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OECD Releases a Discussion Draft on Open Issues in BEPS Action 6 – Prevent Treaty Abuse

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The purpose of this alert is to discuss some highlights of the new discussion draft (the May Draft) that was recently published by the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) on Action 6 of the G20/OECD Base Erosion and Profit Shifting (BEPS) Action Plan.

Context of the May Draft

One of the BEPS reports published in September 2014 addressed Action 6, but its recommendations (chiefly, on changes to the OECD Model Tax Convention) were not final. (None of the other September 2014 deliverables were truly "final," at that point.) In November, a public discussion draft called "Follow Up Work on BEPS Action 6: Preventing Treaty Abuse" (the November Follow Up) listed 20 issues for further discussion. These issues were the subject of public comments and a public consultation meeting in January 2015, followed by meetings of Working Party 1 on Tax Conventions and Related Questions (WP1) in March.

The May Draft reports on progress made with respect to these 20 issues (not all of which will be covered in this alert). The Committee on Fiscal Affairs is seeking comments on the May Draft (due no later than June 17) for use at the meeting of WP1 to be held the week of June 22.

I. Simplified Limitation on Benefits

A. Background

The May Draft proposes to revamp the Limitation on Benefits (LOB) article that the September 2014 Action 6 report (the Report) appeared to propose to add to the OECD Model Tax Convention (the OECD Model).

The Commentary on the OECD Model currently contains LOB rule provisions similar to a U.S.-style LOB article. (See paragraph 20 of the Commentary on Article 1 of the OECD Model.) The LOB rule that the Report would have moved into the OECD Model itself is very similar to the LOB article in the 2006

U.S. Model Income Tax Convention (the U.S. Model) plus a "derivative benefits" provision similar to those in recent U.S. treaties; in addition, the Report would add to the OECD Model a "triangular provision" similar to those in recent LOB articles of U.S. treaties. Finally, the Report proposed an OECD Commentary on the proposed OECD Model LOB article that is very similar to the Technical Explanation (TE) of the LOB article of the U.S. Model.

However, the Report did not recommend that all treaties include such an LOB provision. Paragraph 11 of the Report did recommend generally that treaties include a "specific" anti-abuse rule based on the LOB provisions in U.S. treaties (the LOB rule), and that treaties also include a more "general" anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or PPT rule). But the Report also stated that the combination of an LOB rule and a PPT rule may not be appropriate for all countries.

Finally, paragraph 14 of the Report stated that "[a]t a *minimum*" (emphasis added), countries should adopt "*either*" (emphasis added) of the following: the combined approach described in paragraph 11, the PPT rule, or the LOB rule supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties. This sentence in paragraph 14 represents a so-called "minimum standard."

B. The May Draft

The May Draft proposes to insert into the OECD Model a model "Entitlement to Benefits" (ETB) article (Article [X]) with seven paragraphs, the first six of which would be mere *placeholders* for the *general topics* covered by the first six paragraphs of the proposed OECD Model provision in the Report, and the seventh of which would be the (actual) PPT rule. (In a different passage, the May Draft also appears to propose a "paragraph 8" of the model ETB article to give competent authorities discretion to apply paragraph 7 in a way that affords partial treaty benefits). A footnote to the OECD Model ETB article proposed in the May Draft would read as follows:

> The drafting of this Article will depend on how the Contracting States decide to implement their common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. This could be done either through the adoption of paragraph 7 [i.e., the PPT rule] *only*, through the adoption of the detailed version of paragraphs 1 to 6 that is described in the Commentary on Article [X] together with the implementation of an anti-conduit mechanism as described in paragraph [x] of that Commentary, or through the adoption of paragraph 7 together with *any* variation of paragraphs 1 to 6 described in the Commentary on Article [X].

(Emphasis added.) As an illustration, the May Draft sets forth an alternative LOB rule with the placeholders filled in (a "simplified LOB"), which would not be consistent with the Report's version. For example, among other differences (1) this simplified LOB provision has no base erosion tests; (2) its ownership tests impose no residence requirements on intermediate owners in the case of indirect ownership; (3) its derivative benefits test imposes a 75%-ownership-by-equivalent-beneficiaries test in lieu of the 95%-ownership-by-seven-or-fewer-equivalent-beneficiaries test in the Report's proposed OECD Model

provision, and defines "equivalent beneficiary" differently than the Report's proposed OECD Model provision does; and (4) it has a "carrying on business test" instead of an "active conduct of business" test. The May Draft states: "It was agreed that this approach *was consistent* with the minimum standard described in paragraph 14 of the Report on Action 6, which may be satisfied by the inclusion of *any form of LOB combined with the PPT*, whereas the LOB rule that was included in the Report was considered more appropriate for countries that would prefer to meet the minimum standard through the combination of an LOB rule and a mechanism dealing with conduit arrangements" (emphasis added). The result may be that after Action 6 is fully implemented by amending the OECD Model, substantive LOB rule provisions will remain, as they are now, in the Commentary on the OECD Model rather than in the OECD Model itself.

