OECD Report on Action 6 – Treaty Abuse

22 September 2014

In brief

The OECD published a discussion draft in March 2014 on proposals for addressing perceived abuse of tax treaties. The draft recommended extensive changes to the OECD Model Treaty together with suggested domestic law provisions targeted at treaty abuse or abuse of domestic law where the abuse involves application of treaty benefits. The discussion draft also proposed a change to the preamble of tax treaties to clarify that tax treaties are not designed to create double non-taxation and included potential tax policy issues that countries might consider in deciding whether to enter into a tax treaty. A focal point of the discussion draft was the proposal for a US-style limitation on benefits article (LoB) to provide an objective basis for entitlement to treaty benefits for companies with a nexus in the resident country as well as a subjective main purpose / anti-abuse rule within the LOB article. In lieu of this singular combined LoB/Main Purpose Test approach, the OECD report on Action 6 now proposes a “minimum level of protection” to prevent treaty abuse, suggesting two alternatives to the combined approach that treaty partners may consider. Significantly, the LoB now includes a “derivative benefits test” provision allowing certain entities owned by residents of other States to obtain treaty benefits if these residents would have obtained the same benefits had they invested directly.

While the OECD report on Action 6 addresses some of the problematic provisions identified by stakeholders during the initial comment period, serious concerns still remain. Fortunately, the report recognizes that further work is required on the precise contents of the Model provisions to prevent unnecessary obstacles to cross-border business. Accordingly, the report states that the Model provisions and related Commentary should be considered as drafts subject to improvement before their final release in 2015.

In detail

Entitlement to Benefits article: overly restrictive standards still prevent clarity and predictability

The OECD proposed to include a U.S.-style LoB in its Model Convention. Generally, the U.S.-style LoB targets abuses where a non-treaty resident improperly accesses treaty benefits by filtering income through a treaty-resident intermediary, such as a company organized in a treaty-qualified country. To combat these abuses, the U.S.-style LoB seeks to qualify resident companies only where the resident meets one of several alternative tests intended to establish that the resident company has sufficient nexus to its country of residence to be assumed to not have been established or maintained for a principal purpose of giving third country residents access to the treaty. As a general matter, the various tests of the U.S. LoB aim to carry out this purpose. However, certain provisions in the U.S. LoB are unnecessarily restrictive and do not further the stated policy. Serious concerns arise to the extent
that the OECD Model recommendations are modelled after those U.S. LoB provisions.

Like the U.S. LoB, the OECD Model sets forth multiple tests, at least one of which a resident company must satisfy to be considered generally eligible for the benefits of the treaty. The first, known as the Publicly Traded Company Test (the “PTC Test”), entitles a company to treaty benefits if its principal class of shares is regularly traded on at least one recognized stock exchange. One of the following two additional requirements must also be satisfied: (1) the shares are primarily traded on one or more exchanges located in the company’s country of residence, or (2) the company’s primary place of management is its residence country. Many companies will be challenged to meet either of these alternative tests. Companies typically list their shares on a regional exchange that will provide the best access to the capital markets, which often will not be a local exchange but, rather, an exchange in the same economic region. In addition, the local exchange requirement may well violate EU law. The alternative test of place of management will be a challenge for companies with decentralized management, particularly in light of the guidance in the proposed Commentary that would require analysis of executives employed in affiliated companies. The report’s commentary states that these additional provisions are necessary because, while a publicly-traded company may be technically a resident in a given country, it may not have a sufficient relationship with the country to justify allowing the company to obtain benefits. However, this position runs counter to longstanding policy, found in the Commentaries, that the PTC test recognizes that publicly traded companies present a low risk of being used to extend treaty benefits to third country residents.

These additional restrictions were developed in U.S. LoBs to address the issue of inverting companies, a domestic policy concern better addressed under domestic law.

