



# KPMG Japan Tax Newsletter

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## MULTILATERAL INSTRUMENT (MLI)

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On 26 September, the Japanese government deposited its instrument of acceptance for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI: Multilateral Instrument) with the Organisation for Economic Co-operation and Development (OECD). As a result, the MLI shall enter into force on 1 January 2019 for Japan.

We have set out below an outline of the MLI and the impact that the MLI may cause to the existing tax treaties concluded by Japan.

## I. Outline of the MLI

### 1. Background of Development of the MLI and History of Signature/Entry into Force

The amendment of tax treaties is required in order to implement some of the recommendations made under the Base Erosion and Profit Shifting (BEPS) project. However, as it takes a lot of time to change bilateral tax treaties one by one, the MLI was developed under Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties). The MLI is a mechanism to amend simultaneously and efficiently existing tax treaties to be in line with the recommendations made under the BEPS project.

The text of the MLI was released in November 2016. The history after the release with respect to signature/entry into force of the MLI is as follows:

#### [Signature]

67 jurisdictions (including Japan) signed the MLI on 7 June 2017 (8 June 2017 in Japan). As of 27 September 2018, the number of signatories has reached 82 jurisdictions and 84 jurisdictions (including Hong Kong and Curacao on behalf of which China and the Netherlands signed respectively) are covered.

#### [Entry into force]

The current status of the entry into force of the MLI is as follows:

- 1 July 2018: Austria, Isle of Man, Jersey, Poland and Slovenia (the first 5 jurisdictions which deposited the instrument of ratification)
- 1 October 2018: Serbia, Sweden, New Zealand and the UK
- 1 January 2019: Japan, Australia, France, Israel, Lithuania and Slovak Republic

### 2. Features of the MLI

- The MLI does not function in the same way as existing tax treaties that operate by themselves. It is applied alongside existing tax treaties, replacing or modifying provisions of the tax treaties.
- The tax treaty-related BEPS measures reflected in the MLI include minimum standards (measures that each jurisdiction must implement); i.e. Article 6 (Purpose of a Covered Tax Agreement), Article 7 (Prevention of Treaty Abuse) and Article 16 (Mutual Agreement Procedure). As the minimum standards can be satisfied in multiple different ways, the MLI provides flexibility in such provisions.
- For a provision that does not reflect a minimum standard, a Party of the MLI is generally given the flexibility to opt out of that provision entirely (or part of that provision) or opt out from applying the provision to tax treaties containing specific provisions (e.g. provisions that have already reflected BEPS measures). Some of these provisions include options that a Party can choose to apply to its tax treaties.

- A Signatory (Party) is required to submit its MLI position to represent its reservations, choices and a list of its Covered Tax Agreements (please see 'II. Covered Tax Agreements' for details) to the Depository (the Secretary-General of the OECD). It is common to submit a provisional list of the MLI position at the time of signature and then to submit a definitive list when depositing the instrument of ratification, acceptance or approval.

### 3. Structure of the MLI

The articles of the MLI and the relation between each article and each Action of the BEPS project under which recommendations for tax treaty-related BEPS measures were represented are shown below:

Articles of the MLI		BEPS measures
Part I. Scope and Interpretation of Terms		
Article 1	Scope of the Convention	
Article 2	Interpretation of Terms	
Part II. Hybrid Mismatches		
Article 3	Transparent Entities	Action 2 Neutralising the Effects of Hybrid Mismatch Arrangements (Article 4 also comes from Action 6)
Article 4	Dual Resident Entities	
Article 5	Application of Methods for Elimination of Double Taxation	
Part III. Treaty Abuse		
Article 6	Purpose of a Covered Tax Agreement	Action 6 Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
Article 7	Prevention of Treaty Abuse	
Article 8	Dividend Transfer Transactions	
Article 9	Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property	
Article 10	Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions	
Article 11	Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents	
Part IV. Avoidance of Permanent Establishment Status		
Article 12	Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies	Action 7 Preventing the Artificial Avoidance of Permanent Establishment Status
Article 13	Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions	
Article 14	Splitting-up of Contracts	
Article 15	Definition of a Person Closely Related to an Enterprise	
Part V. Improving Dispute Resolution		
Article 16	Mutual Agreement Procedure	
Article 17	Corresponding Adjustments	
Part VI. Arbitration		
Article 18 – Article 26		
Part VII. Final Provisions		
Article 27 – Article 39		

Note that tax treaty-related BEPS measures were also introduced in the OECD Model Tax Convention in the 2017 update based on the recommendations of the BEPS project.

