OECD releases final report under BEPS Action 6 on preventing treaty abuse

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released the final report with recommendations for addressing treaty abuse in connection with Action 6 of the Action Plan on Base Erosion and Profit Shifting (BEPS). The report titled Preparing the Granting of Treaty Benefits in Inappropriate Circumstances (2015 Final Report or Final Report), which supersedes the interim version issued in September 2014 (2014 Deliverable), contains model tax treaty provisions and related changes to the model commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios. The Final Report notes that a number of changes have been made to the 2014 Deliverable and that further work will be required with respect to certain provisions.

The 2015 Final Report is organized in three sections. Section A includes anti-abuse provisions that provide safeguards against the abuse of treaty provisions. In this regard, the Final Report notes that countries have committed to a minimum standard to provide a minimum level of protection against treaty shopping. In addition to the minimum standard, the Final Report includes targeted rules to be included in tax treaties that would address other forms of treaty abuse, including situations of dual resident entities, and rules that apply to a permanent establishment (PE) situated in a third state.

Section B contains revisions to the title and preamble of the OECD Model Tax Convention (OECD Model) to clarify that the intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion and avoidance, including through treaty shopping arrangements. Section C identifies tax policy considerations relevant to the decision to enter into a tax treaty with another country.
Finally, as indicated above, the 2015 Final Report outlines further work that will be required under Action 6. In particular, the Final Report notes that further work will be required with respect to a US-style limitation on benefits (LOB) rule to prevent treaty shopping, with final versions of the LOB rule and Commentary expected to be completed in the first part of 2016. In addition, the Final Report specifies that further work is needed with respect to the treaty entitlement of non-collective investment vehicles (non-CIVs) and pension funds and indicates that such work would benefit from consultation with stakeholders. Any further work would need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument, which is expected to be finalized in 2016.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final report on Action 6 will be addressed in a webcast on Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 on 19 November at 10 am EST.

Detailed discussion

Background

Action 6 focuses on the prevention of treaty abuse, noting that treaty shopping is one of the most important sources of BEPS concerns. The 2014 Deliverable set out a series of recommendations for addressing treaty abuse, in the form of changes to the OECD Model and related Commentary. On 21 November 2014, following the release of the 2014 Deliverable, the OECD issued a public discussion draft titled Follow-Up Work on BEPS Action 6: Preventing Treaty Abuse (Discussion Draft), that identified a number of issues on which follow-up work with respect to the contents of the model provisions and related Commentary was to be carried out by Working Party 1, the working group responsible for treaty matters (Working Party). A public consultation on the Discussion Draft was held on 22 January 2015, and the Working Party undertook further consideration of the comments received at a March 2015 meeting. On 21 May 2015, the OECD released a revised discussion draft reflecting the conclusions and proposals that resulted from the January public consultation and March 2015 meeting (Revised Discussion Draft).

Additional comments received were further considered by the Working Party at a meeting in June.

The 2015 Final Report reflects the conclusions reached by the Working Party with respect to several matters in the follow-up and incorporates these conclusions with the proposals to modify the OECD Model and Commentary that had been set forth in the 2014 Deliverable (with the Final Report superseding the 2014 Deliverable). The Final Report also indicates that further work will be required under Action 6, including with respect to the LOB rule and with respect to the treaty entitlement of non-CIVs and pension funds.

The 2015 Final Report

Similar to the 2014 Deliverable, the 2015 Final Report is organized into three sections which align with the three different areas identified by Action 6: (A) Treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances; (B) Clarification that tax treaties are not intended to be used to generate double non-taxation; and (C) Identification of tax policy considerations that countries should consider before deciding to enter into a tax treaty with another country.

The Final Report notes that countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). That commitment will require that countries include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. Section A of the Final Report contains details of how that commitment would be implemented. In addition, countries will implement the minimum standard by including in their treaties one of the following: (i) a combined approach consisting of an LOB and a principal purpose test (PPT) rule; (ii) a PPT rule alone; or, (iii) an LOB rule, supplemented by specific rules targeting conduit financing arrangements. The formulation of the minimum standard reflects the agreement that some flexibility in implementation is required.
Treaty provisions and domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

In determining how best to prevent the inappropriate granting of treaty benefits, the 2015 Final Report considers two situations: 1) cases where a person tries to circumvent limitations provided by the treaty itself, and 2) cases where a person tries to abuse the provisions of domestic tax law using treaty benefits.