The OECD Model LoB also allows certain subsidiaries of publicly traded companies to qualify (the “SPTC Test”). A company that is at least 50 percent owned (by vote and value), directly or indirectly by five or fewer companies that satisfy the PTC Test will qualify for benefits. The discussion draft required that, in the case of indirect ownership, each intermediate owner in a chain be residents of one of the Contracting States, as opposed to only testing the subsidiary’s ultimate owner. That restriction remains but is bracketed to reflect the fact that there was not a consensus that the intermediate ownership rule should apply. Such a requirement would be an impediment to multinational enterprises which often have hundreds of affiliates set up in a variety of countries for sound business reasons. It would also if maintained in our view be challengeable under EU law. The report provides no explanation for the rule’s inclusion and the anti-treaty shopping rationale for its inclusion is not clear.

Under the proposed Ownership-Base Erosion Test, a company can qualify for benefits if it satisfies the following two requirements. First, for the majority of the tax year, the company must be at least 50 percent owned (directly or indirectly) by certain Qualified Persons with the same residence country as the tested company (e.g., resident individuals, or a resident company passing the PTC Test). Second (the Base Erosion Test), the amount of deductible payments made to persons other than the aforementioned Qualified Persons must be less than 50 percent of the company’s gross income. However, arm’s length payments will not count against the 50 percent threshold. The report does not discuss why acceptable owners of the tested company must have the same country of residence as the tested company. Historically, the standard US LoB treated Qualified Persons resident in either country to be treated as good owners. The US changed its policy to local ownership pursuant to domestic policy concerns about inverted companies. However, a company wholly owned by residents of the two Contracting States, and meeting the Base Erosion Test, cannot be a vehicle for providing treaty benefits to residents of third countries. As with the SPTC Test, the report includes in brackets the requirement that all intermediate entities in a chain of ownership be residents of one of the Contracting States, creating an obstacle to companies’ ability to meet the Ownership-Base Erosion Test and again raising EU law concerns. A company can also qualify for benefits under the proposed LoB for certain items of income if it is engaged in the active conduct of a trade or business in the Contracting State of which it is resident and the income earned in the other country is incidental or connected to that trade or business. If the tested company conducts business in the source state or the income is received from an affiliated company, the activities conducted in the company’s country of residence must also be substantial in relation to the activities conducted in the country where the income arises. Finally, if a company manages investments for its own account, these activities do not amount to a “trade or business” unless they are in the nature of banking, insurance or securities and are carried on by such a company.
In contrast to the discussion draft, the report now includes a Derivative Benefits article, substantially improving upon the discussion draft. However, the test appears in brackets suggesting the possibility that there will not be a consensus for its inclusion in treaties that choose to use the LoB. The proposed Derivative Benefits test allows treaty benefits for a company that meets two requirements. First, the tested company must be at least 95 percent owned (directly or indirectly) by no more than seven persons who are Equivalent Beneficiaries. In brief, an Equivalent Beneficiary includes certain qualified residents of either Contracting State or a resident of a third jurisdiction that qualifies for benefits under a comprehensive income tax treaty between the owner’s country of residence and the source state and, in the case of dividends, interest, or royalties, would have qualified for equivalent or better treaty benefits under that treaty. Second, the amount of deductible payments (excluding certain arm’s length payments made in the ordinary course of business) made to non-Equivalent Beneficiaries must be less than 50 percent of the tested company’s gross income. The policy justification for a derivative benefits provision is obvious: no abuse occurs where an investor could obtain the same treaty benefits by investing in the source-State directly, as it would through an intermediary. As currently drafted, the proposed Derivative Benefits test also requires intermediate owners in a chain to be residents of the Contracting States. Unlike the subsidiaries of public companies and the Ownership-Based Erosion tests, the questionable restriction on intermediate owners does not appear in brackets even though it is most likely to be an obstacle to qualification under the Derivative Benefits Test. We surmise the absence of brackets was unintentional. The absence of a Derivative Benefits article would as previously mentioned also raise EU law issues.