## II. Covered Tax Agreements (CTA)

A Covered Tax Agreement (CTA) is a tax treaty with respect to which each Party has made a notification to the Depository listing the tax treaty as a tax treaty which it wishes to be covered by the MLI. Where both Contracting Jurisdictions to a tax treaty choose the tax treaty as a CTA, the MLI will be applied to the tax treaty.

Japan has chosen 39 tax treaties concluded with the following jurisdictions as CTAs:

Australia, Bulgaria, Canada, China, Czech Republic, Egypt, Fiji, Finland, France, Germany, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Kazakhstan, Korea, Kuwait, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Pakistan, Poland, Portugal, Romania, Saudi Arabia, Singapore, Slovak Republic, South Africa, Sweden, Turkey, Ukraine, UAE, UK

- The above jurisdictions have notified tax treaties concluded with Japan as CTAs to the Depository. (Note that the information is based on provisional lists for jurisdictions that have not yet ratified, which means it is subject to change.)
- Australia, France, Israel, New Zealand, Poland, Slovak Republic, Sweden and the UK have already deposited their instruments of ratification, acceptance or approval for the MLI to the Depository. (Please see 'I. 1. Background of Development of the MLI and History of Signature/Entry into Force' for the date of entry into force for these jurisdictions.)

## III. Impact of the MLI

We discuss in this section the main impact that the MLI may have on tax treaties concluded by Japan.

(The OECD provides the MLI Matching Database, which is a tool to find matching results of the MLI position of each jurisdiction for a CTA. In this section, we have set out the application of the MLI provisions with respect to Japan's CTAs based on the MLI Matching Database updated on 27 September 2018. There are cases where 'notification mismatch' appears in the database. This is generally because both Contracting Jurisdictions to a CTA have notified different numbers of clauses of the CTA to be replaced by the MLI provisions. Where 'notification mismatch' appears and it is reasonable to understand that the MLI provisions would be applied considering their MLI positions (e.g. where both Contracting Jurisdictions have not made any reservations), we indicate that the MLI provisions would apply.

Please note that the MLI position notified by each jurisdiction before its ratification is generally a provisional list and the MLI Matching Database is a beta version that is being improved over time. Thus, it is recommendable to double-check the original documents of the MLI positions of Contracting Jurisdictions to the relevant CTA before taking any action.)

## 1. Prevention of Treaty Abuse

Article 7 (Prevention of Treaty Abuse) (1) of the MLI provides for the Principal Purpose Test (PPT) provision, which is similar to Article 29 (Entitlement to Benefits) (9) of the OECD Model Tax Convention. The text of Article 7 (1) is as follows:

Notwithstanding any provisions of a CTA, a benefit under the CTA shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the CTA.

Article 7(1) of the MLI will apply to CTAs between Japan and the following jurisdictions:

Bulgaria, Canada, China, Czech Republic, Egypt, Fiji, Finland, Hungary, India, Indonesia, Ireland, Israel, Italy, Kazakhstan, Korea, Kuwait, Luxembourg, Malaysia, Netherlands, Norway, Pakistan, Poland, Romania, Singapore, Slovak Republic, Turkey, Ukraine

(Canada, Kuwait, Norway and Poland have expressed statements that while they accept the application of Article 7(1) alone as an interim measure, they intend where possible to adopt a Limitation on Benefits (LOB) provision, in addition to or in replacement of Article 7(1), through bilateral negotiation.)

(based on the MLI Matching Database updated on 27 September 2018)

Furthermore, Article 7(1) of the MLI will apply to CTAs between Japan and the following jurisdictions in place of provisions to deny treaty benefits depending on the purposes of arrangements (i.e. provisions that deny all or part of treaty benefits that would otherwise be provided where the principal purpose or one of the principal purposes of any arrangement or transaction, or of any person concerned with an arrangement or transaction, was to obtain those benefits) of the CTAs:

Australia, France, Hong Kong, Mexico, New Zealand, Portugal, Saudi Arabia, South Africa, Sweden, UAE, UK

(based on the MLI Matching Database updated on 27 September 2018)

The coverage of provisions to deny treaty benefits depending on the purposes of arrangements included in some of Japan's CTAs is limited to benefits for certain income. Thus, for example, while benefits with respect to dividends, interest, royalties and other income are subject to the PPT under the Japan-UK tax treaty, all benefits under the tax treaty will be subject to the PPT after the MLI is applied.

Note that to increase tax certainty in the application of the PPT, the OECD has formed an informal group of interested delegates that will explore various areas where more tax certainty could be provided in the PPT, including best practices

in the area of the general anti-avoidance rules and will report back with recommendations.

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Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) of the BEPS project recommended as a minimum standard that jurisdictions should include in their tax treaties: (i) a PPT only; (ii) a PPT and an LOB provision; or (iii) a Detailed LOB provision, supplemented by an anti-conduit provision. In this context, Article 7 includes a Simplified LOB provision as an option to apply it with respect to CTAs as well. Japan has not chosen to apply this option.

