Public Discussion Draft

FOLLOW UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

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OECD

BETTER POLICIES FOR BETTER LIVES

GGi GENEVA GROUP INTERNATIONAL

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ITPG WINTER MEETING
MARBELLA, SPAIN
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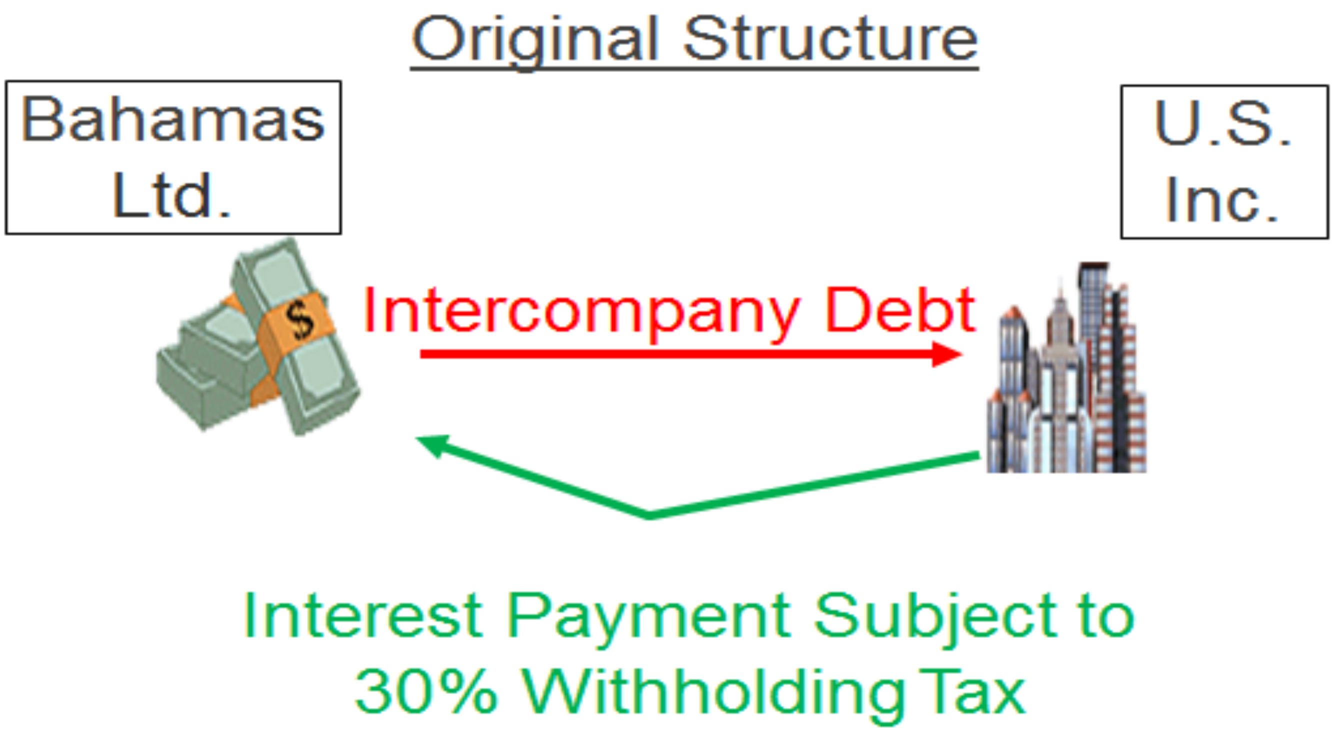
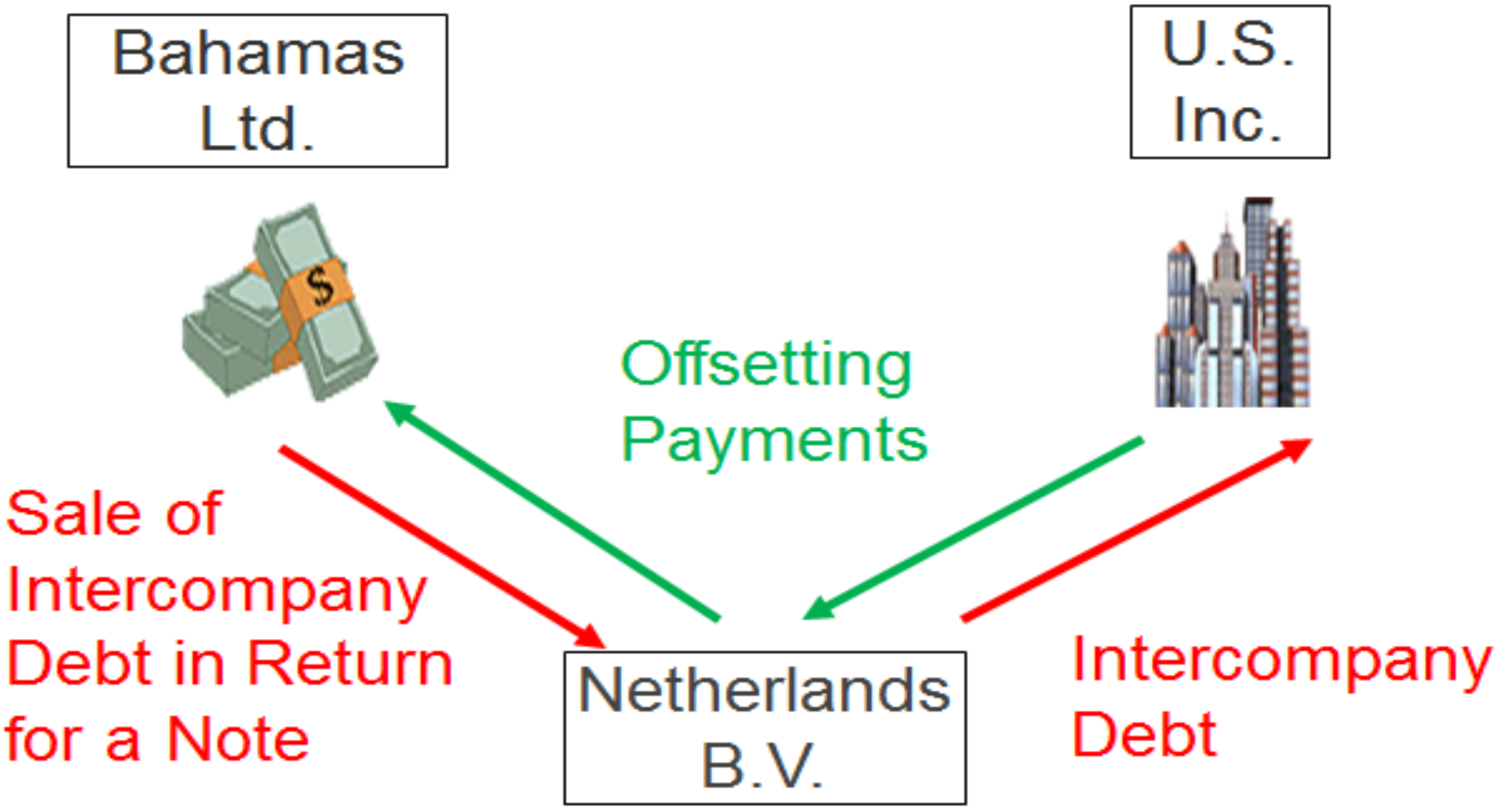
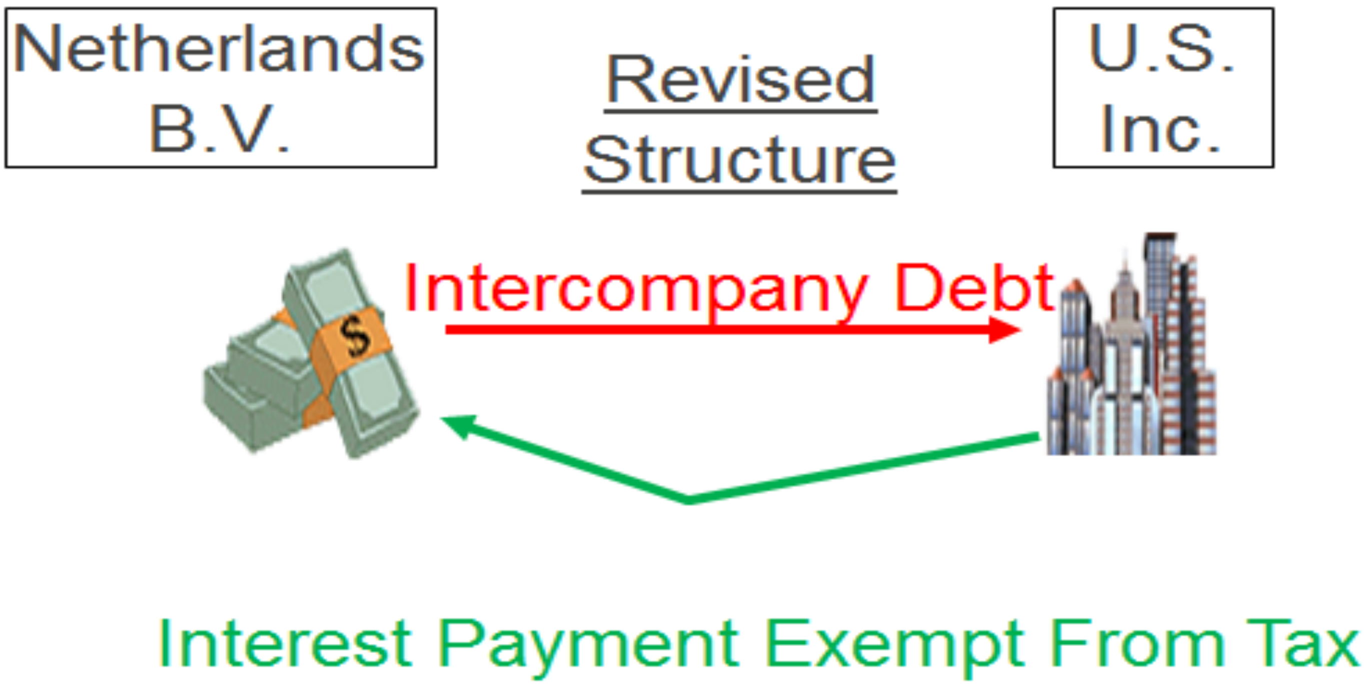
Background


