International Tax

United States Tax Alert

March 21, 2014

OECD Releases BEPS Draft on Inappropriate Circumstances for Treaty Benefits

Contacts

Harrison Cohen
harrisoncohen@deloitte.com

Gretchen Sierra
gretchensierra@deloitte.com

Andy Christiansen
anchristiansen@deloitte.com

On Friday, March 14, 2014, the OECD released a public discussion draft (or note) on Action 6 of its Action Plan on Base Erosion and Profit Shifting (BEPS), entitled "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances." Comments on the draft are to be sent to the OECD by Wednesday, April 9, 2014, less than four weeks from release date. A public consultation meeting is scheduled for April 14-15, 2014 at the OECD Conference Centre in Paris.

The draft is divided into three sections matching the three tasks identified by BEPS Action 6:

A. Treaty provisions and/or domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

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

C. Tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

This alert outlines some of the key features of the discussion draft.

Section A – Limiting Treaty Benefits in "Inappropriate Circumstances"

Section A would revise the OECD Model Tax Convention on Income and on Capital (the OECD Model) and its Commentaries to recommend:

1. A limitation on benefits (LOB) provision like that in the U.S. Model

2. A general anti-abuse rule under which a treaty benefit shall not be granted where it is reasonable to conclude that obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted in that benefit, unless it is established that the benefit would be in accordance with the object and purpose of the relevant provisions of the treaty

3. A minimum shareholding period and other requirements to qualify for reduced source-country tax on dividends

4. Additional rules to prevent avoidance of tax on real property gains through sales of interests in entities

5. Denying treaty benefits for dual-resident entities, except on a determination by the Competent Authorities

6. A "triangular" provision similar to that in some U.S. treaties

7. A "saving clause" for the taxation of a contracting state's own residents

Except for item 2 and parts of item 3 above, these are generally similar to aspects of the U.S. Model Income Tax Convention (U.S. Model) and/or recently negotiated U.S. income tax treaties.

Limitation on Benefits Article

The draft recommends incorporating essentially the U.S. Model's LOB article into the OECD Model. Note that many of the treaties in the U.S. income tax treaty network have yet to be renegotiated to include all of the provisions in the U.S. Model LOB, including some that would be more strict than the corresponding articles of some of the U.S. treaties now in force.

In addition, the draft requests comments on whether a "derivative benefits" provision should also be included in the OECD Model LOB article, recognizing that it "would be an appropriate way of dealing with cases," such as dividends, "where taxation of an item of income in the two Contracting States is comparable to taxation of the same item of income if it had been received directly by the shareholders of the company that received that item of income." In the case of what the draft calls "base eroding" (presumably, deductible) payments, however, the draft states that a derivative benefits provision could result in granting treaty benefits "in situations that have given rise to BEPS concerns." To illustrate this point, the draft sets forth as an example the use of a derivative benefits provision to claim treaty protection from source-country tax on royalty payments, when the payments are made to a sister subsidiary of the relevant third-country resident, and the payee's jurisdiction affords a preferential tax rate for royalty income, while the third country does not.

General Anti-Abuse Rule—the "One of the Main Purposes" Test

The draft recommends including a new OECD Model provision, *in addition to* an LOB article, which would provide as follows:

> 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.

To be "one of the main purposes," a purpose need not be the dominant purpose.

Observation: Provisions similar to this proposed rule were included in the dividends, interest, royalties, and other income articles of the proposed treaty signed in 1999 between the United States and Italy. For example, Article 22(3) of that treaty, as signed, provided: “The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the income is paid to take advantage of this Article by means of that creation or assignment.” In testimony submitted to the Senate Foreign Relations Committee in 1999, the U.S. Treasury Department wrote: “It is expected that the United States will incorporate these new anti-abuse provisions into its Model.” The committee went in a different direction, expressing concern that the standard set forth in these “main purpose” provisions “does not adequately distinguish between legitimate business transactions and tax avoidance transactions,” and requesting a comprehensive analysis of the test before including it in future treaties or the U.S. Model. The Senate gave its consent to ratification of the1999 U.S-Italy treaty only subject to the condition that the provisions be “stricken in their entirety” from the treaty.

