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For comments on Action 6, see **the highlighted text below**.

BEPS

- **BEPS : Discussion draft on Action 6**

Well, this has certainly been a very busy week in the BEPS Project.

Last Friday, 14 March, the OECD issued a discussion draft on Action 6 (the prevention of treaty abuse).

And on 19 March, it released two related discussion drafts on Action 2 (hybrid mismatch arrangements).

Let me first talk about Action 6 (the prevention of treaty abuse).

The discussion draft is 31 pages long, and it contains a number of proposals to dramatically reduce treaty shopping.

Most of the proposals involve changes to the OECD model treaty. Now, of course, if that's all that was done, that would not have a dramatic effect on treaty shopping, because the changes would have to be put into the world's real bilateral treaties. And to do that, the OECD's strategy is the so-called multilateral instrument, which is Action 15 in the BEPS Project. Strangely, there's no reference to the multilateral instrument in this Action 6 discussion draft – but we need to understand that that is the proposed endgame.

OK, there are two major anti-avoidance provisions which the discussion draft proposes to include in the model treaty : a "limitation on benefits" (LOB) provision and a "purpose" provision.

The LOB provision has been largely copied from the version in the current US model treaty – that's Article 22 of the 2006 US model treaty.

For those of you who are not totally familiar with Article 22, let me summarize it in this way :

- Although you have satisfied all the other conditions in the treaty, Article 22 says that you are not entitled to any treaty benefits unless you also comply with Article 22.
- And Article 22 gives you three different ways of complying with it.
- The first and primary way of complying with Article 22 is by satisfying the definition of "qualified person" in paragraph 2 of the article. If you do satisfy the definition of "qualified person", then you are entitled to all treaty benefits (provided, of course, that you have already satisfied all the other conditions outside of Article 22, such as residence or beneficial ownership).
- If you don't satisfy the definition of "qualified person", then Article 22 gives you a second option – this is the so-called "active conduct of a trade or business" condition in paragraph 3. One important limitation to note, however, is this : if you do satisfy the "active conduct of a trade or business" condition, you are not entitled to all treaty benefits – instead, you are only entitled to treaty benefits in regard to items of income which are derived in connection with, or are incidental to, that trade or business. So, there is an important nexus limitation there.

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- And the third and final way of complying with Article 22 is by having the competent authority of the source country agree that you should be granted all or some treaty benefits. Obviously, that's not a good strategy if treaty shopping is your objective.

- Let me go back to the definition of "qualified person" in paragraph 2 :

  - You can satisfy the definition in five different ways – these are in sub-paragraphs (a) to (e), which are all alternatives.

  - Only two of those sub-paragraphs are relevant to the corporate world.

  - The first of these is sub-paragraph (c). This sub-paragraph relates to companies which are publicly listed on a recognized stock exchange (which is a defined term) and to their subsidiaries.

  - The second of these sub-paragraphs is sub-paragraph (e). This sub-paragraph has two conditions, both of which must be satisfied : an ownership condition and a base erosion condition.

- There's one aspect of the LOB provision which the OECD is seeking specific comments on. This is the so-called "derivative benefits" situation. Essentially, this relates to a triangular situation : we have three countries (S, R and T). The income is derived from country S by OPCO 2, which is a resident of country R. Let's assume that, under the R / S treaty, OPCO 2 does not comply with any of those three ways of satisfying the LOB article. However, OPCO 2 is a subsidiary of the Parent company, which is a resident of country T. And, under the S / T treaty, the Parent company does satisfy the LOB article in that treaty; and also, the rate of source country tax permitted under the S / T treaty is no higher than the rate permitted under the R / S treaty. Under a "derivative benefits" paragraph of the LOB article in the R / S treaty, OPCO 2 might then be considered to satisfy the LOB article.

I mentioned that the discussion draft effectively copies Article 22 from the US model treaty. Article 22 is, of course, supported by a US technical explanation, as well as a significant amount of US interpretation and guidance. It's not clear from the discussion draft as to whether the OECD intends to use any part of the existing US guidance on Article 22.

Let me now turn to the second of the two major anti-avoidance provisions : the "purpose" provision. This type of provision has been widely used by the UK in its treaties.

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.