Original Structure
Bahamas Ltd.
U.S. Inc.
Intercompany Debt
Interest Payment Subject to 30% Withholding Tax

Background


Bahamas Ltd.
U.S. Inc.
Offsetting Payments
Sale of Intercompany Debt in Return for a Note
Netherlands B.V.
Intercompany Debt

Background


Netherlands B.V.
Revised Structure
U.S. Inc.
Intercompany Debt
Interest Payment Exempt From Tax

In General

- Action Item 6 addresses abuse of treaties.
- It focuses on treaty shopping as one of the most important sources of B.E.P.S.
- The discussion draft 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.
- An L.O.B. provision in treaties is a U.S. concept.
- A P.P.T. provision is another term for a G.A.A.R. provision and was introduced to tax rules by Canada.

L.O.B. Provision

- 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 * * * unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

Qualified Person

- The following are considered to be qualified residents:
  - 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 that:
    - The exchange is in the treaty country in which the corporation is tax resident;
    - The exchange in in the country where the primary place of management and control exists.

Qualified Person

- The following are considered to be qualified residents:
  - 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:
    - 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,
    - It is not a conduit of income through deductible payments to a related party resident in a third country.

Qualified Person

- The following are considered to be qualified residents:
  - Ownership test (cont.)
    - A conduit entity 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 and in another country by the terms of the transaction.

Qualified Person

- The following are considered to be qualified residents:
  - 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;
    - The resident must act through its officers or employees who must conduct substantial managerial and operational activities.
      - Professional managers and accounting clerks are not sufficient.
    - There is no recognition given for the attribution to a holding company of active operations from an operating company.
      - This means that operating companies must make investments, not intermediate holding company.
  - The business of the person claiming the benefit must be substantial in relation to the business in the payor's state of residence.
    - This is to be determined on a facts and circumstances basis.

Qualified Person

- The following are considered to be qualified residents:
  - A company that is at least 95% owned by seven or fewer persons that are equivalent beneficiaries.
    - In the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary.
    - The company must not be a conduit as previously defined.
  - A company that receives discretionary relief from the tax authorities.

P.P.T.

- 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.

P.P.T.

- The P.P.T. provision appears in paragraph 7 of proposed Article X.
  - Notwithstanding the other provisions of this Convention,
  - A benefit under the 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.

P.P.T.

- The P.P.T. supplements, and does not restrict in any way, the scope and application of the limitation-on-benefits rule.
  - 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.

Comments

- Over 750 pages of comments were submitted by interested parties.
- The main concern is that the procedures for claiming treaty benefits are already onerous and that the draft's proposals are a disproportionate response.
- A general consensus is that abusive tax avoidance should be addressed primarily through domestic law.
- The implementation of an L.O.B. and a P.P.T. provision is seen as causing significant uncertainty and making treaty application more complicated.

Comments

- The L.O.B. provisions eliminate the subjectivity of determining when treaty benefits apply, but are technical and complex in their application.
- The P.P.T. provisions embrace a simple approach but their subjectivity does not offer much guidance on whether treaty benefits will be allowed.
- In order to comply with the L.O.B. rules, C.I.V.'s will be overburdened with tedious documentation requirements that will hinder legitimate transactions.
- A uniform approach to C.I.V.'s should be avoided because of the various structures and diverse investment base of C.I.V.'s do not lend themselves to a simple rule.

Comments

- Non-C.I.V.'s should be considered "look at" rather than "look through" entities, which seems to mean opaque rather than transparent.
- This would prevent increased reporting requirements and would be consistent with the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and the Common Reporting Standards, which do not have a requirement to "look through" these entities.
- L.O.B. provision requiring each intermediate owner to be a resident of a Contracting State would deny treaty benefits when there is a legitimate entitlement to such benefits.

Comments

- In response, the O.E.C.D. requested additional comments on 20 issues.
- Query: Can any transaction that is engineered by a tax adviser pass muster with the P.P.T. rule if it is not plain vanilla?
- Example:
  - Fact pattern 1: Man picks up a shotgun, puts on blindfold, stumbles down the street, and fires blindly. If he hits a goose, he can keep it.
  - Fact pattern 2: Man chooses his shotgun carefully, builds a blind, and carefully aims at a goose. The warden confiscates the goose.
- This may be where B.E.P.S is headed, inclusive of Action 6.

r u c h e l m a n

c o r p o r a t e
i n t e r n a t i o n a l
t a x a t i o n

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