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

In cases where a person tries to circumvent limitations provided in the treaty itself, the section of the Final Report focusing on preventing treaty shopping details the recommendations with respect to both the LOB and PPT rules in the context of the minimum standard, as well as other more targeted rules resulting from other situations that have been identified as prone to the inappropriate granting of treaty benefits.

Treaty Shopping - The LOB Rule

Paragraphs 1 through 6 of a new Article 10 (Entitlement to Benefits) set forth the model treaty provisions for the LOB rule. In general, these provisions consist of a series of objective tests that would determine whether a person is considered to be qualified and therefore eligible for treaty benefits. In this regard, the objective tests are based on characteristics such as legal structure, ownership, or activities, ensuring a link between the person and the residence state. The 2015 Final Report notes that while it has been decided that such a rule will be included in the OECD Model, further work on the LOB rule is necessary. In particular, the Final Report refers to the proposals by the United States to modify the LOB rule in the US Model Treaty. It is noted that the LOB rule, and Commentary related thereto, contained in the Final Report should be considered as draft (and is therefore bracketed) and is subject to change pending further review that will take into account the finalization of the LOB rule in the US Model Treaty. Final versions of the LOB rule and Commentary are expected to be completed in the first part of 2016.

In addition to the LOB rule, the 2015 Final Report contains model treaty provisions for an alternative, simplified LOB rule. The simplified LOB rule sets forth general standards that could be used to address the most obvious cases of treaty-shopping while relying on the PPT rule to cover cases not caught by such an LOB rule. The Final Report clarifies that the simplified LOB rule is only intended to be used if the countries agree to incorporate the combined approach of an LOB rule and a PPT rule.

According to the 2015 Final Report, “qualified persons” entitled to treaty benefits would include the following if such persons are considered to be resident under the terms of the applicable treaty: an individual; Contracting States, its political subdivisions and entities that it wholly owns; certain publicly listed entities and affiliates; certain charities and pension funds; entities meeting certain ownership requirements; certain CIVs; persons engaged in active business activities in the country of residence; persons meeting a derivative benefits test; and persons that have been awarded benefits through a competent authority determination.

A number of items related to the LOB rule were identified for follow-up work after issuance of the 2014 Deliverable. The discussion below identifies how the follow-up items are addressed in the 2015 Final Report.

• CIVs: application of the LOB and treaty entitlement

As a result of the follow-up work on CIVs, it was concluded that there was general support for the conclusions included in the 2010 OECD Report The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles (CIV Report). Subparagraph 2(f) of the LOB rule included in the Final Report reflects the conclusions of the CIV Report. However, subparagraph 2(f) is bracketed to indicate that whether a specific rule addressing issues related to CIVs should be included in the LOB rule of a treaty, and how that rule should be drafted, would depend on how the treaty applies to CIVs and on the treatment and use of CIVs in each country.

• Non-CIV funds: application of the LOB and treaty entitlement

The Final Report does not contain any model provisions or related Commentary in respect of the treaty entitlement of non-CIVs and notes that further work is needed
in this area. The work will first
address real estate investment
trusts (REITs), with the work to
focus on confirming the conclusions
of the 2008 OECD report on tax
treaty issues related to REITs.
The Final Report indicates that it
has been agreed to incorporate a
footnote to the final version of the
Commentary of the LOB rule to
be produced in 2016 that directly
refers to the treaty entitlement of
REITs. Further, the Final Report
notes that the OECD recognizes the
economic importance of non-CIV
funds and the need to grant treaty
benefits where appropriate. The
Final Report indicates that further
work is necessary to address two
general concerns that governments
have about granting treaty benefits
with respect to non-CIVs: that
non-CIVs may be used to provide
treaty benefits to investors that
are not themselves entitled to
treaty benefits and that investors
do not have recognition of income
on which treaty benefits have
been granted. It is noted, however,
that the new treaty provision on
transparent entities as a result of
the work done on Action 2 (Hybrid
Mismatch Arrangements), as well as
the possible inclusion of a derivative
benefits test in the LOB rule, will
likely help to address some of the
concerns regarding the treaty
entitlement of non-CIVs in which
there are nonresident investors.