For those treaties that do not include paragraph 7, the May Draft proposes to add to the Commentary the examples in the U.S.-U.K. Exchange of Notes on the anti-conduit rule of the U.S.-U.K. treaty as examples of what should, or should not, be considered "conduit arrangements."

II. Proposed Changes for Special Tax Regimes and Future Law Changes

The May Draft states that the Delegate for the United States invited WP1 to discuss two proposals designed to address some of the objections to the addition of a derivative benefits provision in the LOB rule: one to deal with "special tax regimes" (STRs), and the other that would make a tax treaty responsive to certain future changes in a country's domestic tax laws. WP1 left these proposals to be decided on at the upcoming June meeting.

The U.S. proposals described in the May Draft are similar, but not identical, to two of the five proposed draft changes to the U.S. Model that were released by the U.S. Treasury Department on May 20 (the Draft U.S. Model Proposals).

A. Special Tax Regimes

Similar to one Draft U.S. Model Proposal, the U.S. proposal to WP1 would amend Article 11 (Interest), Article 12 (Royalties), and Article 21 (Other Income) of the OECD Model to provide that payments made to a person subject to an STR would be taxable as provided under internal law. The proposals for those articles would read:

> [Interest] [Royalties] [Other income] arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime with respect to interest in its Contracting State of residence at any time during the taxable period in which the [interest is] [royalties are] [other income is] paid.

The proposal would amend Article 3 of the OECD Model to include a definition of "special tax regime" as follows:

> [T]he term "special tax regime" with respect to an item of income or profit means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including

through reductions in the tax rate or the tax base. With regard to financing income, the term special tax regime includes notional interest deductions that are allowed without regard to liabilities for such interest. However, the term shall not include any legislation, regulation or administrative practice:

i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof;

ii) except with regard to financing income, that satisfies a substantial activity requirement;

iii) that is designed to prevent double taxation;

iv) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises);

v) that applies to persons which exclusively promote religious, charitable, scientific, artistic, cultural or educational activities;

vi) that applies to persons substantially all of the activity of which is to provide or administer pension or retirement benefits;

vii) that facilitates investment in widely-held entities that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or

viii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation.

Treaty negotiators could also specify particular laws, rules, and practices of the contracting states that they agree are, and are not, STRs.

The U.S.-proposed STR definition as described in the May Draft is almost identical to the corresponding definition in the Draft U.S. Model Proposal on STRs, with a few exceptions. Subparagraph ii) of the Draft U.S. Model provision states that the term STR shall not apply to a regime that, "with regard to royalties, satisfies a substantial activity requirement." The U.S. proposal described in the May Draft on Action 6 has a substantial activity exception with a broader scope, as it covers *any* income other than interest. The U.S. proposal in the May Draft applies to income regardless of who paid it, but the Draft U.S. Model Proposal on STRs applies only to payments from *related* persons. Additionally, the proposed definition of STR in the U.S. proposal described in the May Draft excludes legislation, regulation or administrative practice designed to prevent double taxation. This clause does not appear in the Draft U.S. Model Proposal, although it is clear from its TE that at least foreign tax credit rules are not an STR for this purpose.

What the May Report lacks, in contrast to the Draft U.S. Model Proposal, is a narrative explanation of these exceptions. For example, in proposed TE language the Draft U.S. Model Proposal makes it clear that exception i) (worded identically to exception *i*) above)

> generally applies to the exemption of income attributable to permanent establishments in other states. However, the exception will not apply if the residence State administers such exception in a manner that is

> reasonably expected to disproportionately benefit interest, royalties or other income by, for example, treating such income as attributable to a foreign permanent establishment in circumstances in which the state in which the permanent establishment is situated would not be expected to tax the income.

No similar language appears in the May Report, leaving it for future guidance to determine whether the OECD Model, should it incorporate the U.S. proposal, would also incorporate the same interpretation of exception *i)*.