If a company is unable to avail itself of treaty benefits through one of the methods discussed above, the draft LoB provides that the company can apply for a discretionary grant of benefits with the relevant source country’s competent authority. While a discretionary grant of benefits provision is a critical component to an LoB, the experience in the United States is that applying for discretionary benefits has been a cumbersome, lengthy and costly process for both the applicant and the governmental agency charged with granting the benefits. The report, unfortunately, does not include a mandate for countries to expedite these processes, nor does it include any ideas for potential improvements.

In summary, while the report substantially improves upon the discussion draft reflecting the OECD’s responsiveness to comments submitted by stakeholders, numerous concerns remain, including:

- The requirement for intermediate owners to be “qualified” residents in many of the LoB tests (i.e., the SPTC Test, the Ownership-Based Erosion Test, and the Derivative Benefits Test) means that many resident companies that, by any objective standard, should be found to meet the nexus requirement and not be considered treaty shopping will be denied access to treaty benefits.
- Limitations on the Publicly Traded Test and the Ownership-Based Erosion Test that replicate restrictions found in US tax treaties that are not relevant to access to treaties by third country residents but are present in the US treaties for domestic policy reasons add inappropriate further restrictions on qualification under the LoB.
- It remains unclear how collective investment vehicles (“CIVs”) and other investment entities will access treaty benefits as the LoB provisions are not designed to deal with such entities.
- While addressing certain procedures associated with a discretionary grant of benefits, the report does not include a mandate to expedite the lengthy and cumbersome process of applying for and obtaining the discretionary grant of benefits.

The report clearly demonstrates that the OECD responded to comments provided by stakeholders. Given the significant concerns that remain outstanding, it will be critical for any and all stakeholders to provide the OECD with further comments and feedback on the report on Action 6 to ensure that these concerns are properly addressed.

**Principal Purpose Test-subjectivity and uncertainty concerns**

The PPT is identical to the previous March 2014 version except with the substitution of “principal” purpose for “main” purpose regarding obtaining a treaty benefit, unless granting that benefit would be in accordance with the object and purpose of the relevant provisions of the treaty in question.

The report makes clear that the PPT would be incorporated into the treaty itself, whilst noting that some states may have a purpose based general anti-avoidance rule (GAAR) in domestic law that is capable of applying to transactions involving the application of tax treaties. Accordingly, the proposed PPT would assist those states whose constitution
might not permit a domestic law GAAR override of tax treaties.

In our view, it remains arguable that the PPT saving provision, in referring to granting a treaty benefit in accordance with the object and purpose of the relevant provisions of the treaty, may not go far enough as regards the EU law requirement for an anti-avoidance rule to allow a taxpayer to commercially justify their conduct. This is less clear however in the context of a tax treaty than as regards a domestic law anti-avoidance provision.

The report confirms that if both the LoB and PPT are adopted, the PPT supplements and does not restrict the operation of the LoB provision.

The report gives a number of examples of where treaty shopping e.g., for a lower rate of withholding tax on interest or on dividends via a usufruct would be combatted by the new PPT, whereas locating a new manufacturing plant in a state with a lower dividend withholding tax rate or a CIV investing part of its portfolio in a state with a lower dividend withholding tax rate or an investor increasing their shareholding to qualify for a lower rate of dividend withholding tax are not considered to run afoul of the PPT. However, the guidance proposed in the Commentaries leaves large gaps in illustrating the application of the standards, leaving room for considerable uncertainty, predictable controversy, and inconsistency in how those standards will be applied by various tax authorities.

Curiously, the report’s definition of a conduit arrangement includes precisely the same principal purpose test that it is understood the US refuses to contemplate at treaty level. The income tax treaty between the United States and the United Kingdom contains a conduit arrangement test. In its Technical Explanation to the treaty, the US Treasury stated that it would apply the conduit arrangement standard in accordance with its domestic anti-conduit rules.

