
[97] ibid.

in the covered DTT.[98] No notification is needed as there is no similar provision in the covered DTT.

Where a MLI provision applies 'in place of or in the absence of' an existing provision, the MLI provision will apply in any situation.[99] If all Contracting States notify the existence of an existing provision, that provision will be replaced by the provision of the MLI to the extent described in the compatibility clause.[100] Where the Contracting States do not notify the existence of a provision, the provision of the MLI will still apply. If there is an existing provision which has not been notified by all Contracting Jurisdictions, the MLI provision will prevail over that existing provision, superseding it to the extent of incompatibility between them.[101] In case there is no existing provision, the provision of the MLI will be added to the Covered DTT.[102]

In Arts. 3 to 17 of the MLI, most of these provisions[103] contain a clause that applies 'in place of or in the absence of' an existing provision of a covered DTT, making it the most common type of compatibility clause in the MLI. As mentioned before, these clauses claim priority for the MLI provisions over existing DTT's provisions. Phrases in these compatibility clauses such as 'shall apply' provide force to the provision's wording vis-à-vis the earlier treaties. The compatibility clause in Art. 9 of the MLI illustrates this point clearly:

> Article 9 – Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property
> 5. Paragraph 4 shall apply in place of or in the absence of provisions of a Covered Tax Agreement providing that gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or other rights of participation in an entity may be taxed in the other Contracting Jurisdiction provided that these shares or rights derived more than a certain part of their value from immovable property (real property) situated in that other Contracting Jurisdiction, or provided that more than a certain part of the property of the entity consists of such immovable property (real property).[104]

In this provision, similar to many others in the MLI, the predominance of the MLI over the existing DTTs is clear. The MLI provision annuls the application of the existing DTT provision. Compatibility clauses applying 'in the place of' will have a similar effect while the ones applying 'in the absence of' will overlap the provision of the MLI on the existing DTT. However,

[98] OECD (N 15) 6.
[99] ibid.
[100] ibid.
[101] ibid.
[102] ibid.
[103] The only exceptions are Arts. 5, 12, 13 and 15 of the MLI.
[104] OECD (N 3) 15.

compatibility clauses with the 'applies to' or 'modifies' formulation will change the wording of the existing provision. The next section of this chapter will address the practical implications of these effects resulting from the application of compatibility clauses.

### 4.2.2. Application of Compatibility Clauses and Impact on Interpretation

A first step in the process of implementing the MLI is to see if the MLI applies or not to the existing DTTs. In a recent article, Valente assesses this step by examining four important Italian DTTs with Germany, China, the United Kingdom (UK) and the USA.[105] In his analysis, Valente assumes the Contracting State will not reserve any rights to the application of the MLI.[106] Then, he proceeds to do an initial evaluation of the MLI provision and observes if any similar provision is contained in the existing DTTs.[107] Finally, he assesses on how both provisions will interact by determining which provision will supersede or will be modified.[108] Thereafter, the next step in the process will naturally be to observe how these changes are reflected on paper in a consolidated text.[109] For the sake of simplicity, the author will use the Italy-UK DTT[110] in a practical example as it has already passed through prior examination. Regarding the amendment to the PE definition that targets the issue of commissionaire arrangements, the following chart will show the existing provision in the DTT, the applicable MLI provision, their main differences, the relevant compatibility clause and the new consolidated text:

| **Existing Provision** | **Article 5 – Permanent Establishment**<br>(4) A person acting in a Contracting State on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph (5) of this Article applies—shall be deemed to be a permanent establishment in the first mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.<br>(5) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. |
|---|---|

[105] Piergiorgio Valente, 'BEPS Action 15: Release Of Multilateral Instrument' (2017) 45 Intertax, 220.
[106] ibid.
[107] ibid, 222-227.
[108] ibid.
[109] For the author, the consolidated text provides a final view on the object of interpretation as it embodies what the users of the MLI will actually read when applying it.
[110] 'UK/Italy Double Taxation Convention' [1988] HMSO.