With respect to pensions, the Final
Report notes that work will continue
to ensure that a pension fund
should be considered a resident of
the country in which it is constituted
regardless of whether that pension
fund benefits from a limited or
complete exemption from taxation
in that country. In this respect, the
Final Report notes that changes
to the OECD Model, expected to
be finalized in the first part of
2016, will include a definition of
“recognized pension fund” that will
consider elements such as whether
the fund is created to provide
retirement or similar benefits to
individuals and whether the laws of
the country in which the pension
fund is created treat the fund as a
separate person.

• Alternative LOB rules for EU
countries

The Revised Discussion Draft
reflected a general concern raised
by the European Union (EU) that
some of the tests of the LOB rule
might need to be adapted to reflect
EU law requirements. In addition,
some countries were concerned that
some provisions of the LOB rule,
which must be met by reference
to a certain geographic location,
might need to be revised to take
into account concerns raised by smaller
countries.

In response to these concerns, the
Final Report allows for the inclusion
of alternatives in the Commentary
that would address those issues.
For example, whereas the publicly
traded test in the LOB rule generally
requires that the shares of a
company be primarily traded on one
or more stock exchanges located
in the residence country of the
company, the Commentary notes
that countries may modify this
requirement in cases where they
consider that the fact that shares
are primarily traded on recognized
stock exchanges situated in other
countries constitutes sufficient
safeguards against treaty shopping
(e.g., a country that is part of the
European Economic Area within
which rules relating to stock
exchanges create a single market
for securities trading).
Requirement that each intermediate owner be a resident of either contracting state

In the Final Report, the LOB rule contains a provision dealing with indirect ownership in both the “Subsidiary of a Publicly-Listed Entity” test and the “Ownership/ Base Erosion” test, as well as in the “Derivative Benefits” provision. The indirect ownership rule applicable to the first two tests would require that that each intermediate owner of the entity being tested be a resident of either Contracting State (subsidiary of a publicly-listed entity test) or of the contracting state where the entity being tested is a resident (ownership/base erosion test). The indirect ownership rule in those two tests is bracketed and the Commentary confirms that some countries may consider this indirect ownership rule to be unduly restrictive and prefer to omit such a rule.

A different indirect ownership rule is contained in the detailed version of the “Derivative Benefits” provision. The derivative benefits provision states that each intermediate owner should itself be an equivalent beneficiary. The term equivalent beneficiary generally refers to a person that would be entitled to a comprehensive tax treaty in force between its residence country and the country from which the benefits of the relevant tax treaty are claimed, provided that under such treaty, that person would have been entitled to at least the same benefit had the income in question flowed directly to that owner. As further noted below, the derivative benefits provision is bracketed indicating that further work is necessary with respect to this provision.

Issues related to the derivative benefits provision

A derivative benefits test generally entitles certain companies that are residents of a treaty country to treaty benefits if the owner of the company would have been entitled to at least the same benefit had the income in question flowed directly to that owner. The 2014 Deliverable proposed to include such a provision and the subsequent Discussion Draft and Revised Discussion Draft outlined the comments received on the proposed provision as well as the technical issues related to it. The Final Report includes a detailed version of the derivative benefits test that is bracketed indicating that the inclusion of such a rule will be considered further in light of the outcome of the work on other BEPS Actions (e.g., Action 5 (Harmful Tax Practices) and Action 8 (Transfer Pricing for Intangibles)). In addition, the Final Report notes that the inclusion of a derivative benefits test may also be affected by alternative means of addressing BEPS concerns such as the measure on “special tax regimes” that was proposed by the United States and is discussed in Section C of the Final Report.

