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For comments on Action 1, see **the highlighted text below**.

BEPS

So, in this BEPS recap, I want to focus on the three actions where there has been a flurry of discussion drafts issued in the last three weeks. Those three actions are:

Action 1 (the digital economy)

Action 2 (neutralise the effects of hybrid mismatch arrangements), and

Action 6 (prevent treaty abuse)

ACTION 1: The Digital Economy

The OECD released a discussion draft on Action 1 on 24 March.

The first point to note is that it is quite a different document from all the other discussion drafts which have been issued to date. All of those other discussion drafts contain specific proposals for domestic law changes, for treaty changes, or for changes to the OECD's Transfer Pricing Guidelines. And I might say, even though some of those documents are clearly "works in progress", you still find specific proposals.

Not so the Action 1 discussion draft. It contains no specific proposals for law changes.

What it does contain can be put into three categories.

The **First Category**, and this takes up almost half of the document, is a description of the digital economy - without a single reference to tax. Probably the most notable aspect of this first category is the OECD's conclusion that it is pointless to try to identify the so-called digital economy, as somehow distinct from the rest of the economy. That effectively means, I think, that the OECD's references to "the digital economy" should be understood as references to business models and structures, in any part of the economy, which utilise the Internet. A broad canvas, indeed.

The **Second Category** identifies BEPS tax planning that is currently undertaken in the digital economy. And then the OECD considers to what extent will that tax planning be adversely impacted by all the other Actions within the BEPS Project. The OECD's conclusion, perhaps not surprisingly, is that all of those other Actions, taken collectively, will likely deal a major blow to BEPS planning in the digital economy. More about that in a moment.

The most interesting point in this second category is that the OECD has given us some hints as to what these other Actions will likely consist of - hints that have not been previously publicised.

What caught my eye were these:

(i) For Action 4 (which focuses on interest deductions), the OECD has suggested that limitation of base erosion via interest deductions might require mechanisms that are "within or beyond the arm's length principle". And indeed, there might be a need for a "formulary type of approach which ties deductible interest payments to external debt payments".

(ii) For Actions 8, 9 and 10 (which all concern transfer pricing), the Action 1 discussion draft tells us these things:

In regard to the allocation of business risks : some of these risks are "group risks", and thus they cannot be allocated to any specific entity.

In regard to the recharacterisation of transactions : the OECD suggests that the existing limited circumstances in which recharacterisation is permitted under the Transfer Pricing Guidelines, should be expanded.

In regard to base erosion payments such as interest, royalties and service fees, the OECD says that we should preserve a "measure of reliance" on the arm's length principle, but there should be a departure from the arm's length principle "in targeted circumstances", which would include "caps on certain payments, or formula based allocations".

And in regard global value chains, the discussion draft refers to the need to use profit split methods for integrated and global business models.

(iii) And finally for Action 3 (which is called "strengthen CFC rules") : The OECD raises the issue of whether "anti-inversion rules" are required.

And the **Third Category** in the discussion draft identifies a list of possible options which could be implemented to address the special tax challenges which are raised by the digital economy.

To be honest, what is interesting here is not the list of possible options, but the timetable which the OECD has in mind. As I mentioned in last week's show, the discussion draft indicates that the OECD's plan is not to give us any specific proposals in regard to the list of options. Instead, it wants to "wait and see" whether the other BEPS Actions collectively wipe out BEPS tax planning in the digital economy - and it will only be if the answer is "no, those actions have not done that", will the OECD then identify specific proposals.

As I said last week, a recipe for procrastination, and unilateral actions by countries who don't want to wait that long.

The proposals set out in the discussion draft are these:

A limitation, or indeed elimination, of the exceptions from PE status in Article 5(4).

A new tax nexus based on "significant digital presence".

A revisiting of various virtual PEs which were considered, but not pursued, by the e-commerce TAG over 10 years ago.

A withholding tax on digital transactions, collected by financial institutions.

And two VAT changes - one relating to imports of low value goods, and the other relating to inbound B2C transactions.

ACTION 2 : Hybrid Mismatch Arrangements

The OECD issued two related discussion drafts on Action 2 (hybrid mismatch arrangements) on 19 March.

