Dbriefs Bytes Transcript

25 April 2014

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

BEPS

BEPS : Action 6 (prevent treaty abuse)

Well, BEPS Action 6 (the prevention of treaty abuse) has been lively in the past couple of weeks.

Firstly, on 11 April, the OECD published all of the public comments it had received on the Action 6 discussion draft.

These public comments are from 80 organizations and individuals, and total 543 pages.

And then on 14 & 15 April, the OECD hosted a public consultation meeting in Paris to review many of the comments.

Most of the comments were on two topics :

The need for the "main purpose" provision

And the detailed design of the LOB article.

"Main purpose" provision

In regard to the "main purpose" provision, the overwhelming majority of submissions from the private sector argued that, yes, there should be an LOB article, but, no, there should not be a "main purpose" provision. A number of reasons were given :

Firstly, so-called "layering" – in other words, it's unnecessary to have both a "main purpose" provision and an LOB article – it's an overkill.

Secondly, an LOB article is to be strongly preferred, because it offers mechanical, objective conditions, in contrast to the subjective nature, or judgmental nature, of the "main purpose" provision.

In order to illustrate the subjective nature of the "main purpose" provision, a number of the comments refer to Example C, which is in paragraph 33 of the discussion draft. This example concerns a manufacturing company which decides to locate its new manufacturing plant in the only developing country that has a treaty with its country of residence. The example says that the existence of the treaty was a consideration for choosing that country, but it was not "one of the main purposes" for the building of the plant in that country. A number of the commentators say that it is not clear how the OECD has reached this conclusion, and that illustrates the lack of precision with the "main purpose" provision.

Now, I might say that the initial reaction from the OECD at the public consultation meeting was negative in regard to both of these reasons.

In regard to the "layering" argument, the view was expressed that both provisions are necessary in order to prevent treaty abuse – in other words, the LOB article, on its own, is not sufficient. An example given by the OECD is in regard to conduit arrangements. According to the OECD, the LOB article will not generally protect against conduit arrangements – and they point to a statement in the technical explanation to the US model treaty to that effect. Also, the OECD says, the existing treaty concept of "beneficial ownership" is a narrow test, and leaves unaffected many conduit arrangements.

In regard to the question of preference, the OECD responded by saying that the "main purpose" provision has been used for many years in 300 real bilateral treaties (the OECD's number), without any major problems. In fact, if you

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were to do a count of how many treaties currently contain a “main purpose” provision versus how many treaties contain a long-form LOB article, you will find that the “main purpose” provision will win.

Jacques Sasseville of the OECD also made the point that, at present, many countries use their domestic law GAAR rules to limit treaty shopping. Those domestic law GAAR rules frequently are based on a “purpose” condition. He made the argument that it would be better to effectively bring such rules into the treaty, for two reasons :

Firstly, there would then be clarity as to what the rule is, as well as the fact that it is consistent with the treaty (in other words, the potential issue concerning whether the domestic law can override the treaty, will be avoided)

And secondly, there should be the prospect of the mutual agreement procedure in case of disputes – something which is not always available in regard to the application of domestic law GAAR rules.

He said :

“So I would’ve thought it would be better to have these rules on when you can deny treaty benefits codified in the treaty, rather than just leave it to domestic law, which is exactly where we are now.”

What all that means is that, despite the significant number of comments to the contrary, I think it’s likely that both of these provisions will find their way into the final proposals which the Action 6 focus group will present to the Committee on Fiscal Affairs in June.

LOB article

Most of the detailed public comments were about the design of the LOB article – essentially, folks are arguing that the OECD has chosen a very restrictive version of the US LOB article (in other words, the one that’s included in the current US model treaty), and there are “friendlier” versions of this article in many of the real treaties which the US has entered into.

You will remember that the LOB article is in four parts :

Firstly, there’s the definition of “qualified person” in paragraph (2). If you satisfy the definition of “qualified person”, then you are entitled to all treaty benefits – assuming, of course, that you have satisfied all of the relevant conditions outside the LOB article.

The “qualified person” definition sets out a list of six alternative persons who will qualify. Three of those alternatives are relevant to the corporate sector :

The publicly listed company, as described in subparagraph (c)(i).

The subsidiary of a publicly listed company, as described in subparagraph (c)(ii)

And a company which satisfies both an ownership condition and a base erosion condition, as described in subparagraph (e).

Secondly, the OECD has added a possible provision in regard to so-called “derivative benefits”.

Thirdly, there is the “active conduct of a trade or business” test in paragraph (3). If you satisfy this test, you are entitled to treaty benefits, but only in regard to income connected with, or incidental to, that trade or business.

And finally, there is the discretionary grant of treaty benefits in paragraph (4). In this situation, the treaty benefits are as determined by the source country competent authority.

Let’s run through the main comments on the LOB article.

