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Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances

Introduction

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released final reports in connection with all its 15 Action Plans on Base Erosion and Profit Shifting (BEPS). The BEPS Action 6 identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. OECD states that *'Taxpayers engaged in treaty shopping, and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues'.*

The OECD released three discussion drafts on 14 March 2014, 21 November 2014 and 22 May 2015, as well as an interim version of deliverable on 16 September 2014. This final report on Action 6, which supersedes the interim version issued in September 2014, is organised in the following three sections:

A. *Treaty provisions and/or domestic rules* to prevent the granting of treaty benefits in inappropriate circumstances (i.e. treaty abuse and treaty shopping cases);

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

C. Identify tax policy considerations for jurisdictions to consider before entering into treaties.

The final report contains changes to the OECD Model Tax Convention and related changes to the Model Commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios.

Analysis of the Action 6

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

OECD has distinguished between two types of cases:

- Cases where a person tries to circumvent limitations provided by the treaty itself;
- Cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits

I. The cases that fall under the first category, i.e. where a person tries to circumvent limitations provided by the treaty itself, include the following:

- Treaty shopping; and
- Other situations viz,
  - splitting-up of contracts
  - hiring-out of labour cases
  - transactions intended to avoid dividend characterisation
  - dividend transfer transactions
  - transactions circumventing the application of Article 13(4) which deals with capital gains on the sale of shares of a company deriving substantial value from immovable property in another country
  - tie-breaker rule for dual-residence
  - anti-abuse rules for permanent establishments situated in a third state, etc.

1. Recommendations on treaty shopping

To tackle cases of treaty shopping arrangement, OECD has recommended the following three pronged approach:

- Clarification in treaty title and preamble (Section B of the final report);
- Inclusion of a specific anti-abuse rule based on a draft U.S. style limitation-on-benefits (LOB) provisions;
- Addition of a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or PPT rule)

The final report recommends 'minimum standard' to be adopted by countries to counter the treaty shopping by including any one of the following types of rules:

- Combined approach by adopting both, the PPT and the LOB rule, in tax treaties;
- PPT rule alone in the tax treaties;
- An LOB in tax treaties supplemented by domestic anti-conduit financing legislation.

1.1 LOB provisions

Action 6 has recommended insertion of a new LOB Article. It recommends two versions for the Article, one being a detailed version based on a draft U.S. style LOB provisions and the other being a simplified version of LOB provisions. These provisions provide for qualification for treaty benefits based on a series of alternative tests as under:

a) **'Qualified person' status**: It provides that a resident of a Contracting State shall be entitled to treaty benefits only if it constitutes a qualified person. Qualified persons have been defined to include individuals, certain state-owned entities, certain publicly-traded entities, certain Collective Investment Vehicles (CIVs), certain non-CIVs or ownership by qualified persons.

   Action 6, however, also states that a qualifying person will still have to meet the conditions of the other provisions of the treaty in order to obtain benefits (e.g. a resident must be the beneficial owner of dividends in order to benefit from the provisions of paragraph 2 of Article 10) otherwise these benefits may be denied or restricted under applicable anti-abuse rules.

b) **Active conduct of trade or business**: It provides that the treaty benefits will be available to a resident of a Contracting State (even if he is not a qualified person) in respect of item of income derived from other Contracting State if it satisfies two conditions, i.e. (i) it is engaged in active conduct of business in the resident State and (ii) the income for which benefits are sought is derived in connection with, or is incidental to, that business. In certain cases, an additional requirement of the business being substantial in size in relation to the activity in the source State generating the income must also be met.

   As per Action 6, an entity generally will be considered to be engaged in the 'active conduct of a business' if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities.

   It further states that income from activity in the source State from a business that 'forms a part of' or is 'complementary' to the business conducted in the resident State shall mean to be income derived 'in connection with' the business in the resident State. It also states that income derived from the source State is 'incidental to' the business carried on in the State of residence if production of the item facilitates the conduct of the business in the resident State.

c) **Ownership by equivalent beneficiaries (derivative benefits)**: 'Derivative benefits' rule allows certain entities owned by residents of third States to obtain treaty benefits provided that these residents would have been entitled to equivalent benefits if they had invested directly. This is, however, subject to meeting certain conditions vis-à-vis ownership and base erosion.

d) **Discretionary relief by Competent Authority**: A resident of a Contracting State, who does not fall under any of the above categories (i.e. a, b or c) can be granted treaty benefits vis-à-vis an item of income by approaching the Competent Authority of the other Contracting State from which the benefit is claimed.

