ACTION ITEM 6:
ATTACKING TREATY SHOPPING

BACKGROUND

Action Item 6 addresses abuse of treaties, particularly focusing on treaty shopping as one of the most important sources of B.E.P.S. The approach adopted amends the O.E.C.D. Model Convention that borrows from the U.S.’s approach to treaties but expands upon it in a way that can be very helpful to the U.S. and other developed countries if adopted by the C.F.E. next year in their final report. Among other measures, the report recommends inclusion of a Limitation on Benefits (“L.O.B.”) provision and a general anti-avoidance rule called the Principal Purpose Test (“P.P.T.”) to be included in the O.E.C.D. Model Convention. While it is expected the report will be finalized next year, whether countries will adopt the recommendations is the crucial factor that is still unclear.

RECOMMENDATIONS

The key recommendations can be found in Paragraph 14. It contains two basic recommendations:

- Countries should agree to include in the tax treaties an express statement of the common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance through use of treaties.

- Countries should demonstrate their commitment to this goal by adopting an L.O.B. provision and a P.P.T. provision in income tax treaties.

The report also notes that special rules may be needed to address application of these rules to collective investment funds (“C.I.F.’s”). The provision should be supplemented by a mechanism that would deal with conduit arrangements not currently dealt with in tax treaties.

Having established a goal, Paragraph 6 of Action Item 6 recognizes four constraints that may prevent full adoption of the recommendations in certain circumstances. This caveat will be helpful for a specific country that cannot fully adopt these measures. However, any exception that prevents wide acceptance of a recommendation may prevent the consistent approach needed to insure the success of the recommendations.
These four situations that may call for an exception are the following:

- Some countries have constitutional or E.U. law restrictions that prevent them from adopting the exact recommended wording.

- Some countries may have domestic anti-abuse rules that effectively prevent some of the treaty abuses described in the report. If those rules already address some of the issues in the report then treaty modification may not be needed. Nonetheless, a clear rule in an easily accessible treaty would be more helpful than having to explore the complexities of local law for guidance.

- The courts of some countries have developed judicial tools to combat these issues, such as an economic substance requirement and a substance over form doctrine, that effectively address these concerns. However, dealing with the local courts for relief is a major burden imposed on administrators.

- Limited administrative capacity of some countries might prevent implementation of a program involving detailed treaty rules. Instead, these countries might opt for more general anti-abuse provisions.

**LIMITATION ON BENEFITS**

The L.O.B. proposal recommends the adoption of a new Article X (Entitlement to Benefits) of the O.E.C.D. Model Convention. Paragraphs 1 through 6 of Article X address treaty shopping through a series of objective rules.

Paragraph 1 provides the general rule:

Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

Paragraphs 2 through 5 address when a resident is a “qualified person” and, alternatively, when a resident is entitled to benefits even though it is not a qualified person. The standard used is comparable to that which is applied in an L.O.B. provision of a typical U.S. income tax treaty. Thus, the following are considered to be qualified residents or to be entitled to certain treaty benefits even if not qualified:

- An individual who is a tax resident of a treaty country;

- The Contracting States that are parties to the convention and sub-national governments;

- A corporation having shares that are regularly traded on a recognized exchange (a “Publicly Traded Corporation”) for the entire tax period in which a benefit is claimed, provided either that the exchange is in the treaty country in which the corporation is tax resident or the primary place of management and control is in that country;
• A corporation in which shares representing at least 50% of the voting power and value are owned, directly or indirectly, by five or fewer Publicly Traded Corporations;

• Certain not-for-profit entities and pension arrangements;

• An entity meeting the following tests: (i) shares in the entity representing at least 50% of the voting power and value are owned, directly or indirectly, on at least half the days of the taxable year by any of the above qualified residents other than a Publicly Traded Corporation or an entity it owns, and (ii) it is not a conduit of income through deductible payments to a related party resident in a third country;
  - A conduit relationship exists if at least 50% of the entity’s gross income is paid or accrued directly or indirectly to residents in third countries. Relationships are identified at the time of payment. Arm’s length payments, made in the ordinary course of business for services or tangible property, are not considered to be part of a conduit arrangement.
  - Regrettably, neither the recommendation nor the commentary defines arm’s length for this purpose. This may lead to a dichotomy of treatment if arm’s length is defined in one country by reference to ownership – viz, a sister corporation can never be at arm’s length from a payor – or by the terms of the transaction – viz., a payment of interest to a sister corporation under a loan agreement that sets interest at LIBOR plus an appropriate mark-up based on the credit rating of the borrower is prima facie made at arm’s length terms and conditions. Payments to a local permanent establishment of a related person are not base eroding when the permanent establishment is a full taxpayer in the jurisdiction where it operates.

• A resident of Contracting State that is engaged in the active conduct of a trade or business, but only to the extent that the income is derived in connection with that business or is incidental to that business;
  - An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting, such as officers or employees of a company conduct substantial managerial and operational activities.
  - There is no recognition given for the attribution to a holding company of active operations from an operating company.
  - The business of the person claiming the benefit must be substantial in relation to the business in the payor’s state of residence, which is to be determined on a facts and circumstances basis. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.

• A company that is at least 95% owned by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary. The company
must not be a conduit as previously defined. Where this provision applies, the resident is entitled to the benefit even if not a qualified person;

- A resident benefitting from discretionary relief afforded by the relevant tax authority as to its qualification as a treaty resident. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.

**PRINCIPAL PURPOSE TEST**

While the L.O.B. proposal borrows heavily from the U.S. treaties, the P.P.T. general anti-avoidance rule adopts principles already recognized in the O.E.C.D.’s Commentary on Article 1 of the O.E.C.D. Model Convention. In contrast to the detailed and objective L.O.B. rules, the P.P.T. rule is a more general and subjective way to address treaty abuse cases. The P.P.T. provision appears in paragraph 7 of proposed Article X.

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit 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 this Convention.

The P.P.T. is a rule that will deny tax treaty benefits if “one of the principal purposes of an arrangement or transaction” is to obtain tax treaty benefits “unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant” treaty provision. Where this is the case, however, the last part of the provision allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The P.P.T. supplements, and does not restrict in any way, the scope and application of the limitation-on-benefits rule. Consequently, a benefit that is denied in accordance with the L.O.B. provision is not a benefit that the P.P.T. would also deny. In comparison, the fact that a person is entitled to benefits under the L.O.B. provision does not prevent benefits from being denied under the P.P.T. Thus, for planning purposes, the L.O.B. and the P.P.T. provisions must be met.

**CONCLUSION**

Action Item 6 is a productive step forward in dealing with treaty shopping. From the viewpoint of the U.S. and any country that has an income tax treaty in effect with the U.S., the L.O.B. provisions are “old hat.” However, for a U.S. tax adviser, the scope of the P.P.T. may be problematic because intent to obtain a treaty benefit is typically not enough to deny the benefit if it is accompanied by economic substance.