Provisions dealing with dual-listed company arrangements

Dual-listed company arrangements present specific issues in relation to the publicly traded test because they consist of arrangements adopted by certain publicly-listed companies, each with its own stock listing, that reflect a commonality of management, operations, and shareholders’ rights. In some cases, such an arrangement involves the creation of special voting shares. After consideration of the publicly traded test in the LOB rule to address such arrangements, the Final Report adopts a definition of “principal class of shares” that provides, for example, that if a company participates in a dual-listed company arrangement, the principal class of shares will be determined after excluding the special voting shares that were issued to establish the dual-listed company arrangement.

Timing issues related to various provisions in the LOB rule

As noted in the Revised Discussion Draft, timing conditions are dealt with differently under the various tests of the LOB rule in the 2014 Deliverable. For example, it may be possible to meet the definition of “qualified person” under some tests at a particular moment in time, except that under some other tests, such as the publicly traded test, the conditions to meet that test must be satisfied throughout the taxable period. The 2015 Final Report does not adopt any changes with respect to timing issues related to the LOB rule (i.e., in the publicly traded test and the ownership/base erosion test). Accordingly, to satisfy the conditions of the publicly traded test, those conditions must be met throughout the taxable period of the company or entity. In contrast, under the ownership/base erosion test, the ownership condition must be met by qualified persons on at least half the days of the taxable period.
Conditions for the application of the provision on publicly-listed entities

As proposed in the 2014 Deliverable, some stakeholders noted that the alternative conditions in the publicly traded entity test of the LOB rule (i.e., primary trading test and the primary place of management and control test) may be too restrictive for small countries that do not have important stock exchanges and whose companies are listed on foreign stock exchanges. To address this concern, the Revised Discussion Draft proposed incorporating a list of factors in the Commentary to serve as an aid to the competent authorities when determining which stock exchanges should meet the definition of “recognized stock exchange.” The 2015 Final Report adopts the list of factors which include, for example, standards or requirements to list a company on the stock exchange, requirements to maintain such listed status, and reporting and disclosure requirements.

Clarification of the “active business” provision

The Revised Discussion Draft suggested clarifying the “active business” concept in the active trade or business test in the LOB rule to deal with situations where, for example, the same company carries on both investment and manufacturing operations. The suggested changes were similar to the proposals to modify the active trade or business test in the US Model Treaty. As noted above, those changes to the US Model Treaty have not yet been finalized and therefore, no further changes to this test have been made to the provision in the OECD Model pending finalization of the work by the United States.

Treaty Shopping – The PPT Rule

As noted above, the minimum standard to protect against treaty shopping that was agreed to by countries may be met by including in treaties a PPT rule alone or a PPT rule in conjunction with an LOB rule.

Paragraph 7 of new Article 10 “Entitlement to Benefits” contains the PPT rule. In general, under this provision, treaty benefits would be denied when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining treaty benefits was one of the principal 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 the tax treaty. The Final Report also includes commentary with respect to paragraph 7. The Commentary provides that to determine the principal purpose of an arrangement, it is necessary to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place. According to the Commentary, this requires consideration, on a case by case basis, of all circumstances surrounding the arrangement or event.

A number of follow-up items in relation to the PPT rule were identified in the Discussion Draft and Revised Discussion Draft. The discussion below addresses how these follow-up items were addressed in the 2015 Final Report:

Inclusion in the Commentary of the suggestion that countries consider some form of administrative process ensuring that the PPT is only applied after senior approval

The Final Report retains the suggested provisions and related Commentary proposed in the Revised Discussion Draft indicating that countries may wish to establish some form of administrative process that would ensure that the PPT rule is only applied after approval at a senior level within the tax administration.

Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

The Commentary to paragraph 7 clarifies the interaction between the LOB and PPT rules when these rules are used in combination. Both the PPT rule and the discretionary relief provision of the LOB rule include a test based on whether one of the principal purposes is the obtaining of benefits under a tax treaty. One issue that was discussed by the Working Group was whether parts of the Commentary on the PPT rule and the Commentary on the LOB discretionary relief provision that deal with the principal purposes test
should be aligned. In the Revised Discussion Draft, changes were made to the Commentary on the discretionary relief provision to explain the meaning of “one of the principal purposes” in paragraph 5 of the LOB rule. The Commentary to paragraph 7 also provides guidance with respect to the meaning of “one of the principal purposes” in paragraph 7. The Commentary set forth in the Final Report clarifies that the guidance provided in the Commentary on paragraph 7 should not be used to interpret paragraphs 1 to 6 (LOB) and vice-versa.

