OECD releases discussion draft on the use of treaty benefits in inappropriate circumstances

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In brief

This OECD report calls for a very significant rewrite of both the OECD Model Tax Convention and the Commentary, including a US-style Limitation of Benefits (LoB) article as well as a main purpose anti-abuse rule. A variety of other anti-abuse measures are also proposed. If the recommendations are widely adopted, they will undoubtedly reduce treaty abuse, but also create significant uncertainty for international business. Given that tax treaties play such a critical role in removing barriers to cross-border trade and investment the primary concern with these OECD proposals is that their focus on combating treaty shopping will have a disproportionate impact on cross-border commercial activity.

The OECD's discussion draft issued March 14, 2014 on Action 6 of the Base Erosion and Profit Shifting (BEPS) project puts forward these options for consultation in dealing with prevention of the granting of treaty benefits in what it sees as 'inappropriate circumstances'.

The discussion draft is divided into three primary sections. The first addresses the development of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. The second concerns clarifying that tax treaties are not intended to be used to generate double non-taxation. The third deals with identifying the tax policy considerations that countries should consider before deciding to enter into a tax treaty with another country.

Written responses are requested by April 9. A public consultation is scheduled for April 14/15 but those attending and those wishing to speak will have to be invited to do so, following an application to be received by the OECD by April 3.

In detail

Background to Action 6 of the BEPS project

The BEPS Action Plan identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Action 6 (Prevent Treaty Abuse) describes the work to be undertaken in this area. The relevant part of the Action Plan reads as follows:

"*Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax*

treaty with another country. The work will be co-ordinated with the work on hybrids."

The discussion draft points out that the Commentary on Article 1 of the OECD Model Tax Convention already includes a number of examples of provisions that could be used to address treaty abuse, which may give rise to double non-taxation. Tight treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will, it states, contribute to restore source taxation in a number of cases.

Treaty shopping: limitation on benefits provision

The discussion draft recommends the inclusion in tax treaties of a specific anti-abuse rule based on existing LoB provisions. It specifically refers to the examples included in treaties concluded by the United States and the detailed proposals (which are lengthy) seem to be based on the US approach.

There is no 'derivative benefits' provision currently included (essentially, a derivative benefits provision would mean that if a non-qualifying treaty resident is owned by parties which would themselves be eligible to the benefits of the treaty or another treaty with no less favourable terms, then the treaty may still apply). The OECD suggests that there are possible arguments to support either the inclusion or exclusion of such a clause. It asks for comments and examples to help in arriving at a final decision on whether such a clause should be included.

Observations: In principle, we support the use of more objective tests to police treaty abuse on the basis that this will deliver a greater level of certainty. However, we have concerns that what seems to be the wholesale adoption of the US approach will lead to an inappropriately restrictive outcome.

The US treaty LoB article has evolved over many years, appearing in several different forms. The proposed LoB in the OECD draft includes a series of largely objective tests of qualifying residence status by virtue of ownership (para 2) or business substance (para 3) that must be satisfied. Para 4 provides a relieving provision that the competent authority may apply if a series of largely objective factors indicate that one of the principal purposes of the parties was not the obtaining of benefits under the treaty. The framing of the US LoB tests in US treaties has been materially affected by US domestic tax policy factors (for example, the wish to impose anti-inversion mechanisms).

Perhaps not surprisingly, the US treaty experience indicates that the objective tests can in some cases render residents of a Contracting State as ineligible, notwithstanding the apparent inappropriateness of this result. Whilst the provision does contain a facility to seek relief in such circumstances where treaty abuse is not in point, the process for seeking such relief can be both uncertain and very time consuming. This is of especial concern where, as in the financial services sector, extensive use may need to be made of such a clearance mechanism. Further, the tests in both paras 2 and 3 are open to widely differing interpretations. Hence the treaty Commentary promised in the OECD discussion draft will need to be crafted with some care to reduce the risk of widespread uncertainty leading to an adverse impact on international business.

Treaty shopping: main purpose or general anti-abuse rule

To address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB provision (such as certain conduit financing arrangements), the discussion draft recommends adding to tax treaties a more general anti-abuse rule.

