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International tax alert

OECD BEPS Action 6: Preventing treaty benefits in inappropriate circumstances

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Introduction

Following on the heels of the 2014 Canadian budget proposal to address treaty shopping through a domestic anti-avoidance rule, the Organisation for Economic Co-operation and Development (OECD) released a non-consensus discussion draft on March 14, 2014 (BEPS Action 6) that proposes addressing the issue through changes to tax treaties. The discussion draft was released as part of the OECD/G20's Action Plan on Base Erosion and Profit Shifting (BEPS). The Action Plan identifies treaty abuse, and in particular treaty shopping, as a key concern.

Proposals

(A) Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

Limitation on benefits clause: A specific anti-abuse rule is proposed for inclusion in tax treaties, based on the limitation on benefits (LOB) provision already included in many US treaties. The rule is designed to limit treaty benefits to companies (and individuals, non-profit organizations, pension funds and government bodies) with sufficient presence in the relevant country. The rule operates based on the legal nature, ownership in, and general activities of residents of a treaty country. One of the issues discussed is whether the rule should include a "derivative benefits" clause to allow a contracting state to look through to the ultimate parent. The discussion draft acknowledges that a derivative benefits clause would be an appropriate way of dealing with cases where taxation of an item of income in the two contracting states is comparable to the taxation of the same item of income if it had been received directly by the shareholders of the company that received the income, but also notes that such a provision could result in the granting of treaty benefits in the case of base eroding payments in situations that have given rise to BEPS concerns.

Purpose rule: Similar to the proposed Canadian domestic law test, a broadly drafted general anti-abuse rule aimed at arrangements where one of the main purposes is to obtain treaty benefits is contained in the discussion draft. This rule would supplement the proposed LOB rule. However, unlike the Canadian domestic law proposal, the rule would not apply if the granting of the treaty benefit would be in accordance with the object and purpose of the relevant provisions of the treaty. See below for a chart that compares and contrasts the OECD and Canadian proposals.

Determining treaty residence: The discussion draft proposes removing the place of effective management tie-breaker clause for determining treaty residence (where different domestic rules would treat an entity as resident in two countries). This would be replaced by a requirement that the competent authorities of the two countries endeavour to determine residence, by reference to place of effective management, place of incorporation/constitution and any other relevant factors.

Minimum shareholding period re dividends: It is proposed that the reduced rates of withholding tax applicable to non-portfolio dividends be restricted to shareholdings that are owned throughout a period of months that includes the dividend payment. Comments are sought on what the number of months should be.

Withholding taxes on payments to permanent establishments (PE): A new treaty clause is proposed to restrict relief from withholding taxes on payments to a third country PE of a treaty resident, which would apply where the combined rate of tax paid on the income in the PE and residence countries is less than 60% of the tax rate of the residence country.

(B) Clarification that tax treaties are not intended to be used to generate double non-taxation

The title and preamble to the OECD Model Tax Convention will be amended to clarify that the prevention of tax evasion and avoidance, specifically including but not limited to treaty shopping, is a purpose of tax treaties; countries that enter into a treaty intend to eliminate double taxation without creating opportunities for tax avoidance and evasion. This title and preamble will be relevant to the treaty's interpretation.

(C) Tax policy issues that countries should consider before deciding to enter into a tax treaty with another country

It is proposed that the model tax treaty include key points for countries to consider in relation to the conclusion, modification (or termination) of a tax treaty. The avoidance of double taxation remains a main objective of tax treaties in order to reduce tax obstacles to cross-border services, trade and investment. However, other considerations include the ability to eliminate double taxation domestically, increased risk of non-taxation, excessive taxation from high withholding tax rates, increased certainty and cross-border dispute resolution for taxpayers and the ability of prospective treaty partners to provide assistance in the collection of taxes and exchange of information.

Comparison of the OECD and Canadian approaches

The approach to treaty shopping outlined by the OECD differs in many respects from that outlined by the Canadian government in the **2014 budget**. The chart compares the two approaches. Of particular note is the recommendation in the OECD discussion paper that treaty shopping (as a general rule) be addressed through the inclusion of appropriate anti-abuse rules in treaties. The Canadian government has indicated that it is not willing to wait for the renegotiation of tax treaties in order to address treaty shopping. Time will tell whether and to what extent the OECD discussion paper will influence the development of anti-treaty shopping measures in Canada, including whether the Canadian government will continue to focus on a domestic anti-treaty shopping solution or will pursue both a domestic law and a treaty approach.

Approach	OECD	Canada
Treaty vs. domestic	Treaty-based	Domestic law
Specific vs. general	Specific LOB provision, supplemented by a general anti-abuse rule	General approach, supplemented by more-specific provisions (conduit presumption, safe harbour presumption)
One of main purposes provision	Yes, but not applicable where the granting of the benefit is in accordance with the object and spirit of the treaty	Yes, subject to the conduit presumption, the safe harbour presumption and a reasonableness exception
Qualifying person exception	Yes, included in the LOB provision	Limited; safe harbour presumption would apply for corporations and trusts the shares or units of which are regularly traded on a recognized stock exchange
Active trade or business exception	Yes, included in the LOB provision	Yes, included in the safe harbour presumption
Derivative benefits provision	No, but still under consideration	Yes; safe harbour presumption would apply where the person is not controlled directly or indirectly by a person that would not have been entitled to equivalent treaty benefits, but subject to the conduit presumption
Relieving provision	Yes, competent authority relief	Yes; if the main purpose provision applies in respect of a benefit, the benefit is to be provided to the extent that it is reasonable having regard to all the circumstances

Timetable and next steps

The OECD has requested written comments on the discussion draft by April 9, 2014. A public consultation event will be held at the OECD in Paris on April 14 and 15, 2014, and the proposals are expected to be finalized in September, 2014. Adoption of the final proposals will likely await the conclusion of the BEPS Action Plan on the multilateral convention (Action 15, due December 2015), as individual treaty negotiations would be time-consuming.

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