- **Whether some form of discretionary relief should be provided under the PPT rule**

Acknowledging that an application of the PPT rule results in the denial of treaty benefits, making the relevant income taxable under the provisions of domestic law, the Discussion Draft requested comments as to whether it would be appropriate to provide some form of treaty relief in cases where benefits are denied under the PPT rule. In the Revised Discussion Draft, it was proposed that a discretionary relief provision be included in paragraph 8, after the PPT rule, which appears in paragraph 7. The Final Report, however, provides that including such a discretionary relief provision is optional and includes the language of paragraph 8 in the Commentary to the PPT rule, noting that countries are free to include paragraph 8 in bilateral treaties to allow the competent authority of the country that would otherwise have granted treaty benefits to have the possibility of treating that person as being entitled to treaty benefits where that person is denied a treaty benefit in accordance with the PPT rule in paragraph 7.

- **Drafting of the alternative “conduit-PPT rule”**

As discussed above, countries may implement the minimum standard to protect against treaty shopping by including the LOB rule supplemented by a mechanism that would address treaty-shopping strategies commonly referred to as “conduit arrangements” that would not be caught by the LOB rule. The Final Report notes that these rules would deal with such conduit arrangements by denying treaty benefits in respect of income obtained under, or as part of, a conduit arrangement. Further, they could take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result. The Final Report outlines a series of examples of conduit arrangements that would need to be addressed by such rules as well as transactions that would not be considered to be conduit arrangements. These examples are largely drawn from the exchange of letters between the United States and the United Kingdom in connection with the bilateral treaty between those two countries (which is reproduced in the 2002 Technical Explanation to the treaty).

- **List of examples in the Commentary on the PPT rule**

The Commentary on the PPT rule illustrates how the PPT rule would apply by providing a number of examples. The Discussion Draft, which incorporated five examples, noted that the justification for the result in some of the examples originally included in the 2014 Deliverable could be better articulated and invited commentators to suggest additional examples that could be included in the Commentary. As a result, the Revised Discussion Draft proposed four additional examples to be included in the Commentary on the PPT rule. The 2015 Final Report retains all nine examples as part of the Commentary on the PPT rule and adds a new tenth example to the Commentary on the PPT rule.

A number of the examples illustrate considerations with respect to the application of the PPT rule in cases involving holding and regional companies. The new example that was added by the Final Report illustrates application of the PPT rule to address a situation in which a contract for the construction of a power plant that was to last for 22 months is split up into two contracts, each lasting 11 months. The example concludes that in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract was to obtain the benefit of Article 5(3).

- **Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable**

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As discussed above, the PPT rule is intended to apply where it is reasonable to conclude that obtaining treaty benefits was one of the principal purposes of an arrangement or transaction. The Revised Discussion Draft considered the question of whether the application of the PPT rule should be subject to arbitration under Article 25 of the OECD Model, and concluded that the issue should be addressed as part of the work on Action 14 (Make dispute resolution mechanisms more effective).

The final report on Action 14 notes that the interpretation or application of the PPT rule developed under Action 6 would clearly fall within the scope of the mutual agreement procedure (MAP) in Article 25. That report further notes that with regard to the threshold issue of the acceptance of a MAP case for consideration (i.e., MAP access), where there is a disagreement between the taxpayer and the competent authority to which its MAP case is presented as to whether the conditions for the application of a PPT rule have been met, taxpayers should be provided access to the MAP where they meet the requirements of Article 25(1). The report also notes however, that if a country seeks to limit or deny MAP access in all or certain of these cases, it should specifically and expressly agree on such limitations with its treaty partners, by including a requirement to notify the treaty partner competent authorities about such cases and the facts and circumstances involved. The report notes that it is intended to make amendments to the Commentary on Article 25 as part of the next update of the OECD Model in order to clarify the circumstances in which a country may deny access to the MAP.