So, as you can see, the provision has two limbs :

  - The first limb requires a conclusion as to whether one of the main purposes of the arrangement or transaction was to obtain the treaty benefit.

  - And if that conclusion is satisfied, the second limb then provides for an exception if the granting of the benefit would be in accordance with the object and purpose of the relevant provisions.

In regard to the first limb, the discussion draft says that the phrase, "it is reasonable to conclude", requires "an objective analysis of the aims and objects of all persons involved in putting the arrangement or transaction in place or being a party to it". It also gives some explanation as to what the phrase, "one of the main purposes", means.

There are several examples in the discussion draft illustrating the application of the "purpose" provision.

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And the draft makes clear that you will need to satisfy both the LOB provision and the "purpose" provision, in order to obtain treaty benefits.

In fact, even that might not be enough. The discussion draft then goes on to describe various other provisions which it wants to include in the model treaty. If any of those provisions relate to your situation, you would need to satisfy that as well.

Let me go through the list of these additional provisions fairly quickly :

- There will be an exclusion of treaty benefits in situations where the relevant income is derived by a permanent establishment in a third country. This will be in a new paragraph 4 to Article 1. This provision would be aimed at the finance branch and IP branch structures that you tend to see in Europe, which generally rely on a low effective tax rate in the country where the PE is established, and an exemption (of the PE profits) in the residence country (either under domestic law or under the treaty with the PE country). In the discussion draft, the proposed provision would apply only if there is a minimum differential in the effective tax rates between the residence country and the PE country.

- The OECD is proposing to borrow another provision from the US model treaty. This is the so-called "saving clause", which is contained in paragraphs 4 and 5 of Article 1 of the 2006 US model treaty. The version in the OECD's discussion draft is much shorter, and it is proposed to become paragraph 3 of Article 1 of the OECD model treaty. What it will essentially do is this : it will state that the treaty does not affect a Contracting State's taxation of its own residents, subject to some exceptions. The discussion draft says that this provision is necessary to prevent an argument that some provisions that are aimed at the taxation of non-residents could be interpreted as limiting a Contracting State's right to tax its own residents.

- In regard to Article 10 on dividends, the discussion draft proposes to make a couple of changes :

    - Firstly, a minimum holding period for the shares, in order to qualify for the treaty withholding tax rate, will be inserted into Article 10
    - And secondly, there will be inserted some provisions to deal with situations where intermediary entities in the source country are used, in order to take advantage of lower treaty rates.

- In regard to Article 13 (the capital gains article), there are proposed amendments to Article 13(4), which is the land-rich provision.

- And the discussion draft proposes that the tie-breaker test for corporate residence in Article 4(3) be changed from the current "place of effective management" to a mutual agreement between the two competent authorities.

And the final point to note is that the preamble to the OECD model treaty will be amended to state that the treaty is not intended to be used to generate double non-taxation.

So, all in all, a lot of content in the 31 pages of the discussion draft.

The OECD has asked for public comments by 9 April 2014. And there will be a public consultation meeting, which is currently scheduled for April 14 and 15.

If you would like to obtain a copy of the discussion draft, please go to BEPS Central by following the link in the summary slides at the end of this video.

- BEPS : Discussion draft on Action 2

In regard to Action 2 (hybrid mismatch arrangements), the OECD has released this week two related discussion drafts. The first document covers recommendations for domestic law changes (this is 79 pages long), and the second document relates to treaty issues (and it is merely 14 pages long).

Let's look first at the recommendations for domestic law changes.

The draft identifies three separate categories :

- Hybrid financial instruments and transfers
- Hybrid entity payments, and
- Imported mismatches and reverse hybrids

For each of the three categories, the discussion draft gives a number of examples of the arrangements falling within the category, it identifies the recommended changes to domestic law (which is generally either a denial of a tax deduction or the recognition of taxable income), and it recommends the scope of the domestic law change – for example, should the recommended law changes apply only to transactions between related parties or should they have a wider scope?

Before I take you through the three categories, a couple of points.

Firstly, the discussion draft introduces some new terminology :

- Arrangements that generate double deductions are called DD structures
- And arrangements that generate a deduction on one side, but no income recognition on the other side, are called D/NI structures (deduction / no income)
- For recommended law changes, the OECD's preferred approach in the discussion draft is called the primary response. For example, the primary response might be for the source country to deny a deduction.
- 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 defensive rule.