| | |
|---|---|
| **MLI Provision** | **Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies**<br>1. Notwithstanding the provisions of a Covered Tax Agreement that define the term 'permanent establishment', but subject to paragraph 2, where a person is acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:<br>a) in the name of the enterprise; or<br>b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or<br>c) for the provision of services by that enterprise,<br>that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement (as it may be modified by this Convention).<br><br>2. Paragraph 1 shall not apply where the person acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise of the other Contracting Jurisdiction carries on business in the first mentioned Contracting Jurisdiction as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise. |
| **Main Differences** | - Expansion of the definition of an agent while respecting the concept of a PE under the existing DTT<br>- Description of the contracts concluded in behalf of the enterprise<br>- An independent agent that acts exclusively or almost exclusively on behalf of closely related enterprises (defined in Art. 15 of the MLI) will not be considered an independent agent. |
| **Relevant Compatibility Clause** | Both paragraphs 1 and 2 apply a 'in place of' compatibility clause. |

| | |
|---|---|
| **Consolidated Text** | **Article 5 – Permanent Establishment**<br>(1) For the purposes of this Convention, the term "permanent establishment" means a fixed place of business in which the business of an enterprise is wholly or partly carried on.<br>(2) The term "permanent establishment" shall include especially…<br>(3) The term "permanent establishment" shall not be deemed to include…<br>1. Notwithstanding the provisions of a Covered Tax Agreement that define the term 'permanent establishment', but subject to paragraph 2…<br>2. Paragraph 1 shall not apply where the person acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise…<br>(6) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other. |

The consolidated text combines two different legal texts that should be interpreted simultaneously. As new terms are replacing the text in the existing DTT, the rules on defining their meaning have to be found in both the existing DTT and the MLI. In the Italy-UK DTT, following the 1963 OECD Model Convention[111], the rule of interpretation of an undefined term, also known as the *renvoi* clause[112], is contained in Art. 3(2):

> As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the Convention.[113]

On the other hand, the MLI's *renvoi* clause appears in Art. 2(2):

> As regards the application of this Convention at any time by a Party, any term not defined herein shall, unless the context otherwise requires, have the meaning that it has at that time under the relevant Covered Tax Agreement.[114]

[111] The 1977 OECD Model Convention refers to 'the law of that State concerning the taxes to which the Convention applies'. In 1995, Art. 3(2) was amended to give the status of *lex specialis* to national tax laws over other domestic legislation in order to prevail in its application on interpretation matters.
[112] See Klaus Vogel, 'La Clause De Renvoi De L'article 3, Par. 2 Modele De Convention De L'OCDE', Réflection offertes a Paul Sibille, Études de fiscalité (1st edn, Établissments Émille Bruylant 1981).
[113] 'UK/Italy Double Taxation Convention' (N 110) 5.
[114] OECD (N 3) 2.

The MLI delegates the meaning of undefined terms to the DTT while the DTT refers the same to national legislation of the Contracting State applying it. It is a chain that may cause trouble to treaty interpreters. In the example regarding Art. 5 of the Italy-UK DTT and Art. 12 of the MLI, the meaning of legal terms[115] in the consolidated text will be tracked in three layers of legal text: the domestic legislation, the DTT and the MLI. For instance, the technical meaning of a PE is defined by the text in the DTT (as it may be modified by the MLI).[116] However, the definition of a 'closely related enterprise' is developed in Art. 15 of the MLI whereas other terms such as 'the transfer of ownership' (e.g. legal or economic ownership) will be determined through the application of domestic legislation.

The meaning and application of the *renvoi* clause in Art. 3(2) of the OECD and the UN Model Convention has been a disputed topic in doctrine. As pointed out by Lang, some authors focus on the phrase 'unless the context otherwise requires' and seek for an autonomous interpretation of DTTs, without reference to domestic legislation, whereas others ignore the phrase and, as a general rule, interpret undefined tax treaty terms in accordance with domestic law.[117] In search of a neutral position, other authors put emphasis on the word 'require' as taking into consideration the context only if supported by strong argumentation. Therefore, the *renvoi* clause in Art. 3(2) of the OECD and UN Model Convention has raised many questions related to interpretation that may be relevant for the interaction between the MLI and the existing DTT such as:[118]

- Should the term 'context' in Art. 3(2) be interpreted narrowly to include the text of the treaty only or broadly so as to include other means of interpretation specified in Articles 31 and 32 of the VCLT?
- Does the meaning of a term in its context, however defined always prevail over the meaning of same term under the domestic laws of the Contracting States, or does the word 'requires' in Art. 3(2) imply that there must be strong evidence that the parties intended a specific meaning?