The final report calls for further work on certain aspects such as the definition of a recognised pension fund, granting of treaty benefits to non-CIV funds, etc. The final report also calls for additional work to be done on the granting of treaty benefits to non-CIV funds during the first half of 2016.

The report states that in light of changes to the U.S. Model LOB, which is expected to be finalised by the end of 2015, further work will be done on both the detailed and simplified versions of the LOB and Model Commentary during the first part of 2016.

1.2 PPT rule

Action 6 has also recommended inclusion of a more general anti-abuse rule based on the principal purposes of transactions or arrangement (PPT rule) that is not covered by the specific anti-abuse rules based on the LOB provisions discussed above. The PPT rule incorporates principles already recognised in the Model Commentary.

The PPT rule will have the effect of denying the treaty benefits where 'one of the principal purposes' of an arrangement or transaction is to obtain a benefit under the tax treaty. Under the PPT rule, it is *inter-alia* stated that the reference to 'one of the principal purposes' means that obtaining the benefit under a treaty need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit.

The LOB rule is based on objective criteria that provide certainty whereas as the PPT rule requires a case-by-case analysis based on what can reasonably be considered to be one of the principal purposes of transactions or arrangement.

2. Recommendations on other situations where a person tries to circumvent limitations provided by the treaty

The final report also confirms the specific changes recommended in the 2014 deliverable, including provisions to deny treaty benefits in the following situations:

2.1 Splitting-up of contracts: It refers to cases of treaty abuse by the division of contracts into several parts, each covering a period less than 12 months and attributing them to a different company which is owned by the same group. The final report states that the PPT rule alongwith changes to the Model Commentary on Article 5 as per Action 7 (Preventing the artificial avoidance of PE status) will help address this issue.

2.2 Hiring-out of labour cases: It refers to cases where residents of a Contracting State inappropriately obtain benefit of exemption from source taxation provided for in Article 15(2) i.e. short stay exemption. The final report states that the guidance provided in the existing Model Commentary is adequate to deal with this type of treaty abuse.

2.3 Transactions intended to avoid dividend characterisation: It refers to cases where transactions are entered for the purpose of avoiding domestic law rules that characterize a certain item of income as a dividend so as to benefit from a treaty characterisation of that income (eg. capital gain) to prevent source taxation. As a part of its work on Action 2 (Hybrid Mismatch Arrangements), OECD has recommended to examine the possibility of amending treaty definitions of dividends and interest to deal with such cases.

2.4 Dividend transfer transactions: It refers to cases where a resident increases its holding primarily for the purpose of securing benefits of a lower rate of tax on dividends, shortly before it becomes payable. The recommendation to address this issue includes insertion of the specific anti-abuse rule in Article 10 of the tax treaty.

2.5 Transactions circumventing the application of Article 13(4): Article 13(4) deals with gains from transfer of shares deriving more than 50 per cent of their value from immovable property in the other country. The final report has recommended to amend Article 13(4) in order to cover not only gains from shares but also from the alienation of an interest in other entities such as partnerships or trusts. Further, it has recommended to amend Article 13(4) also to tackle cases where assets are contributed to an entity shortly before the sale of its shares/interest in order to dilute the proportionate value of these shares/interest derived from immovable property situated in other country.

2.6 Tie-breaker rule for dual-residence: Cases where a company is a dual-resident often involve tax avoidance arrangements. The final report has recommended – to replace Article 4(3) [dealing with Place of Effective Management ('POEM')] - by providing that competent authorities of the Contracting States to determine the country of residence by mutual agreement, having regard to its POEM, place of incorporation/constitution and any other relevant factor.

2.7 Anti-abuse rules for permanent establishments (PE) situated in a third state: The final report has recommended draft version of specific anti-abuse rules in the Model Tax Convention to deal with potential treaty abuses resulting from transfer of shares, debt claims, etc. to a PE solely set up in a third state (which offers preferential treatment to income from such assets). However, such draft rules are subject to review, and final version shall be produced in a first part of 2016 after finalisation of the U.S. version of a similar provision.

II. The cases which fall under the second category i.e. where a person tries to abuse provisions of domestic tax laws using tax treaty include the following:

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- Dual residence strategies (e.g. a company is resident for domestic tax purpose but non-resident for treaty purpose);
- Transfer mispricing;
- Arbitrage transactions that take advantage of mismatches found in the domestic laws of one country or both that are related to characterisation of income, characterisation of entities /taxpayers, timing differences;
- Transactions that abuse relief of double taxation mechanisms (e.g. by abusing foreign tax credit mechanisms)

The final report states that the work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing has addressed many of above transactions (viz, thin capitalisation, transfer mispricing, arbitrage transactions, dual resident strategies, etc.).