A similar provision has never been proposed to be included a U.S. income tax treaty since then.

The BEPS Action 6 discussion draft discusses at length how the Commentaries would explain the recommended provision, including at least six examples of when the general anti-abuse rule would or would not be violated.

The draft sets forth as examples a non-treaty-country resident’s dropping of a note, or stock, of a related or unrelated company into a subsidiary residing in a country that has a treaty with the source country of the interest or dividends to be paid on the note or stock. The draft suggests that it could well be reasonable to conclude that these arrangements or transactions had the prohibited purpose, resulting in denial of treaty benefits to the recipient of the note or stock on its interest or dividend income. In another example, a person holding property located in a foreign country changes its residence, before selling the property, from residence in a country that has no treaty with the property location’s country, to a country that has such a treaty. The draft indicates that the general anti-abuse rule could result in denial of treaty benefits under the facts of this example.

By contrast, the draft indicates that in the case of an industrial company choosing to place a new plant in a country that has a treaty with the company’s residence country, and in the case of an investment management company choosing to invest in portfolio stock issued by residents of a country that has a treaty with the company’s residence country, the arrangements or transactions generally need *not* result in denial of treaty benefits under the proposed rule, even if treaty benefits entered into the decision. The draft indicates that the anti-abuse rule would not deny benefits because treaties are *intended* to encourage cross-border commerce and investment.

Observation: The draft presents a somewhat confusing message: governments intend to confer treaty benefits, unless taxpayers intend to avail themselves of them—unless, perhaps, the tax-motivated behavior is consistent with promotion of “bona fide exchanges of goods and services, and movements of capital and persons.”

Other Recommendations to Prevent Circumvention of Treaty Limitations

Portfolio Dividends: The draft recommends the addition of a holding period requirement in Article 10(2)(a) of the OECD Model in order for a recipient of dividends to benefit from a lower treaty withholding rate than the rate intended to be afforded to portfolio dividends. This recommendation is intended to address the possibility of temporarily shifting ownership of stock in order to drop the treaty rate below 15%. The draft also would add anti-abuse rules to deal with efforts to achieve a less-than-15% rate through the use of certain types of “intermediate entities” (similar to the rules in U.S. treaties dealing with dividends from RICs and REITs).

Gain on Sale of Real Property Partnership or Trust: The draft recommends amending Article 13(4) of the OECD Model to permit source country taxation of gains on the sale of a partnership or trust that derives more than 50% of its value from immovable property. In U.S. treaties, the object of this recommendation is generally achieved by incorporating internal law standards into the treaty determination.

Residence Tie-Breaker Rule: Article 4(3) of the OECD Model provides a residence tie-breaker rule for dual resident entities under which the entity is considered a resident of the country in which its place of effective management is situated. The draft notes that “the view of many countries” has been that “cases where a company is a dual-resident often involve tax avoidance arrangements.” As a result, it recommends amending the tie-breaker rule to provide that the competent authorities of the Contracting States shall endeavor to determine by mutual agreement the residence of the person. In the absence of such agreement, the person generally shall not be entitled to any benefits of the treaty. The recommendation bears some similarities to Article 4(4) of the U.S. Model.

Third State PE “Triangular” Provision: The drafters considered “triangular” cases in which an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment in a third State. The draft notes that in this situation the income is possibly not taxed in any of the three states. The draft recommends the addition of a specific triangular anti-abuse rule to the OECD Model in Article 1. The drafters considered the triangular provision that the United States has adopted in several bilateral tax treaties, and the draft requests comments on whether that rule, or a different rule, should be adopted.

“Saving Clause”: In order to ensure that tax treaties do not override, in unintended ways, a country’s ability to tax its own residents, the draft recommends the addition of a “saving clause” to Article 1 of the OECD Model. The proposed saving clause corresponds with the saving clause in the U.S. Model.

Section B – Clarifying Treaties Are Not Intended to Create Double Non-Taxation

The title of the OECD Model today is simply “Convention . . . with respect to taxes on income and on capital” with a footnote providing: “States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.” The BEPS Action 6 discussion draft proposes the following new title: “Convention . . . for the elimination of double taxation on income and on capital and the prevention of tax evasion *and avoidance*” (emphasis added).