According to the discussion draft, that rule should incorporate into a tax treaty the principle that its benefits should not be available where one of the main purposes is securing a treaty benefit. The discussion draft goes on to state that neither should it be possible to obtain those benefits if this result would be contrary to the object and purpose of the relevant provisions of the tax treaty.

The discussion draft indicates that detailed Commentary will be produced on how such main purpose/ anti-abuse rule should operate (including the process by which a treaty claimant can produce 'counter evidence').

The intention is clearly to supplement the LoB provision. This means that passing the LoB test would not, of itself, exclude the application of the main purpose/ anti-abuse rule.

It is also suggested that the broader context of the Model Tax Convention (and Preamble), updated as set out below, should provide broader guidance on what is acceptable.

In framing this main purpose test it is clarified that a tax treaty 'benefit' should be broadly defined as including any limitation in the amount of tax due to one of the Contracting States. Accordingly, a benefit is widely defined. Some examples have been listed in the discussion draft and respondents are invited specifically to comment on them.

Observations: The main concern relating to the proposed introduction of this new main purpose/ anti-abuse rule is the potential for it to lead to a

high degree of uncertainty, particularly if introduced by tax authorities with little experience in applying such a rule and without the domestic jurisprudence to interpret the concept.

The apparent breadth of its scope, and the fact that it may be applied independently of the LoB clause add to these concerns. Many countries already have a general anti-avoidance rule (GAAR) which often extends to nullify treaty benefits under domestic law. Further, such domestic law may have a 'dominant purpose' test, whereas the proposed rule simply has a 'one of the main purposes' test. This means there would be three levels of test (treaty LoB, treaty main purpose rule, domestic main purpose rule) all of which would need to be addressed, raising clear potential for conflicts of interpretation and application.

Overall, the approach proposed in the discussion draft seems overly protective and may go so far as to discourage legitimate trade. While we recognise there are reasons to support either have a LoB article or a GAAR within the treaty, the inclusion of both may well prove problematic in the application of treaties.

The examples in the discussion draft which are intended to set out what would and what would not be caught by such a main purpose rule deal with relatively extreme situations (rather than practical situations which genuinely test the distinctions being drawn) and therefore they are not overly helpful. This means that much will ride on the development of the promised 'detailed Commentary' on the rule. It will be important that such Commentary provides more clarity on the practical application of these proposals and the 'burden of proof' as to purpose.

Specific anti-avoidance rules where persons otherwise seeking to circumvent treaty limitations

In addition to the need for a general anti-abuse rule, as set out above, the OECD sees the need for various targeted anti-abuse measures. A number of examples where such measures might be required are listed in the discussion draft. These include measures to combat:

- artificial splitting-up of contracts arranged to support permanent establishment (PE) planning;
- hiring-out of labour to circumvent the operation of the treaty provisions on income from employment;
- certain transactions relating either to dividend characterisation or the transfer of dividends which are designed to reduce to incidence of withholding; and
- transactions that circumvent a capital gains charge on immovable property .

It is also proposed that changes are required to the tie-breaker rules for determining the treaty residence of a dual-resident person. An anti-abuse rule for PEs in third country states (i.e. to deal with cases of triangulation) is also proposed.

Observations: The range of specific provisions clearly raises a wide variety of points. Further, as the discussion draft notes, some of these issues require more consideration or are to be addressed under another BEPS Action Plan item. In relation to those specific points on which immediate change is proposed, we would comment as follows.

On dividend transfer transactions, the proposed holding period which must be satisfied before treaty benefits are available does not seem unduly onerous provided the minimum period required is reasonable.

In relation to the proposals on tie-breakers for determining treaty residence, our concern is that replacing the traditional tie-breaker rule with a mutual agreement procedure, as proposed, is unlikely in practice to be an improvement, as prior experience of such a rule in some treaties has shown. In our view the proposals need to be improved further to provide a more efficient and timely outcome for dealing with dual residents under treaties.

In the case of PEs and triangulation, the proposal to require a minimum effective tax rate before a PE in a third country can be afforded treaty benefits would represent a major departure from the existing operation of most tax treaties and would seem to require justification in any particular case on the grounds of treaty abuse rather than simply by reference to an effective tax rate measure.

Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

To counter certain abuse, the discussion draft suggests it may be necessary to change domestic law in some territories. The main purpose would be to avoid the situation in which treaties can be used to prevent the application of domestic anti-abuse rules. The OECD quotes, by way of example, cases involving thin cap, dual residence, transfer pricing and anti-arbitrage rules.

The discussion draft confirms that many of these situations will be dealt with under the BEPS Action Plan in any event. However, a number of changes are proposed to the OECD Model to reinforce the point that a tax treaty may generally not be used to prevent the taxation under domestic legislation of its residents by a contracting state.

Observations: The discussion draft proposals for the Model Convention will allow contracting states to invoke their domestic anti-abuse provisions, irrespective of the specific treaty otherwise applying, except for a limited number of cases which are listed and further explained in new text which is proposed should be inserted in the Commentary on article 1.

This would be a significant change given that articles 26 and 27 of the Vienna Convention on the Law of Treaties typically require in such a situation that the treaty should prevail over domestic law.

It will be important that the OECD guidance distinguish between domestic laws that are truly anti-abuse and those that are treaty overrides.

Other provisions

It is recommended in the discussion draft that a clear statement be included in the Title and Preamble of treaties that the contracting states wish to prevent tax avoidance and treaty shopping. In particular, there should be a clear indication that a treaty is not intended to be used to generate double non-taxation.

Additional wording should also be included, it states, to reflect the wish to improve administrative co-operation, notably through exchange of information and assistance in collection of taxes.

It is also proposed to insert into the Introduction to the OECD Model a new discussion dealing with tax policy considerations which should be taken into account in the decision of whether to enter into a tax treaty or amend an existing treaty.

Observations: The proposal expressly to broaden the purpose of treaties by the inclusion of references to the prevention of tax avoidance and evasion in the title of treaties (as well as adding wording to this end in the Preamble and Introduction) reinforces the overall messages from the discussion draft. Although presumably not intended, it is possible this might encourage some states to the view that even after the application of the various anti-avoidance tests there remains a further residual anti-abuse principle based on this new wording.

With regard to the last segment of the discussion draft which sets out a number of valid considerations that contracting states should bear in mind before entering into a tax treaty, there is a suggestion that many cases of double taxation can be resolved through domestic law changes. It will be important that this endorsement of unilateral change does not open the door to uncoordinated action.

Building on other work of the OECD

The OECD is at pains to point out that it has already carried out much previous work in this area. Some of that has resulted in Commentary to the Model Tax Convention which, it suggests, will reinforce the current recommendations. Other work is still ongoing alongside the BEPS project. In particular, the discussion draft refers to:

- 1977: introduction of the beneficial ownership concept in the Model Tax Convention
- 1986: reports on the use of base/ conduit companies
- 1992: examples added to Commentary on art.1
- 2003: report on restricting entitlement to treaty benefits
- Present: ongoing work on clarification of the beneficial ownership concept.

Observations: The beneficial ownership concept has caused confusion for some time due to a) its use by some tax authorities as an anti-abuse measure, notwithstanding that it is not intended to fulfil that function; and b) the difference in interpretation as between Civil Law countries and Common Law countries which has led to a wide range of contradictory case law. In that context, the use of an alternative solution (such as a LoB) offers the potential for improvement. However, it remains to be seen how this can be reconciled with the beneficial ownership concept in the context of EU Directives, for example as followed by Germany and Austria which have applied the concept strictly to address treaty shopping.

The takeaway

Tax treaties play a critical role in removing barriers to cross-border trade and investment. The introduction to the BEPS Action Plan recognises this and underscores the importance of establishing “agreed international rules which are clear and predictable, giving certainty to both governments and businesses”. If, in addressing the legitimate concerns of treaty abuse, rules are incorporated that create uncertainty and unpredictability for taxpayers about whether they’re going to be eligible for the benefits of a treaty, this key role of tax treaties is undermined. The focus of the discussion draft on combatting treaty shopping without an appropriately balanced regard for its potential impact on the vast majority of the global business community that are not engaging in treaty shopping is a matter of concern.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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