Application of the PPT rule where benefits are obtained under different treaties

The 2014 Discussion Draft noted that it had been suggested that the wording of the PPT rule should be modified to make clear that where an arrangement is entered into for the purpose of obtaining benefits under a number of treaties or under both a treaty and domestic law, this should not lead to the conclusion that obtaining one benefit under one treaty was not a principal purpose for that arrangement. Despite comments received in response to the 2014 Discussion Draft on the need for clarification with respect to the application of the rule to situations where multiple jurisdictions are being considered and both treaty benefits and domestic laws are factors in the business decision, the Revised Discussion Draft concluded that the last four sentences of paragraph 13 of the Commentary on the PPT rule already addressed the issue in clear terms and that no changes were therefore needed. The Final Report retains the same language in paragraph 13 of the Commentary on the PPT rule as set forth in the 2014 Deliverable. Thus, where an arrangement is inextricably linked to a core commercial activity, and its form has not been directed by an attempt to obtain a benefit, it is unlikely that its principal purpose will be considered to be to obtain a benefit. However, the 2015 Final Report clarifies that where an arrangement has been entered into for the purpose of obtaining benefits under a number of treaties, it should not be considered that seeking to obtain a benefit under a number of treaties will prevent obtaining one benefit under one treaty from being considered a principal purpose for that arrangement.

Other situations where a person seeks to circumvent treaty limitations

In addition to the minimum standard to prevent treaty shopping, the 2015 Final Report includes recommendations for targeted anti-abuse rules. These rules would cover specific scenarios including splitting-up of contracts to avoid PE thresholds, hiring-out of labor cases, transactions intended to avoid dividend characterization, dividend transfer transactions, capital gains on the sale of real property, tie-breaker rules for determining the treaty residence of dual-resident persons, and triangular arrangements involving income attributable to a PE in a third country.

With respect to the splitting up of contracts to avoid PE thresholds, the 2015 Final Report notes that the inclusion of the PPT rule and more specifically the new example explained above regarding construction contracts would help limit those situations. It further notes that the issue also has been dealt with in Action 7 (Artificial Avoidance of Permanent Establishment). The Final Report notes that hiring out of labor
can also be used to abuse a given treaty where the taxpayer attempts to obtain inappropriately the benefits of the exemption from source taxation provided for in Article 15(2) (Income from Employment). However, the Final Report notes that the existing Commentary on that paragraph adequately addresses the issue. With respect to transactions to avoid domestic law rules that characterize an item of income as a dividend to benefit from a treaty characterization of that income, for example as capital gain to prevent source country taxation, the 2015 Final Report notes that, in the context of the work being done on Action 2 (Hybrid Mismatch Arrangements), the Working Party has examined whether the treaty definitions of dividends and interest could be amended to permit the application of domestic law rules that characterize an item of income as such. The 2015 Final Report notes that further work to examine the possibility of making such changes will be undertaken after the completion of the work on the BEPS Action Plan.

Dividend transfer transactions are described in the 2015 Final Report as transactions where a person entitled to the 15% portfolio rate of Article 10(2)(b) (Dividends) seeks to obtain a lower rate (e.g., the 5% direct dividend rate) by engaging in transactions to increase the number of shares held at the time the dividend is legally available to the shareholder. In order to deal with such transactions, the 2015 Final Report notes that it was concluded that a minimum holding period of 365 days should be included in Article 10 of the OECD Model for shareholders seeking to apply the reduced 5% withholding rate on dividend payments (see Article 10(2) (a)). The Final Report also concludes that additional anti-abuse rules need to be adopted to deal with cases where certain intermediary entities established in the country of source are used to take advantage of the treaty provisions that lower the source taxation of dividends. For example, the Final Report refers to an alternative provision provided in the Commentary to Article 10 to limit access to the 5% rate in cases of payments by domestic REITs to nonresident investors.

The 2015 Final Report also outlines some changes with respect to the rules on immovable property in Article 13(4) (Capital Gains). In general, this provision allows the country in which immovable property is situated to tax capital gains realized by a resident of the other country on shares of companies that derive more than 50% of their value from such immovable property. The Final Report amends that article to ensure that the same treatment is extended to interests in other entities such as partnerships and trusts. The Final Report also outlines another revision to the language of paragraph 4 to cover situations where assets are contributed to an entity shortly before the sale of shares or other interests in an entity in order to dilute the proportion of value that is derived from immovable property. To address such a situation, a holding period has been added to preserve the ability of the country where the immovable property is located to tax the gain if, for example, at any time during the 365 days preceding the alienation, the shares derived more than 50% of their value directly or indirectly from immovable property in that country.