And they fall into these categories:

Intermediary entities

Derivative benefits

Base erosion test

Headquarter companies

Publicly listed companies

Collective investment vehicles

Dual-listed company structures

Discretionary benefits

Active conduct of a trade or business

Reconciliation with laws of trading blocs

Intermediary entities

So the first category of comments concerns intermediary entities, such as subsidiaries.

The discussion draft's version of the LOB article generally disqualifies the use of third country intermediary subsidiaries, in the "qualified person" definition.

Thus, in subparagraph (c)(ii), which concerns a subsidiary of a publicly listed company, there is this requirement :

"…provided that, in the case of indirect ownership [by the publicly listed company], each intermediate owner is a resident of either Contracting State".

So this would mean that you can't trace the ownership through a subsidiary in a third country.

There's a similar restriction in subparagraph (e), which is the "ownership plus base erosion" situation. Towards the end of the ownership condition, this is stated :

"…provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State".

This is actually a tougher restriction, because it excludes not only third country tracing, but also tracing through a subsidiary in the other Contracting State.

Many comments argued that both of these provisos should be deleted.

Derivative benefits

The discussion draft included a possible provision in regard to so-called "derivative benefits", and it asked for comments whether such a provision should be included in the LOB article.

Well, the unanimous response from the private sector was, yes, please include a "derivative benefits" provision. There were also some comments asking for changes to the version in the discussion draft.

The "derivative benefits" provision operates by reference to a so-called "equivalent beneficiary", which is a defined term.

For example:

Imagine a three country scenario : Publicly listed company is resident in country T, it directly owns 100% of the shares of Subco which is resident in country R, and Subco derives interest income from country S. Under the country S tax law, a withholding tax of 10% is levied on the interest.

Assume that country S has a treaty with each of country R and country T.

The interest withholding tax rates under the two treaties (the R/S treaty and the T/S treaty) are the same : 5%.

Subco wants to claim the 5% rate under the R/S treaty. However, it doesn't qualify as a "qualified person" under the R/S treaty, because the publicly listed company is a resident of a third country, country T.

However, the publicly listed company should qualify as an "equivalent beneficiary", because it is entitled to treaty

benefits under the T/S treaty, and the withholding tax rates under the two treaties are the same.

That status as an “equivalent beneficiary” then enables Subco to qualify for treaty benefits under the “derivative benefits” provision of the R/S treaty.

The version of the “derivative benefits” provision in the discussion draft contains the same type of disqualification of intermediary entities.

It’s expressed this way :

“…provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary”.

A number of comments called for that proviso to be deleted.

Base erosion test

The third category of comments is in regard to the base erosion test.

The base erosion test is contained in two parts of the LOB article :

Firstly, in subparagraph (e) of the “qualified person” definition.

And secondly, in the possible “derivative benefits” provision.

In both parts, the base erosion test has a restrictive list of so-called “good” recipients of payments.

In subparagraph (e), the “good” recipients are individuals, government entities, publicly listed companies, and charities and pension funds, in all cases provided they are resident in either of the two Contracting States. All other recipients are “bad” recipients.

In the “derivative benefits” provision, the “good” recipients are limited to “equivalent beneficiaries”.

In both of these cases, a 100% subsidiary of a publicly listed company will be a “bad” recipient – even if it is resident in the same country as the payer.

This particular aspect was criticized in a number of comments.

Headquarter companies

A number of comments argued that headquarter companies (in other words, companies which undertake regional management for a multinational group) should be specifically qualified under the LOB article.

Under the current draft, they’re not mentioned, and they would generally struggle to fit any of the existing requirements.

Publicly listed companies

Publicly listed companies are covered by subparagraph (c)(i) of the “qualified person” definition.

However, the version in the discussion draft requires either of two additional conditions be satisfied.

The first is that the shares in the company are “primarily traded” on a recognized stock exchange in the country of residence. This condition was criticized by several commentators who said that it fails to recognize that some companies seek to list their shares on third country stock exchanges such as in London, New York or Hong Kong, where there is a deep pool of investors.

The second of the conditions is that the company’s “primary place of management and control” must be located in the residence country. The “primary place of management and control” is defined to mean day-to-day management by senior executives. Several comments criticized this condition on the basis that it fails to recognize that some companies use decentralized management structures.

Collective investment vehicles (CIVs)

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Many comments criticized the fact that collective investment vehicles (CIVs) are not specifically qualified under the version of the LOB article in the discussion draft.

In fact, many commentators expressed their surprise at this omission, due to the fact that the OECD had studied the whole issue of CIVs some years ago, and the results of the 2010 report have been included in the Commentary to Article 1 of the OECD model treaty.

Dual-listed company structures

Groups with a dual-listed company structure (in other words, two parent companies, both of which are publicly listed – for example : BHP Billiton and Unilever) face challenges with the application of the “qualified person” definition. Several comments were made that the LOB article should recognize their special situation.