Furthermore, where a Contracting Jurisdiction to a CTA (not both Contracting Jurisdictions) chooses to apply the Simplified LOB provision, the provision may be applied with respect to the CTA by both Contracting Jurisdictions or by the Contracting Jurisdiction that chooses to apply the Simplified LOB provision, upon an agreement/choice by the other Contracting Jurisdiction. Japan has not expressed such an agreement/choice. Therefore, the Simplified LOB provision of the MLI will not apply to any of Japan's CTAs.

## 2. Prevention of Artificial Avoidance of PE Status

### (1) Agent PE

A provision for the definition of a PE in a tax treaty generally includes a clause to define the scope of an agent PE, whereunder a person having and habitually exercising an authority to conclude contracts in the name of an enterprise is defined as an agent PE for the enterprise and an independent agent does not constitute an agent PE.

Article 12 (Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies) of the MLI provides for BEPS measures to prevent artificial avoidance of agent PE status.

- Article 12 (1) (similar provision to Article 5 (Permanent Establishment) (5) of the OECD Model Tax Convention)

Article 12 (1) provides that a commissionnaire is also treated as an agent PE in addition to a person having and habitually exercising an authority to conclude contracts in the name of an enterprise.

- Article 12 (2) (similar provision to Article 5 (6) of the OECD Model Tax Convention)

Article 12 (2) provides that an independent agent does not constitute an agent PE and a person acting exclusively on behalf of its closely related enterprise is not considered to be an independent agent.

- Application of Article 12 to Japan's CTAs

Article 12(1) and (2) of the MLI will apply to CTAs between Japan and the following jurisdictions in place of the existing provisions:

Egypt, Fiji, France, India, Indonesia, Israel, Kazakhstan, Malaysia, Mexico, Netherlands, New Zealand, Norway, Romania, Saudi Arabia, Slovak Republic, Turkey, Ukraine

(based on the MLI Matching Database updated on 27 September 2018)

## (2) Provision for the specific activity exemptions

A provision for the definition of a PE in a tax treaty generally includes a provision for the specific activity exemptions (i.e. a provision having a list of specific activities that do not constitute a PE).

Article 13 (Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions) of the MLI provides for BEPS measures to prevent artificial avoidance of PE status by utilizing such a provision.

- Article 13 (2) (similar provision to Article 5 (4) of the OECD Model Tax Convention)

Article 13 (2) provides Option A as a provision for the specific activity exemptions. Under Option A, all listed activities must be of a preparatory or auxiliary character in order for them to be exceptions to PE status.

Japan and the following jurisdictions have chosen Option A. Thus, Article 13 (2) (Option A) of the MLI will be applied to CTAs between Japan and these jurisdictions in place of the existing provisions for the specific activity exemptions in the CTAs:

Australia, Egypt, Fiji, Germany, India, Indonesia, Israel, Italy, Kazakhstan, Kuwait, Malaysia, Mexico, Netherlands, New Zealand, Norway, Romania, Saudi Arabia, Slovak Republic, South Africa, Turkey, Ukraine

(based on the MLI Matching Database updated on 27 September 2018)

Article 13 (3) provides Option B as a provision for the specific activity exemptions. Under Option B, being of a preparatory or auxiliary character is not required for activities which are considered per se exceptions to PE status irrespective of whether they are of a preparatory or auxiliary character under a CTA.

- Article 13 (4) (similar provision to Article 5 (4.1) of the OECD Model Tax Convention)

Article 13 (4) provides for the anti-fragmentation rules, which operate to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to avoid a PE status.

Article 13(4) (the anti-fragmentation rules) will be applied to CTAs between Japan and the following jurisdictions:

Australia, Egypt, France, India, Indonesia, Ireland, Israel, Italy, Kazakhstan, Kuwait, Malaysia, Mexico, Netherlands, New Zealand, Norway, Portugal, Romania, Saudi Arabia, Slovak Republic, South Africa, Turkey, Ukraine, UK

(based on the MLI Matching Database updated on 27 September 2018)

### 3. Improving Dispute Resolution/Arbitration

#### (1) Mutual agreement procedure

Article 25 (Mutual Agreement Procedure) (1) of the OECD Model Tax Convention was amended in the 2017 update to include a BEPS measure. While a taxpayer was allowed to submit a Mutual Agreement Procedure (MAP) request only to the competent authority of a Contracting Jurisdiction where the taxpayer is a resident (or a national for issues caused by discrimination due to nationality) before the update, a taxpayer is allowed to submit a MAP request to the competent authority of either Contracting Jurisdiction of the relevant tax treaty after the update.