B. Subsequent Changes in Law

Also similar to another proposed Draft U.S. Model Proposal, the U.S. proposal described in the May Draft on Action 6 would add a provision to the OECD Model giving each Contracting State the option to notify the other State that it will cease to apply Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) to individuals or companies, effective six months after the notification, if, after the treaty is signed, one of the states provides an exemption from taxation on "substantially all foreign source income (including interest and royalties)" to individuals or companies, as the case may be. (This differs from the corresponding Draft U.S. Model Proposal in that the latter was also triggered by a reduction below 15% of either the general company income tax rate or the highest marginal rate of individual income tax.) The May Draft does not elaborate on the proposal. The TE of the Draft U.S. Model Proposal on this topic explains that the phrase "substantially all foreign source income" would include a regime where 95% of foreign source income is exempt from tax and 5% remains taxable as a proxy for the disallowance of allocable deductions. Adoption of a tax regime where only foreign source dividends or business profits from permanent establishments are exempt from tax would *not,* however, trigger the provision.

III. The Active Business Provision of the LOB Rule

The May Draft mentions one other proposal that was presented by the Delegate for the United States and that the WP1 left to be decided at its upcoming June meeting. This proposal would amend the "active trade or business" test in paragraph 3 of the LOB article that the Report proposed to add to the OECD Model. In the case of a resident that seeks to meet the active trade or business test vicariously through a connected person's active trade or business, this proposal would prevent the resident from taking into account the activities of a connected person who enjoys an STR, and also would require that the resident and any connected person be in the same or a similar line of business before the latter's activities may be taken into account. The "same or similar line of business" language is not unlike the Draft U.S. Model Proposal to change the "active trade or business" test in the U.S. Model's LOB article, which appears to be designed to prevent a holding company or a financing entity from resorting to the "active trade or business" test in order to satisfy the LOB rule (and force it to resort instead to the "derivative benefits" test).

IV. The PPT Rule

The May Draft contains four new examples in the Commentary on the PPT rule intended to illustrate cases in which the PPT rule is not intended to deny treaty benefits. The examples focus on regional and holding companies, which were

absent from the examples provided in the Report.

In addition, the May Draft proposes to add another paragraph (paragraph 8) to the proposed ETB article to work together with the proposed OECD Model PPT Rule (paragraph 7 as explained above). This new paragraph 8 would provide that where a benefit under the Convention is denied to a person under paragraph 7, the competent authority of the Contracting State that otherwise would have granted this benefit shall nevertheless treat that person as being entitled to the benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request and after consideration, determines that such benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 7.

Example

Assume, for example, that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that company to another company resident of State R which owns more than 25% of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for Article 10(2)(a) (i.e., 5%). If it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 7, the competent authority of State S shall, under paragraph 8, grant the benefit of the reduced rate provided for in Article 10(2)(b) (i.e., 15%) if it determines that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.

V. Triangular Provision for PEs of Third States

The Report proposed to add to the OECD Model a “triangular provision” intended to prevent low-taxed permanent establishments (PEs) located in third countries from being granted benefits under the treaty, with exceptions for income derived in the active conduct of certain businesses by the PE, and for royalties from intellectual property (IP) produced or developed through the PE. The May Draft indicates an agreement to eliminate the exception for royalties from IP produced or developed through the PE. It also tweaks the rule so that the rate of tax in the PE is compared to the “general rate of company tax” in the residence State (and thus, for example, *not* the rate under an STR).

Conclusion

The May Draft describes a number of other changes that WP1 would make to OECD Model or Commentary provisions that would be changed by the Report, and many more proposed changes that it either rejected or left for decision at the June meeting. Those who are particularly interested in any one of the 20 topics that the November Follow Up raised, or a summary of the comments received on them, should refer to the specific section of the May Draft that deals with that topic.

Public comments on the May Draft, which must be submitted by June 17, will be published.

The work on Action 6 is scheduled to be completed by September 2015. However, just as the work continues on the actions that were the subjects of the September 2014 deliverables, one senses that WP1 may also let completion of

some of the items in Action 6 wait until 2016. A comment in the May Draft on treaty benefits for funds that are not collective investment vehicles (i.e., that are "non-CIVs") predicts that "work on these and other options might continue after the September 2015 adoption of the final report on Action 6 but should in any event be completed before the December 2016 deadline for the negotiation of the multilateral instrument that will implement the conclusions of the work on Action 6." Perhaps other issues will remain unresolved until then, as well.

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