OECD releases discussion draft on preventing treaty abuse under BEPS Action 6

Executive summary

On 14 March 2014, the Organisation for Economic Cooperation and Development (OECD) released a Discussion Draft in connection with Action 6 on treaty abuse under its Action Plan on Base Erosion and Profit Shifting (BEPS). The document titled *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (the Discussion Draft or the Draft) contains proposed tax treaty provisions and related commentary together with proposed domestic law provisions to address treaty shopping and other potential treaty abuse.

The Discussion Draft is one of a series of such drafts that the OECD is releasing this spring in connection with the BEPS Action Plan. The recommendations proposed in the Draft include incorporating in tax treaties both “limitations on benefits” (LOB) rules similar to those found in US tax treaties and broad anti-abuse rules similar to the “main purpose” tests found in UK tax treaties.

Detailed discussion

The 14 March 2014 Discussion Draft under Action 6 focuses on concerns about the potential for benefits of tax treaties to be granted to a taxpayer in inappropriate circumstances and provides recommendations for addressing these concerns. The OECD issued the Draft to provide stakeholders with an opportunity to comment on the proposals before the OECD issues its final recommendations under Action 6 by September 2014. Comments should be submitted to the OECD on or before 9 April 2014. The OECD has indicated its intention to have a public consultation on the Draft on 14-15 April 2014.
The Discussion Draft is organized into three sections that align with the three areas of focus identified by Action 6 of the OECD BEPS Action Plan related to preventing treaty abuse:

- Development of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances;
- Clarification that tax treaties are not intended to be used to generate double non-taxation; and
- Identification of tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

The Discussion Draft proposes changes to the OECD Model Treaty and the related Commentary and recommendations regarding domestic law provisions.

**Treaty provisions and domestic rules to prevent the granting of treaty benefits in inappropriate circumstances**

In considering how best to prevent the granting of treaty benefits in inappropriate circumstances, the Discussion Draft distinguishes two situations: (1) cases where a person tries to circumvent limitations provided by the treaty itself and (2) cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits.

**Cases where a person tries to circumvent limitations provided by the treaty itself**

The Discussion Draft describes “treaty shopping” as involving the attempt by a person who is not a resident of a Contracting State to attempt to obtain benefits that a tax treaty grants to a resident of that State. The Draft briefly reviews the prior work done by the OECD with respect to treaty shopping and notes that countries use a variety of approaches to address instances of treaty shopping that are not addressed by provisions in the OECD Model Treaty. The Draft proposes a series of recommended additions or changes to tax treaties.

The Discussion Draft's first recommendation is the addition to the preamble of tax treaties of a clear statement that “the Contracting States, when entering into a treaty, wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping.”

The Discussion Draft's second recommendation is the inclusion in tax treaties of a general anti-abuse rule (GAAR) that is based on a main purpose test. Under this rule, treaty benefits would be denied when one of the main purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining such benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty.

The Discussion Draft also notes that the OECD Focus Group working on this issue also considered whether a LOB rule should include a so-called “derivative benefits” provision. The Draft states that the Group recognized that such provision would be an appropriate way of dealing with cases where taxation of an item of income in the two treaty countries is comparable to the 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. However, the Group also noted that such a provision could result in the granting of treaty benefits in situations that could give rise to BEPS concerns, such as where a treaty-benefited payment is taxed at a more favorable rate in the country where the recipient company is located than it would be in the country where the shareholders are located. The Discussion Draft includes a specific request for comments on possible ways to address such cases if a “derivative benefits” provision were included in the LOB rule. It also requests examples of situations that should be covered under a “derivative benefits” provision.

The Discussion Draft’s third recommendation is the inclusion in tax treaties of a specific anti-abuse rule that is based on the LOB provisions included in treaties concluded by the United States and some other countries. The Draft includes proposed language for a LOB rule and further states that detailed commentary would explain the main features of the proposed rule.

The Discussion Draft also notes that the OECD Focus Group working on this issue also considered whether a
The Draft indicates it is intended that detailed Commentary would explain such a rule and include examples. The Draft includes a specific request for comments on what the Commentary should cover.

The Discussion Draft includes several explanatory points that could be included in the Commentary. The Draft makes clear that it is intended that the main purpose test would supplement the LOB rule. A benefit that would be denied under the LOB rule would not then be subject to analysis under the main purpose test. Conversely, a benefit that would be allowed under the LOB rule would be denied if the main purpose test is not satisfied.

The Discussion Draft further states that a treaty country may deny the benefits of the treaty if it is reasonable to conclude, having considered all the relevant facts and circumstances, that one of the main purposes of an arrangement or transaction was to gain a benefit under a tax treaty. Moreover, the Draft states that conclusive proof of such a main purpose is not required under this test. The Draft also notes that obtaining treaty benefits need not be the sole or dominant purpose of an arrangement but rather it is sufficient for purposes of the test that obtaining the treaty benefit is at least one of the main purposes.

The Discussion Draft sets forth two examples of situations where treaty benefits would be disallowed under the main purpose test and two examples where treaty benefits would not be disallowed under the main purpose test. The Draft requests comments on these examples and on additional examples that could be included in the Commentary in order to illustrate cases in which the main purpose test would or would not be satisfied.