Article 16 (Mutual Agreement Procedure) of the MLI provides for provisions that are similar to Article 25 (1), (2) and (3) of the OECD Model Tax Convention as minimum standards. As a Party is allowed to make reservations to opt out of such provisions on the basis that it intends to meet the minimum standard by using certain different ways, some jurisdictions for Japan's CTAs have made the reservations. Thus, provisions for the MAP of Japan's CTAs will be generally modified to be in line with Article 25 of the OECD Model Tax Convention except for cases where they were concluded with the jurisdictions that have made the reservations.

#### (2) Corresponding adjustments

Article 17 (Corresponding Adjustments) of the MLI provides a provision that is similar to Article 9 (Associated Enterprises) (2) of the OECD Model Tax Convention.

Article 17 (1) of the MLI will be applied to Japan's CTAs which do not include provisions for corresponding adjustments:

China, Fiji, Finland, Hungary, Ireland, Italy, Poland, Romania, Slovak Republic

(based on the MLI Matching Database updated on 27 September 2018)

#### (3) Arbitration

Japan has chosen to apply Part VI (Arbitration) of the MLI with respect to its CTAs and 15 jurisdictions which are Contracting Jurisdictions to Japan's CTAs have also chosen to apply Part VI of the MLI. However, as Japan and some of the jurisdictions have reserved the right for Part VI of the MLI not to apply with respect to CTAs including mandatory binding arbitration provisions, Part VI of the MLI will be applied to CTAs between Japan and the following 9 jurisdictions:

Australia, Canada, Fiji, Finland, France, Ireland, Italy, Luxemburg, Singapore

(based on the MLI Matching Database updated on 27 September 2018)

Note that as a Party may formulate reservations with respect to the scope of cases being eligible for arbitration, and Japan and some of the above jurisdictions have made the reservations, the scope of cases being eligible for arbitration may be restricted.



## IV. Entry into Effect

### 1. Basic Rules

The provisions of the MLI shall have effect in each Contracting Jurisdiction with respect to a CTA as follows:

#### (1) Taxes withheld at source

Amounts paid or credited to non-residents, where the event giving rise to such taxes occurs on or after the first day of the next calendar year that begins on or after the latest of the dates on which the MLI enters into force for each of the Contracting Jurisdictions to the CTA

Note that 'calendar year' in the above will be replaced with 'taxable period' with respect to the timing of entry into effect for the following jurisdictions due to their choices:

Hong Kong, India, Israel, Pakistan

(based on the MLI Matching Database updated on 27 September 2018)

#### (2) All other taxes

Taxes levied with respect to taxable periods beginning on or after the expiration of a period of 6 calendar months (or a shorter period, if both Contracting Jurisdictions notify the Depository that they intend to apply such shorter period) from the latest of the dates on which the MLI enters into force for each of the Contracting Jurisdictions to the CTA

Note that 'taxable periods beginning on or after the expiration of a period' in the above will be replaced with 'taxable periods beginning on or after 1 January of the next year beginning on or after the expiration of a period' with respect to the timing of entry into effect for the following jurisdictions due to their choices:

Bulgaria, Finland, Germany, Hungary, Indonesia, Israel, Italy, Mexico, Romania, Sweden

(based on the MLI Matching Database updated on 27 September 2018)

#### [Note]

A Party may reserve the right to replace 'the latest of the dates on which the MLI enters into force for each of the Contracting Jurisdictions to the CTA' in provisions discussed in (1) and (2) with '30 days after the date of receipt by the Depository of the latest notification by each Contracting Jurisdiction making the reservation described in Article 35 (7) (the clause that provides for this reservation) that it has completed its internal procedures for the entry into effect of the provisions of the MLI with respect to that specific CTA'.

A Party making the reservation shall notify the confirmation of the completion of its internal procedures simultaneously to the Depository and the other Contracting Jurisdiction.

Although Japan has not made the reservation, as the following jurisdictions have made the reservation, the replacement will be applied to CTAs between Japan and the following jurisdictions:

Germany, Hong Kong, India, Italy, Romania, Sweden
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(based on the MLI Matching Database updated on 27 September 2018)

## 2. Special Measures

Notwithstanding the basic rules discussed in 1., there are special measures for entry into effect of Article 16 (Mutual Agreement Procedure) and Part VI. (Arbitration).

### 《Related information》

The following page on the Japanese Ministry of Finance website provides various information about the MLI:

- Convention to Implement Measures to Prevent BEPS (MLI)  
([https://www.mof.go.jp/english/tax\\_policy/tax\\_conventions/mli.htm](https://www.mof.go.jp/english/tax_policy/tax_conventions/mli.htm))

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