Deloitte.

10 June 2015
2015/18

Tax insights
BEPS Action 6: Preventing treaty abuse

Snapshot

On 22 May 2015, the OECD, as part of its work on the action plan to address base erosion and profit shifting (BEPS), released a revised discussion draft (the draft) on Action 6 in relation to preventing the granting of treaty benefits in inappropriate circumstances. As with other discussion drafts on BEPS actions, the proposals do not represent a consensus view from the G20/OECD governments involved.

The draft maintains the minimum standard (with three options) as to how countries can put in place a minimum level of protection against treaty abuse. Of note is the introduction of two new provisions which will allow the source country to remove treaty benefits and instead apply domestic law: this could apply where income is subjected to a “special tax regime” (a preferential effective tax rate in the residence country) or where, after the treaty is signed, one of the states provides an exemption on certain foreign source income.

The Australian Government announced in the 2015-16 Budget that it will be supportive of the OECD recommendations on Action 6 and that these recommendations will be incorporated into Australian tax treaty practice.

The main proposals are discussed below.

Limitation on benefits rule

In the discussion paper released in September 2014, the OECD set out three proposals for the prevention of treaty abuse. At a minimum, tax treaties should include:

- A principal purposes test (PPT);
- A limitation on benefits (LOB) rule, supplemented by a mechanism, such as a restricted PPT rule, that would deal specifically with conduit arrangements; or
- A combined approach of a PPT and an LOB.

The LOB was based on the LOB contained in US tax treaties.

Following consultation and extensive discussions at the March 2015 meeting of the Working Party, the latest discussion paper sets out a “simplified” LOB provision, intended to be used in combination with the PPT, as an alternative to the full LOB. The simplified LOB would cover individuals; governments; publicly-traded entities; entities owned, directly or indirectly, more than 50% by qualified persons; derivative benefits; active businesses; and competent authority discretionary relief. It does not contain detailed anti-avoidance provisions, which is expected since it is to be combined with a PPT rule. The Working Party has proposed that the simplified LOB could be incorporated into the model tax convention by describing the main features in the articles of the model and presenting alternative formulations of each paragraph in the commentary.

Publicly-traded entity

The draft does not propose that any changes be made to the requirement that an entity needs to be publicly traded throughout a period, the view being that, if this is not the case, the entity may be able to qualify by some other means (e.g. competent authority discretionary relief). In respect of a recognized stock exchange, it is proposed that the commentary include a number of factors that should be considered in making this determination.

Discretionary relief

The proposals in the revised discussion paper provide greater clarity on when discretionary relief should be available. For example, for flows of income to a company that is a subsidiary of a company in a third state, the fact that the withholding tax rate on a direct payment from the source state to the parent company is not higher would be a relevant factor, but not conclusive. When making a request for discretionary relief, the person making the request would need to demonstrate to the competent authority that the relevant transactions were undertaken for clear nontax reasons. Competent authorities also are urged to process requests for relief expeditiously.

Intermediate owners

The simplified LOB would permit indirect ownership, although the provisions still are restrictive, which is felt to be necessary to prevent the interposition of a company in a tax haven to which base-eroding payments could be made. This matter is to be discussed further in the June 2015 meeting.

Denial of treaty benefits

The draft raises two new concepts: one to deal with “special tax regimes” (STRs), and the other that would make a tax treaty responsive to certain future changes in a country’s domestic tax laws. These are similar, but not identical, to recent proposed changes to the US model treaty.

In respect of special tax regimes, Article 11 (Interest), Article 12 (Royalties), and Article 21 (Other Income) of the OECD Model would be amended to provide that payments made to a person subject to a STR would be taxable as provided under domestic law of the source country. A STR is broadly any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit.

The draft proposes a provision in the OECD Model giving each Contracting State the option to notify the other State that it will cease to apply Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) to individuals or companies, effective six months after the notification, if, after the treaty is signed, one of the states provides an exemption from taxation on “substantially all foreign source income (including interest and royalties)” to individuals or companies, as the case may be. Adoption of a tax regime where only foreign source dividends or business profits from permanent establishments are exempt from tax would not, however, trigger

the provision. Where the provision is activated, the source country domestic law will apply in priority to Articles 10, 11, 12 and 21.

PPT

It has been proposed that four new examples be added to the commentary to illustrate the application of this rule.

The commentary on the PPT rule also is to be updated to include the suggestion that states may wish to form an advisory panel, similar to those used in the application of general anti-abuse rules, to advise on the application of the PPT rule. The inclusion of the PPT in the arbitration mechanism is to be discussed as part of action 14 (make dispute resolution more effective). It also is proposed that competent authorities should be given the discretion to provide relief, although this may not be possible in some countries, due to their underlying legal system.

Other matters

Application of the new treaty tiebreaker rule

Although concerns were raised about creating uncertainty by moving away from the use of place of effective management as a treaty tiebreaker where an entity is considered resident in more than one contracting state, the proposals for the determination to be made by competent authorities have not been changed.

Permanent establishment (PE) in a third state

Treaty benefits would not apply to any item of income on which the effective rate of tax on the profits of the PE is less than 60% of the general rate of corporate tax of the head office and the branch profits are exempt in the head office country. This rule would not apply if the PE carries on an active business. The specific exclusion from this rule for royalties in respect of intangible property produced or developed by the PE has been dropped. The Working Group will consider this matter further in the June 2015 meeting, including whether discretionary relief should be available and whether the focus should be on artificial transfers of shares, loans or intangible rights or property to the PE, rather than low tax rates.

Deloitte perspective

One of the benefits of a LOB rule could be its mechanical nature, although, in certain circumstances, this could result in treaty benefits being denied in inappropriate circumstances. The combination of a LOB rule with a PPT rule could result in greater uncertainty for some taxpayers.

No changes have been proposed to the active business test that would allow holding companies outside of the financial services industry to qualify under this test. Such businesses, therefore, would need to consider other options, which may be limited to competent authority discretionary relief that could take a number of years to agree.

In respect of the new proposals regarding special tax regimes, the definition and its application in practice will be of crucial importance if the consequence of the rule applying is that anticipated treaty benefits will no longer be available.

The four new examples of the application of the PPT rule are helpful. However, the use of an advisory panel could further ensure that the rule is applied in a consistent manner and reduce taxpayer uncertainty. This review could be particularly beneficial where a country has not needed to consider a purpose test before

Timetable

Comments are invited by 17 June 2015. No public consultation meeting will be held, since this is the third discussion draft on Action 6 and extensive comments already have been provided. A further meeting of the Working Party will take place in June 2015 to discuss a number of issues that have yet to be finalized.

Contacts

For more information, please contact

Vik Khanna
Partner
+61 (3) 9671 6666
vkhanna@deloitte.com.au

David Watkins
Partner
+61 (2) 9322 7251
dwatkins@deloitte.com.au

Mark Hadassin
Partner
+61 (2) 9322 5807
mhadassin@deloitte.com.au

Fiona Craig
Partner
+61 (2) 9322 7770
ficraig@deloitte.com.au

Claudio Cimetta
Partner
+61 (3) 9671 7601
ccimetta@deloitte.com.au

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's approximately 195,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© 2014 Deloitte Tax Services Pty Ltd.