The OECD Discussion Draft on BEPS Action 6 (Prevent treaty abuse): A critical analysis

By Etter R. Hoor and Pere Kreemer

On 14 March 2014, the OECD released its Commentary entitled “Preventing the granting of Treaty Benefits in Inappropriate Circumstances” (the “Discussion Draft”) for public consultation. The Discussion Draft includes proposals in relation to tax treaty abuse. The OECD received more than 60 public comments on this issue, which were considered in the Discussion Draft.

The OECD Commentary provides a critical analysis of the proposals contained in the Discussion Draft and considers limitations set by EU law.

I. Introduction

Treaty abuse is an important and well-established feature of the international tax system. The main purpose is to promote cross-border trade and investment, which is also a fundamental principle of the OECD tax conventions. The treaties aim to prevent double taxation, ensure taxable income is obtained, and avoid tax evasion and avoidance.

II. What is treaty shopping and how is it tackled?

Treaty shopping can be defined as the use of tax treaties to artificially shift income from high-tax to low-tax jurisdictions, with the aim of reducing tax liabilities. The OECD multilateral instrument (OECD-MC) on erosion baseless of tax treaties, including in a “limitation on the benefits” (LOB) provision, which is to be inserted into the OECD-MC.

III. Critical review of the Discussion Draft

1. Opening comments

The Discussion Draft recommends a three-pronged approach to address situations of treaty shopping:

a) Clarify in the title and the preamble of tax treaties and the Commentary thereto provide for a number of anti-abuse provisions to be inserted into the OECD-MC.

b) Include in tax treaties a LOB provision based on Article 7(5) of the OECD-MC.

c) Include a MPT and GAT in tax treaties.

The Discussion Draft further identifies situations where anti-abuse provisions are being dealt with through other BEPS actions.

The LOB provision is very complex, entails a number of terms and concepts which are not clearly defined, and does not state the extent to which the provision applies. The LOB provision is also complex with a number of anti-abuse provisions included in tax treaties and under the domestic tax law of the Contracting States.

IV. Critical analysis of the proposed LOB provision

1. Background

The LOB provision is almost identical to the LOB provision in the OECD-MC. The proposed LOB provision contains several anti-abuse provisions, which may be applicable where a resident of a Contracting State is entitled to the benefits of a tax treaty.

The proposed LOB provision would be applicable where a resident of a Contracting State is entitled to the benefits of a tax treaty. Where dividends, interest or royalties deriving from a Contracting State are paid to a resident of the other Contracting State, this resident is entitled to the benefits of the tax treaty.

Where a resident of a Contracting State is entitled to the benefits of a tax treaty, the proposed LOB provision would be applicable where the resident is deemed to be tax resident if either their seat or their place of effective management is located in that state. In these circumstances, the entity shall be deemed to be tax resident if either their seat or their place of effective management is located in that state. The proposed LOB provision is very complex, entails a number of terms and concepts which are not clearly defined, and does not state the extent to which the provision applies. The LOB provision is also complex with a number of anti-abuse provisions included in tax treaties and under the domestic tax law of the Contracting States.

2. Proposed LOB provision

The proposed LOB provision contains several anti-abuse provisions which may be applicable where a resident of a Contracting State is entitled to the benefits of a tax treaty. The proposed LOB provision is very complex, entails a number of terms and concepts which are not clearly defined, and does not state the extent to which the provision applies. The LOB provision is also complex with a number of anti-abuse provisions included in tax treaties and under the domestic tax law of the Contracting States.

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The proposal regarding the amendment of the corporate tax rules has been criticized by a number of commentators who consider that the proposal would undermine legal certainty and the rule of law by placing the burden within the hands of the competent tax authorities. Indeed, the proposal starts from the wrong assumption that the corporate tax base rule aims primarily at the prevention of trading without making a profit, thus reducing the tax base. It is evident that the nature of the activity should not be compromised if such passive income is principally sourced outside the jurisdiction of the country in which it is earned. Furthermore, the reference made by the EU to 'abusive' corporate tax rules is not sufficiently supported by the underlying agreements or arrangements.

The notion of "genuine economic activity" should be understood in a very broad manner and may include the exploitation of property and intellectual property rights, including as registrations, licences and intangibles for foreign or third parties. The nature of the activity should not be compromised if such passive income is principally sourced outside the jurisdiction of the country in which it is earned. Thus, in essence, the opinion that one can rely on such a new regime on the condition that it is denominated in terms of "genuine economic activity" or "true economic activity" is contradicted by the fact that it is the purpose of genuine business activities performed on behalf of the taxpayer and the activities carried out by the intermediary company (even if the structure is "abusive") that should suffice to be out of the scope of domestic anti-base rules. The LOB provision, the MPT and some specific anti- abuse rules may be rejected in the Discussion Draft may in result of a tax treaty benefits and, in particular, where the trigger test will be applied in certain circumstances. Such restrictions can only be justified by the need to prevent tax avoidance, where a specific anti-abuse rules targets "wholly artificial" arrangements aimed at obtaining national tax benefits.

It is evident that the activities performed by the intermediary company should contribute in the analysis of the "genuine economic activity", thus the LOB provision may be revised in order to include a "less aggressive" approach to the inclusion of such arrangements in the scope of domestic anti-base rules. It is likely that the case studies discussed in the LOB provision and treated in the LOB provision.

The value of tax treaties will be significantly reduced if their applicability is less certain. Many commentators consider that significant changes need to be made in order to achieve a balance between the fundamental freedom of establishment and the protection of the interests of the contracting parties. Furthermore, the EU has acknowledged that a fair and transparent taxation system is essential for the maintenance of an open economy.

In this regard, it should be clarified that holding, financing, licensing and investment activities are not considered to be "wholly artificial" arrangements and may therefore be included in the scope of domestic anti-base rules. Furthermore, the EU has acknowledged that a fair and transparent taxation system is essential for the maintenance of an open economy.

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The authors wish to thank Oliver KIRK for his assistance.

3 Tax Notes, 30th October 2010, p. 618.
4 La Commission Européenne a par exemple rappelé que le 80% des clients de PwC pour l'année fiscale 2010-11 ont des clients qui résident en France et paient impôts dans leur pays d'origine.
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7 The inclusion of provisions which exclude from treaty benefits any company which is owned by shareholders that are resident in a third state.
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