The use of a *renvoi* clause is necessary as the MLI is not isolated from the DTTs but they are intimate, coexistent instruments. Contrary to the application of the *renvoi* clause in a DTT, the *renvoi* clause in the MLI is supported by compatibility clauses that dictate the scope of the reference of the MLI to the existing DTT. Also, both instruments share most of their legal terms and technical meanings. However, the context in which a term is used in the MLI and the DTT may differ as an interpreter has to analyze the weight of the text of the existing DTT against the

[115] The renvoi clause only deals with legal terms as terms not found in law should be interpreted in accordance with Articles 31 and 32 of the VCLT. Franciscus Antonius Engelen, Interpretation Of Tax Treaties Under International Law (1st edn, IBFD 2004), 485.
[116] According to the *renvoi* clause in the MLI, the term will have the meaning at the time when covered DTT was signed.
[117] Michael Lang, 'OECD - 2008 OECD Model: Conflicts Of Qualification And Double Non-Taxation' (2009) 63 Bulletin for International Taxation, 209.
[118] Engelen (N 115) 475.

purpose of the MLI which is to implement the tax treaty-related BEPS measures. Because the provisions of the MLI become part of the text of an existing DTT through the use of compatibility clauses, the context in which a term is used in the existing DTT should be interpreted in accordance with the purpose of the MLI. A case of conflicts of qualification is a good illustration of the latter statement.

Art. 5 of the MLI refers to the application of methods for the elimination of double taxation.[119] In brief, this asymmetric provision targets qualification problems from the application of DTTs in relation to domestic legislation. The three options given to the Contracting States require additional conditions for the Residence State to provide for exemption of income or a switch-over clause from exemption to the credit method. In any way, these options only affect existing DTTs that apply the exemption method. In the DTTs examined by Valente, this MLI provision would only be added to the Italy-Germany DTT[120] which determines a conditional exemption of dividends paid between companies-residents of both States and also for exemption in Germany of taxable income items in Italy.[121] If Option C of Art. 5 (switch-over clause to credit method) of the MLI is chosen by Germany, income taxable in Italy will qualify for deduction of the tax actually paid and not for exemption in Germany.[122] Assisted by a 'in place of' compatibility clause, Option C replaces the previous provision that granted an exemption with progression.

Similar to the existing provision in the Italy-Germany DTT, Art. 23(a) OECD and UN Model provides that a Contracting State is required to grant relief from double taxation, through the exemption method, if a resident of the Residence State derives income or owns capital which, in accordance with the provisions of the Convention (DTT), may be taxed in the Source State. The words 'in accordance with the provisions of this Convention, may be taxed' are read in the context of the *renvoi* clause for the purpose of an interpretation of Article 23(a). As Engelen states, this phrase is open to two interpretations:[123]

1. So far as the application of the DTT by the Residence State, any term not defined in the DTT should be deemed to have the meaning it has for the purposes of the relevant provisions in its domestic legislation. In this case, the Residence State is under no obligation to grant relief from double taxation in situations where the provisions of the DTT provide that the item of income concerned, as characterized under that State's domestic legislation, may not be taxed in the Source State. This way of interpretation ignores that the DTT provides that the item of income may be taxed in the Source State if characterized in accordance with the provisions of its domestic law.

[119] OECD (N 3) 6.
[120] 'Germany/Italy Double Taxation Convention' [1993] IBFD.
[121] Valente (N 105) 223.
[122] ibid.
[123] Engelen (N 115) 503-505.

2. A Residence State should grant relief from double taxation in cases where the provisions of the DTT provide that the income, as characterized under the Source State's domestic legislation, may be taxed in that State even if there is a possibility that the item of income may not be taxed in the Source State. In good faith, the Residence State cannot ignore its own obligation and the legal right of the Source State to characterize an item of income by reference to its domestic legislation.

If Article 23(a) is interpreted in good faith in accordance with the ordinary meaning to be given to the words 'in accordance with the provisions of this Convention, may be taxed' in their context and in the light of the object and purpose of the DTT, then the Residence State must comply with the characterization of an item of income according to the domestic legislation of the Source State unless the context requires differently.[124] The Residence State cannot escape its obligation on granting a relief for double taxation since an item of income is involved that may be taxed in the Source State. However, this reasoning diverges when a MLI provision is applied. A similar phrase appears in Option C of Art. 5 of the MLI that announces:

> Where a resident of a Contracting Jurisdiction derives income or owns capital *which may be taxed in the other Contracting Jurisdiction in accordance with the provisions of a Covered Tax Agreement (except to the extent that these provisions allow taxation by that other Contracting Jurisdiction solely because the income is also income derived by a resident of that other Contracting Jurisdiction)* (emphasis added) the first-mentioned Contracting Jurisdiction shall allow…[125]

In the author's opinion, based on the context of the MLI, the Residence State has no obligation to grant relief from double taxation if the item of income concerned, as characterized in that State, may not be taxed in the Source State. There is strong evidence, in the wording of the MLI and its clear preamble, that supports the meaning of terms in its context. Therein, the MLI provision does not only supersede the provision in the DTTs but also modifies the context in which the *renvoi* clause of the DTTs applies in regard of the text of the DTTs and the domestic laws of the Contracting States. Following the rules of interpretation in the VCLT, it is important that the context in which a term is used in the MLI leads to a result that opposes BEPS schemes while having in mind that the context itself may not give rise to an obligation that cannot be derived from the text of the DTTs referred.[126] These remarks concern any interpretation issue arising from the interaction of MLI provisions with existing DTTs.

