

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

On 16 September 2014, ahead of the G20 Finance Ministers' meeting on 20-21 September, the OECD published seven papers as a first tranche of deliverables under the Base Erosion and Profit Shifting ('BEPS') Project. The OECD will be continuing its work on the remainder of the 15 Actions on BEPS throughout 2015. It is clear that the G20 and OECD governments intend that recommendations under each of the BEPS Actions will form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under the model tax treaty and transfer pricing guidelines. As a result, the proposed solutions in the first seven papers, while agreed, are not yet finalised and may be affected by decisions and future work on BEPS in 2015.

Deloitte Comments and Business Next Steps

The inclusion of both limitation on benefits (LOB) and principle purpose test (PPT) rules in a treaty may go further than is needed to prevent abuse. The inclusion of the derivative benefits clauses in the LOB rules, together with the ability for competent authorities to override the rules where there is no evidence of abuse are welcome developments, but there will continue to be practical issues for businesses seeking to determine whether the rules apply, particularly in third party situations with limited information. The absence of a clearance mechanism for the application of the PPT rules will increase uncertainty, as could the potential removal of the effective management tie breaker clause from UK treaties.

Businesses should start to identify circumstances that may be affected by the PPT, as this is the UK government's preferred option, and evaluate the potential consequences for treaty benefits. Groups with entities that are resident by virtue of effective management should also identify those companies potentially affected.

OECD proposals

Prevention of abuse: At a minimum, tax treaties should include either:

- (i) a principle purposes test ('PPT') rule;
- (ii) a limitation on benefits ('LOB') rule supplemented by a mechanism, such as a restricted PPT rule, that would deal specifically with conduit arrangements; or
- (iii) a combined approach (i.e. including both LOB and PPT rules).

Certain targeted anti-avoidance clauses are also proposed, together with changes to the title, preamble and Commentary on the OECD Model Tax Convention to clarify that the prevention of tax evasion and avoidance, specifically including but not limited to treaty shopping, is one of the purposes of a double tax treaty.

Limitation on benefits rule: A specific anti-abuse rule is proposed based on the LOB provision already included in many US treaties. The rule is broadly designed to limit treaty benefits to companies with sufficient presence in the relevant country, based on their legal nature, ownership and activities. There are some new proposals including

optional clauses on the treatment of Collective Investment Vehicles ('CIVs'); competent authorities' considerations for discretionary relief; and the ability to take into account regional groups (e.g. the European Union) when drafting clauses. There are also proposed amendments to the Commentary on the OECD Model Tax Convention, such as discussion of what constitutes an 'active business' for the purposes of LOB, which indicates that a company functioning solely as a headquarters company could have difficulties in meeting the test.

LOB – derivative benefits clause: The LOB proposals provisionally include a 'derivative benefits' clause, which would allow a treaty country to look through to the shareholders where the shareholders would also be entitled to benefits under a treaty. Negotiating states would be given the flexibility to restrict the clause to dividend income. The inclusion of the derivative benefits clause is based on an assumption that other BEPS Actions will address specific concerns which may arise from its inclusion, and this will therefore be re-examined in 2015.

Principle purposes test rule: The paper proposes a broadly drafted general purpose rule aimed at removing treaty benefits where one of the principal purposes of arrangements or transactions is to obtain treaty benefits.

Determining treaty residence: The existing 'place of effective management' tie-breaker clause for determining treaty residence is to be replaced by a requirement that the competent authorities of the two countries endeavour to determine residence. Countries which share the view that the 'place of effective management' rule was not being abused can continue to use it. However there are indications that the UK government has a preference for the competent authority approach, as demonstrated by the 2008 UK-Netherlands treaty.

Minimum shareholding period re dividends: Reduced rates of withholding tax applicable to non-portfolio dividends will be restricted to shareholdings that are owned throughout a 365-day period that includes the date of the dividend payment, taking into account any internal reorganisations in the period.

Withholding taxes on payments to permanent establishments: There will be restriction of relief from withholding taxes on payments to a permanent establishment in a third country with a low rate of tax, where the permanent establishment's profits are exempt from tax in the resident country.

Timetable

Further work will be undertaken in 2015 ahead of the multilateral instrument to implement changes, in particular in respect of the treatment of CIV and non-CIV funds, and on the implementation of minimum standards.

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