In addition, the Discussion Draft discusses other situations where a person may seek to circumvent specific limitations or conditions with respect to particular treaty benefits, stating that although the GAAR type approach of the main purpose test would be useful in such situations, targeted specific treaty anti-abuse rules generally would provide greater certainty for both taxpayers and tax administrations. The Draft identifies a series of areas where a specific treaty anti-abuse rules could be helpful, including splitting-up of contracts to avoid permanent establishment thresholds; hiring-out of labor to obtain the benefits of Article 15; transactions intended to avoid dividend characterization; dividend transfer transactions; transactions that circumvent the application of article 13(4) (related to taxation of capital gain from immovable property); tie-breaker rules for determining the treaty residence of dual-resident persons; and triangular cases involving a permanent establishment in a third country. The Draft includes recommendations for specific anti-abuse provisions with respect to some of these situations and notes that some of the situations will be dealt with in the work under other BEPS Actions.

Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

The Discussion Draft also discusses what it describes as tax avoidance risks that are not caused by tax treaties but may be facilitated by tax treaties. These are situations where there is an attempt to use a tax treaty benefits to avoid provisions of domestic law. The Draft lists a series of strategies that fall into this category, including thin capitalization and other financing transactions, dual residence strategies, certain transfer pricing strategies, arbitrage transactions that take advantage of either mismatches within a country’s domestic laws or mismatches between the domestic laws of two countries related to the character or timing of income or deductions, the characterization of entities, or the treatment of taxpayers. The Draft notes that many of these transactions will be addressed through other items on the BEPS Action Plan and states that the main objective of the treaty work with respect to these types of transactions is to ensure that treaties do not prevent the application of specific domestic law rules that would otherwise prevent such transactions.

The Discussion Draft notes that the current Commentary already addresses some of these situations, making clear that treaties do not prevent the application of various domestic law provisions and providing a general discussion regarding the interaction between tax treaties and domestic anti-abuse
rules. However, the Draft reiterates the recommendation, described above, to include a treaty GAAR provision.

In order to prevent interpretations of the provisions of tax treaties in a manner intended to circumvent of a country’s domestic anti-abuse rules, the Discussion Draft recommends the addition of a provision like the US “savings clause,” which confirms a country’s right to tax its residents without regard to the provisions of any tax treaty (other than those provisions that are clearly intended to apply to residents).

**Clarify that tax treaties are not intended to be used to generate double non-taxation**

The Discussion Draft further recommends inclusion of specific language clarifying that tax treaties are not intended to be used to generate double non-taxation. The Draft notes that the Commentary on Article 1 of the OECD Model Treaty has since 1977 included a statement that tax treaties should not help tax avoidance or evasion and that this statement was further strengthened in 2003. However, in order to provide clarification, the Draft recommends stating clearly in the title of treaties that the prevention of tax evasion and avoidance is a purpose of tax treaties. The Draft also recommends inclusion of a preamble that expressly provides that the countries entering into the treaty “intend to eliminate double taxation without creating opportunities for tax evasion and avoidance,” and that refers specifically to treaty shopping as an example of such avoidance that should not result from treaties.

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

The final section of the Discussion Draft discusses tax policy considerations relevant to a country’s decision whether to enter into, modify or terminate a tax treaty with another country. The Draft notes that a clear articulation of these considerations would be useful to countries in justifying their decisions not to enter into tax treaties with certain low or no-tax jurisdictions. The Draft also recognizes that there are many non-tax factors that can lead to the conclusion of a tax treaty between two countries and that a country has a sovereign right to decide to enter into tax treaties with any jurisdiction.

The Discussion Draft proposes changes to the introduction to the OECD Model Tax Treaty discussing these policy considerations. As a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border economic activity, the Draft identifies the existence of risks of double taxation resulting from the interaction of the tax systems of the two countries involved, as the primary tax policy concern that should be considered. As such, where a country levies no or low income taxes or where elements of a country’s tax system could increase the risk of non-taxation, other states should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. Another consideration referenced is the risk of excessive taxation from high withholding taxes. Additionally, the Draft mentions the willingness and ability of a prospective treaty partner to implement effectively the provisions of tax treaties concerning administrative assistance (e.g., the ability to exchange tax information), as being a key aspect that should be taken into account when deciding whether or not to enter into a tax treaty.

**Implications**

The Discussion Draft is the first draft of the output to be produced under Action 6 of the OECD BEPS project. The use of a LOB provision is consistent with the historic approach of the United States in its treaties. The use of a main purpose test is consistent with the practice of the United Kingdom in its treaties. Moreover, each of these approaches has been adopted by some other countries. The Discussion Draft’s approach of recommending both approaches in combination raises issues regarding the potential uncertainties that could be created for businesses engaging in cross border transactions.

Companies should evaluate how the proposed changes may impact them, stay informed about treaty developments in the OECD and in the countries where they operate or invest, and consider participating in the dialogue regarding the BEPS project and the underlying international tax policy issues.
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