[124] ibid, 506.
[125] OECD (N 3) 6.
[126] Schoueri (N 35) 3.

### 4.2.3. Incompatibility

With regard to conflict between treaties, incompatibility exists when it is possible for a party to two treaties to fulfill with an obligation only by thereby failing to comply with another obligation.[127] The MLI anticipates this issue in respect of the framework of compatibility clauses. Incompatibility exists when the two provisions being connected have opposite effects regarding a specific situation. In other words, if similar provisions in the MLI and the existing DTT are applicable simultaneously, they cannot be antagonistic to each other. As a result, one provision will have to prevail over the other.

The Explanatory Statement declares that 'an existing provision of a Covered Tax Agreement is considered 'incompatible' with a provision of the Convention if there is a conflict between the two provisions'.[128] The Explanatory Statement gives an example of incompatibility with Article 17 on corresponding adjustments.[129] The compatibility clause in Article 17(2) provides that this Art. will apply in place of or in absence of an existing provision that requires a Contracting State to make a corresponding adjustment if certain conditions are met. However, if the existing provision does not require a Contracting State to make a corresponding adjustment but instead allows discretion to perform it or not, then the existing provision will still be applicable unless it becomes incompatible with Art. 17 of the MLI. Incompatibility would arise if the existing provision permitted the Contracting State to neglect Art. 17 of the MLI even if the triggering conditions are fulfilled. In this situation, Art. 17 of the MLI would supersede the existing provision and replace it to the extent to avoid conflict between them.

Therefore, it can be deduced that incompatibility may arise whenever a discretionary provision in the DTT counters a MLI provision with a strict application. The latter are easily recognized as they introduce new conditions that shall be applied. For example, Art. 9 of the MLI presents an imperative testing period of 365 days to determine if the condition of the value threshold regarding capital gains or interest has been met. If the DTT provision disregards the testing period, both Arts. become incompatible and the MLI provision shall prevail.

Outside of the interaction between treaties, users may raise the question on the possibility of incompatibility between domestic legislation and the DTT provision as modified by the MLI. With reference to the MLI provisions as anti-abuse rules incorporated to DTTs, their application should be complementary to any national General Anti-Abuse Rules (GAARs) and should precede domestic rules that may allow prominence of BEPS schemes. However, treaty overrides will occur as the level of commitment on the application of the MLI is not the same for every State. In this

[127] International Law Commission of the United Nations (N 82) 19.
[128] OECD (N 15) 6.
[129] ibid, 7.

matter, States will need to rely on the improved Mutual Agreement Procedure (MAP) and the mandatory binding arbitration found in Article 16 and 18 of the MLI, respectively.

# 5. A Reflection on the Need of Common Interpretation

Throughout many years, the OECD and the UN have developed an international fiscal language which is reflected in the text of the worldwide DTT network. Tax treaties in general should be interpreted in a common way. Regarding DTTs, it is important that both parties interpret it in the same manner but it is almost as important that expressions frequently found in these conventions should have the same meaning.[130] Uniform criteria between both Contracting States establishes a common interpretation of the text and leads to a consistent application of the norms in it.

However, as Vogel and Prokisch argued in the 1993 IFA Cahiers, the practical problem of common interpretation is linked with the problem of information.[131] Even in a globalized world, courts and authorities around the globe will not know of relevant decisions made in other States. Also, due to language barriers, a variety of translations would be needed to understand how countries are applying DTTs. To fix this issue, the constant consideration of model conventions and their commentaries as part of the context of the DTT or a supplementary means of interpretation has eased the decision-making process in countries like Belgium and Austria.[132]

In the case of the MLI, there is also a need for common interpretation of its text as it modifies the DTTs. Nonetheless, as this instrument has not entered into force, a thorough analysis of the particular interpretation for each MLI provision cannot be made yet. Still, it is essential to establish a common ground in doctrine regarding the application of the MLI and its internal systems to achieve the coordinated interpretation of its provisions. It is critical to search for a common interpretation on two specific subjects: The interaction of the MLI's text with the content of the DTTs and how the resulting modification should be read within the context of the MLI. As Reiner asserts, the requirement of common interpretation concerning international treaties derives from the fact that it is necessary to achieve their object and purpose.[133]

