International Tax

OECD Tax Alert

29 May 2015

BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

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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 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 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 addition, it was not felt that any changes needed to be made to reflect EU law since the meaning of "recognized stock exchange**"** is open-ended. 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.

Derivative benefits/active business

The September 2014 discussion paper on action 6 proposed a derivative benefits clause to ensure an entity owned by nonresident "equivalent beneficiaries" may qualify for treaty benefits. The inclusion of this derivative benefits clause was based on the assumption that other BEPS actions would address specific concerns that may arise as a result of its inclusion.

A number of technical issues were raised during the discussion of the proposals in this area, resulting in two newly proposed treaty provisions in the revised discussion paper. The new provisions, which could address some of the concerns regarding the inclusion of a derivative benefits test, include making tax treaties responsive to certain future changes in a country's domestic tax laws. Specifically, they propose the removal of treaty benefits where a "special tax regime" exists that provides for a preferential tax rate on interest, royalties or other income, or where future changes are made to domestic tax rules that provide an exemption from taxation to resident companies for substantially all foreign-source income.

It also is proposed that the special tax regime rule be reflected in the active business test. The activities of a connected person subject to a special tax regime could not be combined with a resident's activities. In addition, the connected person would have to be in the same or a similar line of business before their activities could be aggregated.

Again, these matters will be discussed in the June meeting.

Funds

The policy considerations behind the treatment of collective investment vehicles (CIVs) under tax treaties has been an area of focus for the Working Party, specifically, the application of the LOB to CIVs, taking into account the approach suggested by the 2010 OECD Report, "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles," and advances since 2010, in particular, the results of the work on the Treaty Relief and Compliance Enhancement (TRACE) project.

Following comments received and discussions at the March 2015 meeting, the Working Party has concluded that the conclusions of the 2010 Report remain relevant and that LOB proposals incorporate these recommendations; therefore no additional changes to the report on Action 6 are required to address these issues. However, the discussion paper notes that the implementation of the recommendations of the TRACE project is important in relation to the practical application of these conclusions.

Pension funds and other non-CIV funds

The report acknowledged that further work is required in respect of the policy considerations relating to non-CIV funds, such as REITs, sovereign wealth funds, pension funds and alternative funds, such as private equity funds. The Working Party recognizes the economic importance of these funds and the need to grant treaty benefits where appropriate, but did not consider that most comments received took sufficient account of the treaty-shopping concerns.

Most of the issues identified related to the LOB; however, there were suggestions that the PPT rule could adversely affect non-CIV funds. Conclusions have not been reached on the treatment of all non-CIV funds at this stage and proposals relating to REITs in particular, are to be addressed at the June 2015 meeting of the Working Party. It has been proposed that the commentary should refer to the 2008 "Tax Treaty Issues Related to REITs" report.

The Working Party agreed that pension funds should be considered to be a resident of the state in which they are constituted, regardless of whether they benefit from a limited or a complete exemption from taxation in that state. Commentators had suggested the removal of all restrictions on the residence of beneficiaries of a pension fund, specifically, to counteract concerns surrounding EU law. The Working Party has concluded that removing all restrictions would raise treaty-shopping concerns, especially as substantial foreign participation in a pension fund already is permitted. The proposal is that pension funds where 90% of beneficiaries are resident in either contracting state, or are residents of a third state if those individuals are entitled to the benefits of a treaty between the source state and the third state and would be subject to the same or a lower rate of tax on dividends or interest, also should qualify. This issue is to be considered further at the June 2015 meeting.

It is recognized that work on non-CIV funds could continue after September 2015, but should be completed before December 2016.

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 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.

Comments and timetable

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 recognition of the importance of non-CIVs is welcome, especially as pension funds may invest through such vehicles rather than making direct investments. The specific inclusion of non-CIVs in the LOB rule would reduce uncertainty about the application of treaty benefits. However, if this is not possible, it would be hoped that specific reference could be made to them in the commentary on competent authority discretionary relief. In addition, the extension of pension funds that are to be recognized as qualifying persons is helpful, but the associated compliance obligation could be onerous.

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.

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.