- **Tie-breaker rule for determining the treaty residence of dual resident persons other than individuals**

To address situations in which a person is considered a resident of both contracting states, subparagraph 3 of Article 4 contains a tie-breaker rule to determine a single treaty residence for persons other than individuals. The Final Report notes that in the view of many countries where a company is a dual resident tax avoidance arrangements often are involved and concludes that the current rule found in Article 4(3) should be replaced. Revised paragraph 3 will provide that in cases where a person other than an individual is a dual resident, the competent authorities of the two countries shall endeavor to determine by mutual agreement the country of residence having regard to the place of effective management, the place where it was incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, Article 4(3) provides that such person will not be entitled to any relief or exemption from tax provided by the treaty except to the extent and in such manner as may be agreed upon by the competent...
authorities. The Commentary on Article 4 of the OECD Model notes however, that some countries consider it preferable to deal with cases of dual residence through the rule based on “place of effective management.” In such cases, the Commentary explains that such countries are free to include an alternative paragraph 3 in their bilateral treaties.

The Commentary also clarifies that that fact that a dual resident entity is not entitled to treaty benefits would not prevent the dual resident entity from being considered a resident of an applicable country for purposes other than granting treaty benefits to that person. For example, in the case of a company, it will be considered to be a resident of each country for purposes of the application of Article 10 to the dividends that it will pay.

- Anti-abuse rule for permanent establishments situated in third State

The 2015 Final Report notes that where the residence state exempts, or taxes at low rates, profits attributable to a PE situated in a third state, the source state should not be expected to grant treaty benefits to that person. For example, in the case of a company, it will be considered to be a resident of each country for purposes of the application of Article 10 to the dividends that it will pay.

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

The focus of the work undertaken by the Working Party on the issue of domestic tax law avoidance, facilitated by tax treaties, was to ensure that tax treaties would not operate to prevent the application of specific domestic law provisions. The 2015 Final Report notes that in respect of certain strategies, including thin capitalization, dual residence, and transfer pricing strategies, the Commentary on the applicable articles of the OECD Model already provides that treaties do not prevent the application of such rules.

To address the interaction between tax treaties and domestic law for a number of other specific domestic anti-abuse rules, the Final Report includes some new Commentary on Article 1 (Persons Covered), in addition to retaining much of the existing Commentary. According to the Final Report, the new Commentary articulates the relationship between domestic anti-abuse rules and tax treaties and will reflect the conclusion that as a general rule, there will be no conflict between tax treaties and judicial anti-abuse doctrine or general domestic anti-abuse rules. The new Commentary notes, for example, that if a domestic anti-abuse rule or judicial doctrine such as “substance over form” or “economic substance” results in characterization of income or in a redetermination of the taxpayer that is considered to derive income, the provisions of the treaty will be applied taking into account these changes. The Commentary notes however, that while these rules do not conflict with tax treaties, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there are no clear evidence that the treaties are being abused.

Application of tax treaties to restrict a Contracting State’s right to tax its own residents and “departure” or “exit” taxes

Two specific issues related to the interaction between treaties and specific domestic anti-abuse rules are addressed in the 2015 Final Report: the right of a country to tax its own residents, and “departure” or “exit” taxes and the double taxation issues that might arise in that context.

In order to confirm a country’s right to tax their residents, the Final Report notes that the OECD Model will be revised to include a provision similar to the “saving clause,” used in US tax treaties, to confirm a country’s right to tax its residents.
without regard to the provisions of any tax treaty, other than those provisions that are intended to apply to residents.

Second, the Final Report discusses “exit” or “departure” taxes, which is generally a tax imposed on certain types of income that is triggered in the event of a resident of a country ceasing to be a resident. The 2015 Final Report notes that the application of such taxes creates the risk of double taxation where a person becomes resident in another country and that country seeks to tax the same income that was subject to a departure or exit tax at a different time. While the Final Report notes that tax treaties should not prevent the application of these taxes, it suggests that the mutual agreement procedure could be used to provide relief as a potential solution for double taxation issues which might arise in such situations.