Eventually, to solve any interpretation issue, consolidated or annotated texts for DTTs will be needed by the States. However, the lack of a mechanism in the MLI to produce these texts will conclude in the complexity of determining the precise wording change to a particular DTT according to the reservations formulated by the Contracting States and the compatibility clauses for each provision.[134] If this situation triggers rounds of new, long-lasting bilateral negotiations to

[130] John Prebble, 'Interpretation Of Double Taxation Conventions' (2015) 5 Victoria University of Wellington Legal Research Papers, 483.
[131] Klaus Vogel and Rainer Prokisch, 'Interpretation Of Double Taxation Conventions' [1993] IFA Cahiers, 64.
[132] See Michael Lang, Tax Treaty Interpretation (1st edn, Kluwer Law International 2002).
[133] Ekkehart Reimer, 'Interpretation Of Tax Treaties' (1999) 39 European Taxation, 458-474
[134] Hattingh (N 32) 5.

develop the actual textual changes to their DTTs, then it might have not been worth it to create such a complex instrument.

# 6. Conclusions

This thesis aimed to determine how the interaction between the MLI and the existing DTTs will transform the text of the latter in order to dissipate new interpretative challenges. The author has analyzed this subject in two different parts: a) an overview of the MLI and its interpretation; and, b) an examination of its reservations and compatibility system. In this respect, the following concluding remarks can be drawn.

The text of a treaty is the primary object of interpretation.[135] The MLI, as a third layer of content, comes into play to alter the text of DTTs with new sets of taxation rules. Consequently, it will modify the way in which DTTs will be interpreted as users will have to take into consideration a new instrument with different provisions. Following Art. 31 of the VCLT, the MLI has to be interpreted in 'good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its objective and purpose'. The Explanatory Statement and the BEPS Final Reports form part of this context while the implementation of tax treaty-related BEPS measures must be regarded as the object and purpose of the MLI.

The implementation of BEPS measures requires a high level of commitment between the Signatory States of the MLI. For this reason, flexibility is an inherent trait of the MLI that provides certain freedom to the States on how to apply this multilateral agreement. This characteristic creates varied ranges of possibilities on the applicable content of the MLI and the wording of the existing DTTs, establishing unevenness in the tax treaty landscape. In the MLI, the main tools that achieve the flexibility needed to attract every country are the reservations system and the compatibility clauses.

Whenever a Contracting State formulates a reservation in the MLI, there will be an effect on the wording of the modified provision in the DTT as a consequence of the legal effects of reservations in combination with the bilateral nature of DTTs. Congruent to the flexibility of the MLI, amendments enacted by reservations should be interpreted in a way that only the words in common between a reserving State and an accepting State provide modifications of their DTT. Formulated reservations will define the MLI provisions that will be taken into account in the use of compatibility clauses.

The relationship between the MLI and DTTs is regulated by different types of compatibility clauses. In general, compatibility clauses in the MLI follow the spirit of the *lex posterior* principle as they establish that provisions in the MLI have primacy over those in the existing DTT.

[135] Engelen (N 115) 417.

Compatibility clauses determine if the MLI provision annuls the clause in the DTT, overlaps on its text or changes the wording of the existing provision. However, their effectiveness depends on the identification of the affected provisions and its notification by the Contracting States.

In the application of compatibility clauses, Contracting States should establish the consolidated text between the MLI and the existing DTT to prevent the user of the MLI from ignoring relevant text or adding excluded content to it. This consolidated text combines two different legal texts that should be interpreted simultaneously. As a result, the undefined terminology replacing the text in the existing DTT has to be given a meaning according to their respective *renvoi* clauses.

It is a fact that both instruments share most of their legal terms as they were developed in the international fiscal language. Nonetheless, as shown through the case of conflicts of qualification, the context in which a term is used in the MLI and the DTT may differ. When the text of a DTT as modified by the MLI is examined, it should be interpreted in accordance with the purpose of the MLI. The ordinary meaning given to undefined terms in the MLI has to be in line with the context conceived by the BEPS Project. In summary, the author demonstrates how the MLI establishes new taxation rules and different context that brings out new ways of understanding the text of DTTs.

With the culmination of this thesis, the author encourages tax experts to become more interested on the development of the MLI and its application. Also, as Douma states, the BEPS Project provides a unique opportunity for international tax lawyers to become more acquainted with international law as much can be learned from it.[136] Most certainly, new international instruments will be developed by the OECD and the UN. If the MLI becomes a successful achievement, the trend of the internationalization of tax law will continue further and different unconventional interactions will arise to change the global tax treaty network.

[136] Sjoerd Douma, Legal Research In International And EU Tax Law (1st edn, Kluwer 2014), 15-16.

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