Additional items
The report continues to recommend that treaties include in their title and preamble a clear statement that the Contracting States, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements which the proposed preamble defines as “arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States.”

The report also includes recommendations to deal with

- certain dividend transfer situations seeking to access the (normally 5%) lower treaty rate of dividend withholding tax by introducing the requirement of a 365 day continuous holding of the requisite percentage ownership into Article 10(2)(a);
- transactions designed to circumvent the application of the treaty rule that allows source taxation of real estate companies by introducing new wording into Article 13(4) to extend to partnership interests or trusts and include a 365 day testing period for triggering the 50% of value from real estate threshold at any time in that period;
- situations where an entity is a resident of two Contracting States where a competent authority tie-breaker is recommended as the default wording in Article 4(3) but States retain the right to use the effective management tie-breaker, and
- situations where the State of residence exempts the income of permanent establishments (PEs) situated in third States and where shares, debt-claims, rights or property are transferred to PEs set up in countries that do not tax such income or offer preferential treatment to that income, where it is recommended that to fully access treaty benefits the income must be taxed at a rate that is at least 60% of the rate that would have applied absent the residence country tax exemption of the PE.

The report refers to the splitting up of contracts with respect to the 12 month threshold of Article 5(3) and says this will be dealt with in the Action 7 work on PEs.

The report also proposes new Model Treaty Commentary language to make clear that domestic anti-abuse provisions such as thin capitalisation, exit tax or dividend stripping rules are not necessarily over-ridden by tax treaties. The report does acknowledge that where the application of provisions of domestic law and those of tax treaties produce conflicting results, the provisions of tax treaties are intended to prevail, citing the Vienna Convention. It then suggests that nonetheless each case must be analysed based on its own circumstances with respect to the relevant tax treaty (and, although not expressly mentioned, the constitutions of the two treaty partner States). Domestic anti-abuse rules may however be over-ridden where the new PPT is not triggered. But for GAARs the report suggests this will seldom be the case.

The report includes proposed Model Treaty Commentary wording to clarify that a treaty does not affect the
taxation by a State of its own residents, except with respect to benefits granted under Article 7(3) (income attributable to a PE), Article 9(2) (correlative adjustments for transfer pricing) and Article 19 (government service), Article 20 (students), Article 23 (double tax relief), Article 24 (non-discrimination), Article 25 (mutual agreement procedure) & Article 28 (members of diplomatic missions and consular posts).

Lastly, the report updates the Model Treaty Commentary guidance on when a State should enter into a tax treaty with another State.

**The takeaway**
The report as noted above states that further work is required on the precise contents of the model provisions and related Commentary and in particular the LoB rule, and on the policy considerations relevant to treaty entitlement of CIVs and non-CIV funds. Accordingly, the Model provisions and related Commentary should be considered as drafts subject to improvement before their final adoption in September 2015.

**Let’s talk**
For a deeper discussion, please call your local contact. If you don’t have one or are not sure who to speak to on a global level, the people below listed by BEPS Action Plan area will be happy to help you.

**Tax policy**

Richard Collier, London  
+44 (0) 20 7212 3395  
richard.collier@uk.pwc.com

Stef van Weeghel, Amsterdam  
+31 (0) 88 7926 763  
stef.van.weeghel@nl.pwc.com

Phil Greenfield, London  
+44 (0) 20 7212 6047  
philip.greenfield@uk.pwc.com

Pam Olson, Washington  
+1 (202) 414 1401  
pamolson@us.pwc.com

**Prevent treaty abuse**

Peter Cussons, London  
+44 (0) 20 7804 5260  
peter.cussons@uk.pwc.com

Steve Nauheim, Washington  
+1 (202) 414 1524  
stephen.a.nauheim@us.pwc.com

David Swenson, Washington  
+1 (202) 414 4650  
david.swenson@us.pwc.com

© 2014 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

SOLICITATION
This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.