Clarify that tax treaties are not intended to be used to generate double non-taxation BCH
The 2015 Final Report recommends the inclusion of specific language clarifying that tax treaties are not intended to be used to generate double non-taxation. It notes that the Commentary on Article 1 of the 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. In order to provide additional clarification, the Final Report recommends stating clearly in the title of treaties that the prevention of tax evasion and avoidance is a purpose of tax treaties. The Final Report also recommends the inclusion of wording in the preamble that expressly provides that the countries entering into the treaty intend to conclude a treaty for the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Last, the Commentary to the OECD Model includes specific language referring to the BEPS project and the intention to address BEPS concerns arising from treaty shopping arrangements.

Tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country BCH
The 2015 Final Report discusses tax policy considerations relevant to a country’s decision whether to enter into, modify, or terminate a tax treaty with another country. The Final Report notes that a clear articulation of these considerations would be useful for countries in justifying their decisions not to enter into tax treaties with certain low or no-tax jurisdictions. The Final Report 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 certain low or no-tax jurisdictions. The Final Report 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. Along with more general considerations, the Final Report includes two proposals that are bracketed that would specifically address some concerns with respect to the domestic law of the potential treaty partner.

Such proposals were included in the Revised Discussion Draft as introduced by the US delegate and are also proposals with respect to the US Model Tax Convention. In particular, the first proposal would modify Article 3 of the OECD Model to include a definition of “special tax regime.” Further, new provisions would be added to Articles 11 (Interest), 12 (Royalties), and 21 (Other Income) of the OECD Model that would deny treaty benefits with respect to interest, royalty payments, or other income beneficially owned by residents benefiting from a “special tax regime” in their country of residence at any time during the taxable year in which such income was paid. The second proposal provides a new general treaty rule that would “turn off” the treaty provisions on dividends, interest, royalties, and other income if certain changes to a country’s domestic law are made in the future. The 2015 Final Report notes that these proposals will be further considered once the United States finalizes the work on the US Model Treaty.

Implications

The 2015 Final Report reflects agreement among countries on ensuring that treaties include sufficient safeguards to prevent treaty abuse and in particular treaty shopping. To that end, countries have committed to a minimum standard that should be implemented to provide protection against treaty abuse. Acknowledging that model provisions must be adapted for
individual countries, and as such flexibility in implementation is required, the Final Report recommends alternative ways to meet that standard.

The 2015 Final Report indicates that further work will be required under Action 6, in particular with respect to the LOB rule, which is expected to be finalized in the first part of 2016. In addition, the Final Report specifies that further work is needed with respect to the treaty entitlement of non-CIVs and pension funds and indicates that such work would benefit from consultation with stakeholders.

Importantly, the various anti-abuse rules included in the 2015 Final Report will be among the changes proposed for inclusion in the multilateral instrument. With approximately 90 countries participating, work on the multilateral instrument is already underway with the goal of concluding the work and opening the multilateral instrument for signature by 31 December 2016. Any further work under Action 6 would need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument. As this work continues, companies should continue to monitor the latest developments with respect to Action 6, evaluate how any proposed changes may impact them, and stay informed about developments in the OECD and in the countries where they operate or invest, and consider participating in the process to provide stakeholder input.

Webcasts
EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10 am EDT
- New Reporting under BEPS Action 13 - 20 October, 10 am EDT
- Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
- Permanent Establishment Developments and BEPS Action 7 - 5 November, 10 am EST
- Transfer Pricing and BEPS Actions 8-10 - 12 November, 10 am EST
- Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10 am EST
- Financial Payments and BEPS Actions 2 and 4 - 3 December, 10 am EST
- Dispute Resolution and BEPS Action 14 - 10 December, 10 am EST

For more information and to register for the webcast series, click here.

Endnotes
2. See EY Global Tax Alert, OECD releases public discussion draft on follow up work on treaty abuse under BEPS Action 6, dated 26 November 2014.
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