Action 6 has also provided draft changes to rules vis-à-vis the application of tax treaties to restrict a Contracting State's right to tax its own residents as well as application of tax treaties in relation to departure or exit taxes (applicable when a resident ceases to be a resident of a Contracting State).

B: Clarify that tax treaties are not intended to be used to generate 'double non-taxation'

The second part of the work mandated by Action 6 is to clarify that tax treaties are not intended to be used to generate double non-taxation but are intended to eliminate double taxation without creating opportunities for tax evasion and avoidance. In order to provide such clarification, Action 6 has recommended changes to the Title and Preamble of the OECD Model Tax Convention supplemented by changes to relevant paragraphs of the Introduction to OECD Model Tax Convention.

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

Action 6 states that having a clearer articulation of the tax policy considerations could make it easier for countries to justify their decision to enter/not to enter into tax treaties with certain low or no-tax jurisdictions. It has recommended certain tax policy considerations that may be taken into consideration while negotiating/modifying/replacing/terminating treaty with a Contracting State. Some of the tax policy considerations recommended by Action 6 are existence of risk of double taxation (this being the primary tax policy concern), risk of excessive taxation that may result from high rate of withholding in the source State, protection from discriminatory tax treatment of foreign investment, greater certainty of tax treatment for taxpayers.

Action 6 also states that while negotiating a tax treaty, if a country has BEPS concerns with respect to certain features of the domestic law of a prospective treaty partner (such as providing preferential tax rules) or with respect to drastic changes that might be made after the conclusion of a tax treaty, then such country may want to protect its tax base against such risks and may therefore find it useful to include in its treaties provision that would restrict treaty benefits to taxpayers benefitting from the above aspects. In this connection, Action 6 has recommended two draft proposals on 'new treaty provision on special tax regimes' and 'new treaty rule intended to make a tax treaty responsive to certain future changes in a country's domestic tax laws'. Further work will be done on the above proposals during the first part of 2016, in light of changes to the U.S. version of similar proposals.

Conclusion

Conduit arrangements are a particular focus of attention of Action 6 and are specifically targeted through the changes recommended in the Model Tax Convention and Commentary. The changes recommended by the final report will be incorporated into the OECD Model Tax Convention and are expected to be included in the multilateral instrument that is being developed under Action 15 for jurisdictions to amend their bilateral treaties.

It is not clear that the simplified LOB as currently drafted is, in all cases, more taxpayer favourable than the detailed LOB, and its development should be closely monitored by taxpayers. The fact that both the detailed LOB and the simplified LOB are subject to further work seems like continued uncertainty in this area.

India’s observations

Denial of tax treaty benefits by the Indian tax authorities on the ground of ‘treaty abuse’ or ‘treaty shopping’ is not novel. To curb the practice of ‘treaty shopping’, as per the recent news reports, the Indian government is believed to be re-negotiating the tax treaty with Mauritius, inter alia inserting an LOB clause in the tax treaty. Off late, insertion of the LOB clause has been a key component of the Indian government’s tax treaty negotiations/re-negotiations with the counter parties (for instance the U.K., Spain, Poland, etc.). The recommendations of Action 6 are likely to provide further impetus to such negotiations.

In order to address situations which abuse treaty benefits, the PPT rule recommended by the final report suggests that anti-avoidance provisions can be triggered if ‘one of the principal purposes’ of an arrangement is to gain treaty benefits. It may be noted, that under the Indian domestic law, the GAAR provisions introduced earlier also provided for ‘main purpose or one of the main purposes’ as a test to trigger the anti-avoidance rules. However, after representations from Indian taxpayers, the GAAR provisions were subsequently amended to limit the applicability only to cases where the ‘main purpose' is to obtain the tax benefit. Thus, the PPT rule under Action 6 appears to be wider as compared to the provisions of GAAR.

Accordingly, it would need to be seen as to how the Indian government would introduce such a rule in its tax treaties considering the fact that the language of amended GAAR provisions (applicable from FY 2017-18) is narrower as compared to the language of the PPT rule.

The OECD recommendations coupled with the introduction of GAAR provisions under the domestic tax law (once introduced), are likely to address the issue of ‘treaty abuse’ or ‘treaty shopping’ to a large extent.

The impact of the proposed recommendations on the Indian as well as multinational groups will largely depend on the approach as well as the extent to which the Indian government implements the OECD’s recommendations, together with the measures taken by the India’s bilateral treaty partners.

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