Secondly, the discussion draft contains quite a few diagrams illustrating the various arrangements. We've included many of those diagrams in this video. To keep the show on time, I'm going to move through those diagrams pretty quickly – but if you want to spend some time studying a diagram, just hit the pause button.

- Hybrid financial instruments and transfers

If we look at the first category (hybrid financial instruments and transfers) :

- Examples of arrangements covered by this category include :
    - The so-called basic hybrid instrument which is treated as debt in one country and as equity in another
    - But also variations on that theme, such as :
        - A subscription or sale of shares with a deferred purchase price component
        - A premium paid on converting a mandatory convertible note
        - An embedded option in an optional convertible note, and
        - An interest-free shareholder loan which is bifurcated into equity and debt components
    - And then we have so-called hybrid transfers, which are all various types of repo, such as :
        - A collateralized loan repo
        - And a bond lending repo with a foreign tax credit double dip
- The discussion draft recommends that the primary response to such transactions should be for

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the payer to be denied a deduction. However, it also recommends, as a defensive rule if the payer's country does not do that, that the recipient should recognize the receipt as taxable income.

    - And the discussion draft has left open for consideration the question of the scope of these recommended law changes.

- Hybrid entity payments

The second of the three categories is called "hybrid entity payments" :

- Examples of arrangements covered by this category include :

    - A series of DD (double deduction) structures,

such as those involving the use of a hybrid entity (for example, an entity which is treated as a company in one country, but which is disregarded in the other),

those involving the use of a permanent establishment,

and also dual resident or dual consolidated structures.

    - And there's also a series of D/NI (deduction / no income) structures, such as a structure involving disregarded payments made by a hybrid entity to a related party,

and another one involving disregarded payments made by a PE.

- In regard to both recommended responses and scope, the discussion draft differentiates DD structures from D/NI structures. Let me cover D/NI structures first, because it's simpler :

    - For D/NI structures :

        - The primary response should be a denial of the deduction in the payer country, with the defensive rule being that the recipient's country should recognize the receipt as taxable income.

        - In regard to scope : the discussion draft recommends that the response be limited to related parties (which includes parties acting in concert) and structured arrangements.

    - For DD structures :

        - The discussion draft recommends that the primary response should be for the investor country to deny a deduction. However, the defensive rule should be for the subsidiary country to deny a deduction.

        - In regard to scope, the discussion draft recommends that there be a differential scope :

            - For the primary response : there should be no limitation
            - But for the defensive rule : the response should be limited to related parties (including parties acting in concert) and structured arrangements.

- Imported mismatches and reverse hybrids

And the third and final category is called "imported mismatches and reverse hybrids" :

This is the example the discussion draft gives of a reverse hybrid structure, which is a relatively well-known strategy.

Now, the discussion draft explains that it treats reverse hybrid structures as a subset of the larger

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category of “imported mismatch arrangements”.

And by “imported mismatch arrangements”, the discussion draft is referring to…

“….hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction. Once a hybrid mismatch has been engineered between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter to shift the effect of that mismatch into a third jurisdiction (through the use of an ordinary loan, for example).”

The discussion draft gives two examples of an imported mismatch.

This is the first. You can see the hybrid financial instrument at the top between countries A and B, which is then effectively imported into country C through a plain vanilla loan.

And this the second example, again being imported into country C via a plain vanilla loan.

And the discussion draft gives recommendations in regard to the primary response, defensive rule and scope for these various structures.

Let me now briefly turn to the second of the discussion drafts, which deals with treaty issues.

This draft only makes one proposed change to the OECD model treaty, but it is an important one.

The proposal is to include a 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.”

This provision is loosely based on paragraph 6 of Article 1 of the 2006 US model treaty.

And it recognizes the huge gap that the OECD had left in this area after the partnerships report of over 10 years ago.

The document also contains thoughts in regard to the alignment of the treaty provisions with the proposed domestic law treatment as described in the first of the two discussion drafts.

If you would like to obtain a copy of the two discussion drafts, please go to BEPS Central by following the link in the summary slides at the end of this video.

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