The preamble of the OECD Model today is merely a blank space headed by the words “PREAMBLE TO THE CONVENTION” with a footnote providing: “The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States." The BEPS Action 6 discussion draft would fill the blank space with a declaration that the parties intend that the Convention eliminate double taxation "without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)."

Observation: The drafters of the note appear to expect that a treaty's incorporation of such a title and preamble language will be relevant to the interpretation and application of the treaty. This would seem to be true either in cases where treaty interpretation is governed by the Vienna Convention on the Law of Treaties (cited in the discussion draft), or by U.S. law.[1] It may be that proposed preamble language would only be relevant when interpreting terms of a treaty that are ambiguous. This might be consistent with the method of interpretation generally used by U.S. courts. Alternatively, some may be concerned that the title and preamble language could broadly turn treaty interpretation into a subjective exercise, requiring a consideration of the context, object and purpose of treaty provisions to determine whether reduction of internal law tax is warranted, even when interpreting *un*ambiguous treaty provisions. One might hope that this latter approach would be ruled out by the Commentary to any title and preamble provisions incorporated into the OECD Model pursuant to the discussion draft's proposal.

Section C – Tax Policy Considerations for Entering into a Treaty

The draft recommends adding six new paragraphs to the Introduction to the OECD Model which would discuss tax policy considerations that are relevant to the decision of *whether* to enter into a tax treaty (or amend an existing treaty) with a particular country. These would include statements that treaty restrictions on the right to tax "elements of income" involve an understanding that these elements of income are taxable in the other country; and that when a country does not impose an income tax, or imposes a low income tax, then there is little need to adopt a tax treaty to prevent double taxation. Under the draft's proposed Commentary, elements of another country's tax system that could increase the risk of double non-taxation may include "income tax advantages that are ring-fenced from the domestic economy." The draft also notes that exchange of information and other administrative cooperation are important objectives of tax treaties. Therefore, the proposed Commentary recommends that States consider whether their prospective treaty partners are willing and able to implement effectively these aspects of tax treaties.

Conclusion

It is still too soon to tell whether U.S. tax treaty policy may or may not be affected by the aspirations set forth in the BEPS Action 6 discussion draft; but whatever effect the BEPS project may have on U.S. treaties (if any), we expect that it will be felt only gradually. First, U.S. tax treaties are generally negotiated, signed, and ratified one step at a time, and one country at a time, and often even a single treaty relationship will change only over a period of many years. Second, even those BEPS treaty proposals that ultimately *are* adopted by the OECD's Committee on Fiscal Affairs (if any), will not thereby become the treaty policy of

[1] *See, e.g., Xerox Corp. v. United States,* 41 F.3d 647, 660 (Fed. Cir. 1994), *cert. denied,* 516 U.S. 817 (1995), where the opinion referred to the "clear purpose of avoidance of double taxation" of the 1975 U.S.-U.K. treaty (as amended) which happened also to be set forth in the title of that treaty: "Convention . . . for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains."

the United States unless the Administration and the Senate are willing to adopt those policies. The independence of our executive and legislative branches was brought home in stark relief when the "main purpose test" provisions that the Clinton administration proposed to include in the U.S. Model, and in the U.S.-Italy treaty, were "stricken in their entirety" on the advice of the Senate. Third, aside from the "main purpose test" which the discussion draft proposes to add to the OECD Model, the proposals in the draft generally either *already* reflect current U.S. treaty policy or, in the case of the proposals regarding treaty titles and preambles, seem likely to be felt (if at all) only in the grayer areas of treaty interpretation, where the impact may emerge only slowly as taxpayers, the IRS, and the courts test their limits in real cases and controversies.

In addition to their effects on U.S. tax treaty policy, BEPS-inspired treaty policy changes also may indirectly influence U.S. tax practice through their effects on treaties between U.S. treaty partners and third countries. Observers may wish to consider what those indirect consequences might be as the BEPS project continues toward completion.