The first document is 79 pages long and covers recommendations for domestic law changes.

The second document is 14 pages long and covers proposed amendments to the OECD model double tax treaty.

Let's go to the first document.

And my first comment is that it needs a good editor. It is internally inconsistent in parts, and there are some important rules that are not clearly stated, but you have to "tease" them out of the document.

The discussion draft uses some key terms, such as these:

(i) Arrangements that generate double deductions are called DD structures.

(ii) Arrangements that generate a deduction on one side, but no income recognition on the other side, are called D/NI structures.

(iii) For recommended law changes, the OECD's preferred approach in the discussion draft is called the primary response or rule. For example, the primary response might be for the payer country to deny a deduction for the payment.

(iv) But to guard against the situation where the primary response is not implemented by the relevant country, the discussion draft also includes a back-up response, which is called the secondary rule or defensive rule.

(v) And finally there is the scope of the recommended law changes - for example, should it impact only arrangements between related parties or should it be wider?

The document adopts a "laser" approach (my terminology), rather than a recharacterisation approach. So, for example, if there is a hybrid financial instrument which is treated as debt in country B, but as equity in country A, the document focuses on the hybrid tax effect : a deduction in country B for interest, and an exemption in country A for dividends. Depending on the circumstances, it recommends the reversal of one of those tax effects (for example, the interest payment might become non-deductible in country B, or the dividend might become non-exempt in country A). But the document does not recommend any recharacterisation of the instrument (to debt in both countries or to equity in both countries).

The discussion draft applies only to "payments". Now, the term, "payment", is defined in the document to "include any amount capable of being paid including (but not limited to) a distribution, credit, debit or accrual of money or money's worth but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties."

I must say that that definition does raise some questions, particularly in regard to repo transactions.

However, the document does make clear that tax rules that grant "deemed" interest deductions for equity capital are not covered. So, this should mean that Belgium's notional interest deduction is outside the scope of the document.

In defining hybrid mismatch arrangements, the OECD makes a number of interesting points:

Firstly, the OECD is not concerned with timing mismatches. For example, if the payer obtains a deduction up-front, but the income is recognised only on an accruals basis, that is not a hybrid mismatch arrangement. Only permanent differences are relevant.

Secondly, tax rate differentials are irrelevant. Thus, a tax deductible payment made from Japan (which has a relatively high tax rate) to Singapore (which has a relatively low tax rate) is outside the scope of the document.

And thirdly, the mismatch in tax outcomes must be due to the hybrid nature of the instrument, and not for other reasons. For example, if a Hong Kong company lends money to an Australian company, in the form of plain vanilla debt, both jurisdictions will treat the instrument as debt; however, Australia will generally grant a tax deduction for the interest payment, but Hong Kong will generally treat the interest income as tax-exempt because it is foreign sourced. That mismatch in tax outcome is not due to the hybrid nature of the instrument, and thus it is out of scope.

And finally, the OECD makes clear that their objective with the recommended law changes is not for the relevant countries to directly raise revenue from hybrid mismatch arrangements. Instead, it is to drive taxpayers away from such arrangements to plain vanilla structures - and, in that way, for the relevant countries to indirectly raise revenue.

The discussion draft identifies four types of hybrid mismatch arrangement.

Firstly, hybrid financial instruments. This term covers a basic hybrid instrument, which is treated as debt in one country and as equity in the other (for example, redeemable preference shares issued by an Australian company to its Netherlands parent). It also covers more complicated structures, such as a share subscription for a deferred purchase price.

Thirdly, hybrid entity payments. This term covers both DD structures and D/NI structures.

And fourthly: Imported mismatch arrangements. This term refers to a triangular situation, where there is a hybrid mismatch arrangement between two countries (A and B), which is then used as a platform from which to import (so to speak) the effect of the arrangement into a third country (C) via a plain vanilla loan.

Let me briefly now go to the second discussion draft, which concerns amendments to the OECD model treaty.