Discretionary benefits

Not surprisingly, the discretionary benefits provision in paragraph (4) was approved of by all of the private sector commentators. However, some folks commented that a time limit should be set for deliberation, and also that the Commentary should include factors which should be taken into account.

Active conduct of a trade or business

There were relatively few comments on the “active conduct of a trade or business” test in paragraph (3).

However, those that were made focused on the “substantiality test” in subparagraph (3)(b). One comment said that it should be replaced by a “de minimis” test.

Reconciliation with laws in trading blocs

And there were several comments about the need to reconcile the LOB article with the existing laws, particularly against discrimination, in some trading blocs, notably in Europe.

Other comments

There were a number of other interesting comments which were made – for example:

In regard to the “main purpose” provision : a number of commentators asked that this be changed from “one of the main purposes” to “the main purpose”.

And the proposal to change the corporate residence tie-breaker test in Article 4(3) from “place of effective management” to “as agreed by the two competent authorities” was criticized.

And, finally, several commentators said that, if the “main purpose” provision is retained, there should be a source country clearance or ruling procedure.

BEPS Action 1 (the digital economy)

There’s also been recent activity in regard to BEPS Action 1 (which concerns the digital economy).

Firstly, on 16 April, the OECD published all of the public comments it had received on its 24 March discussion draft.

In total, 63 organizations and individuals have made comments, occupying 479 pages.

And then on Wednesday of this week, the OECD held a public consultation meeting in Paris.

Let me summarise the private sector comments which have been submitted. And I’ll do that by addressing five key issues :

Is it possible or appropriate to ring-fence the digital economy?

Should the broader question of “source versus residence taxation” be considered as part of BEPS Action 1?

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Is it likely, as the OECD asserts, that all the other BEPS Actions, collectively, will significantly reduce the impact of BEPS tax planning in the digital economy?

Is it appropriate, as the OECD suggests, to "wait and see" whether the other BEPS Actions have been successful in eliminating BEPS tax planning in the digital economy, before deciding which of the list of options in Chapter VII of the discussion draft should be implemented?

So, the **first issue** is: is it possible or appropriate to ring-fence the digital economy?

The strong consensus view of the private sector commentators was : "no, it's not possible or appropriate to try to ring-fence the digital economy, either from a definitional perspective or from the perspective of a separate tax regime" – which is the conclusion reached by the OECD in the discussion draft.

However, one of the commentators, the Digital Economy Group, did make the point that some of the options in Chapter VII of the discussion draft :

"are in essence proposing a separate tax regime for the digital economy, despite the Discussion Draft conclusion that ring-fencing the digital economy is not feasible."

The **second issue** is : should the broader question of "source versus residence taxation" be considered as part of BEPS Action 1?

I think it's true that there are elements of this broader question which have crept into the Action 1 discussion draft.

Several commentators referred to this.

For example, BIAC said this :

"…in keeping with the publicly stated parameters of the project, we do not believe this paper is the place to consider 'source' vs. 'residence' issues. That is clearly an issue of concern to G20 and OECD members, but if that discussion is to happen, it needs to take place more deliberatively than can be done in this paper."

The **third issue** is : is it likely, as the OECD asserts, that all the other BEPS Actions, collectively, will significantly reduce the impact of BEPS tax planning in the digital economy?

Again, the consensus from the private sector commentators is that, yes, all of the other Actions will likely cause a significant reduction in the impact of BEPS tax planning generally, as well as in the digital economy (whatever that means).

But some commentators were concerned about the fact that the Action 1 discussion draft gives "hints" as to the expansive scope of many of these other Actions.

BIAC said this:

"…we believe that the Discussion Draft should not seek to prejudge discussions still to be held on other substantive Action Items, but leave those to be developed by the other Working Parties according to the structure of the BEPS Action Plan."

And this :

"We are also concerned that a number of proposals described in Chapter V, if adopted, would reflect a clear move towards formulary apportionment."

The **fourth issue** is: is it appropriate, as the OECD suggests, to "wait and see" whether the other BEPS Actions have been successful in eliminating BEPS tax planning in the digital economy, before deciding which of the list of options in Chapter VII of the discussion draft should be implemented?

Not many commentators referred to this issue.

However, the Digital Economy Group, for example, did expressly agree with this "wait and see" approach.

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And the **fifth issue** : what do the commentators think about the draft list of options in Chapter VII?

Well, the short answer is : apart from the VAT options, not positively.

This is how I would summarise the private sector comments :

Moderate support for : Limitation or elimination of the exceptions from PE status in Article 5(4)

No support for : New tax nexus based on “significant digital presence”

No support for : Various types of “virtual PEs”

No support for : Withholding tax on digital transactions, perhaps collected by financial institutions

Good support for : VAT changes (one relating to imports of low value goods, and the other relating to inbound B2C transactions)

And, of course, if you want to access all of the public comments on Action 6 and on Action 1, you can do so on BEPS Central.

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