The OECD is proposing only one change to the treaty - this is a proposed new paragraph (2) in Article 1:

"For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]"

The first sentence in this new paragraph has been borrowed from the current U.S. model treaty. It will "plug the gap" in the OECD model, which was left after the Partnerships Report over 10 years ago. The second sentence refers to the proposed new "saving clause", which is covered in the discussion draft on Action 6 - which I will turn to now.

<u>ACTION 6 : Prevent Treaty Abuse</u>

The discussion draft for Action 6 was issued by the OECD on 14 March.

It contains a long list of proposed amendments to the OECD model treaty, most of them with the draft provision included.

Before we get started, a preliminary point to note is that Action 6 needs to understood together with Action 15, which talks of developing a multilateral instrument. Making changes to the OECD model treaty will have an impact in the real world with the speed of a glacier. In order to have an immediate real world effect, the new provisions will need to be inserted into the world's real bilateral treaties. The OECD strategy to do that is the multilateral instrument.

The Action 6 discussion draft consists of two major anti-treaty shopping provisions, and also a string of specific provisions.

The two major anti-treaty shopping provisions are the "limitation on benefits" (LOB) article and the "purpose" provision.

The LOB article has been largely copied from the current U.S. model treaty - Article 22.

Essentially, it permits treaty benefits to be claimed, against country S, by a resident of country R, only in three circumstances:

The first is where the resident satisfies the definition of "qualified person", which is set out in paragraph (2) of the article. If the resident does satisfy that definition, then it is entitled to all treaty benefits - assuming, of course, that it has already passed all of the conditions outside the LOB article, such as residence and beneficial ownership.

The second is where the resident satisfies the "active trade or business" condition in paragraph (3). If the resident does satisfy the "active trade or business" condition, it is entitled to treaty benefits in regard to income it derives which is connected with, or is incidental to, the active trade or business - but no other treaty benefits.

The third is where the resident obtains the approval of the source country's competent authority.

There is a possible fourth situation in which treaty benefits can be claimed under the LOB article. This is the so-called "derivative benefits" paragraph which the OECD is seeking specific feedback on. Essentially, this would permit treaty benefits, under the R / S treaty, for a company which is resident in country R if that company were a subsidiary of a parent which is resident in country T, and the withholding tax rates under the R / S treaty are no better than the rates under the T / S treaty.

As I said, the proposed provision is largely copied from the LOB article, Article 22, in the U.S. model treaty. As you would expect, the U.S. has a library full of interpretation and guidance in respect of Article 22. The OECD has not made clear to what extent, if at all, it will use that existing U.S. interpretation and guidance.

Let's turn to the "purpose" provision. It reads this way:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main 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 this Convention."

You can see the key elements of this provision:

Firstly, the level of purpose is "one of the main purposes", not the main purpose. That level of purpose is quite slippery - I can imagine huge difficulties in practice.

Secondly, it appears that that purpose must be determined objectively, not subjectively. In other words, it's not the taxpayer's real purpose which is relevant; instead, it is what his purpose appears to be, viewed objectively. This is shown in the words : "it is reasonable to conclude, having regard to all relevant facts and circumstances".

Thirdly : even if you are caught by the main part of the provision, you can be "rescued" by the exception at the end : "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 this Convention."

There is a string of specific anti-avoidance provisions which the discussion draft proposes to include in the model treaty:

There's a provision which will exclude, from treaty benefits, income derived via a PE in a third country - subject to conditions.

The existing corporate residence tie-breaker in Article 4(3) will be changed from place of effective management to as agreed by the two competent authorities. As a practical matter, this will make it more difficult for a dual resident company to qualify for treaty benefits.

A couple of anti-avoidance rules will be inserted into Article 10, to prevent minor shareholders from obtaining reduced dividend withholding tax rates that are intended only for substantial shareholders.

The capital gains "land rich" provision, Article 13(4), will be strengthened in a couple of ways.

The so-called "saving clause" from the U.S. model treaty will be included in Article 1. This will ensure, amongst other things, that the treaty cannot be used to defeat domestic law CFC rules of the residence country.

And finally, the preamble to the treaty will be changed to expressly note that it should not be used for situations which result in double non-taxation or reduced taxation through avoidance or treaty shopping arrangements.