BEPS MONITORING GROUP

Revised Discussion Draft for BEPS Action 6: Prevent Treaty Abuse

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Francis Weyzig.

We welcome this opportunity to comment on the Revised Discussion Draft (DD).

SUMMARY

A key test of whether the BEPS project can be a success is whether it will result in the inclusion of effective anti-abuse provisions in all tax treaties, not only prospectively, by formulating suitable provisions in the model treaty, but also more directly and quickly, by inclusion of such provisions in the proposed Multilateral Convention (MC), which aims to amend existing treaties.

The RDD proposes a 'simplified' limitation of benefits (LoB) provision, and as a minimum standard either (i) a combination of a principal purpose test (PPT) and an LoB provision, or (ii) a PPT provision alone, or (iii) an LoB rule plus some mechanism for dealing with conduit arrangements which are not already covered by other treaty provisions. However, the LoB provision is stated as only a bare outline with a direction to include whatever wording each pair of negotiating states can agree, while the full detailed wording of an LoB article is only in the Commentary, for use by states which prefer not to include a PPT provision.

This approach has exacerbated the concerns we expressed on the previous draft, that it would make it harder for small developing countries to conclude suitable treaties, and result in a kaleidoscope of different provisions, very likely leaving a continued scope for treaty shopping and increasing complexity for tax authorities as well as tax payers.

Furthermore, the RDD does not discuss how such provisions might be included in the MC, and the proposed 'flexible' format would make such inclusion difficult if not impossible.

Our comments also include a number of specific technical suggestions.

A. GENERAL COMMENTS

Technical and Policy Aspects

This is the third discussion draft under this Action, and we have been asked to keep comments as short as possible. This implies that they should be confined to specific technical points. However, it is essential in our view for technical points to be considered in the context of the wider policy issues. No doubt some of the participants are aware of these wider issues, but failing to make them explicit impoverishes the debate, and certainly excludes from participation many who do have an interest in those issues, but find it hard to understand the policy implications of the detailed technical proposals.

This Action aims to deal with the problem of treaty-shopping, i.e. taking advantage of the benefits of tax treaties by routing investments into a country through corporate or other legal entities formed in a jurisdiction which has a treaty with that country. Since tax treaties mainly

restrict the right to tax income or profits at source, treaties without effective anti-abuse rules damage countries which are either mainly capital-importing or have significant capital inflows. Thus, both developing countries and many developed countries are hurt by treaty shopping and have a strong interest in preventing it. However, developed countries that also have significant capital outflows will typically benefit from the restriction of taxation rights in source countries. For many developing countries, though, as some commentators have pointed out, concluding tax treaties makes little sense in tax terms. This is because without them such countries are free to take their own decisions on the most appropriate regime to apply to inbound investment, including making appropriate provisions to prevent genuine double taxation. Many developing countries are nevertheless persuaded to enter into such treaties, due to the perception that they help attract investments.

It is therefore very important that international bodies responsible for designing model treaties should ensure that such models include effective anti-abuse provisions, yet regrettably they have failed to do so. Those responsible for designing tax treaties have given higher priority to encouraging international investment than to ensuring effective taxation of income from such investment.

A key test of whether the BEPS project can be a success is therefore whether it will result in the inclusion of effective anti-abuse provisions in all tax treaties. This should be done prospectively, by formulating suitable provisions in the model treaty, but also more directly and quickly, by inclusion of such provisions in the proposed Multilateral Convention, which aims to override existing treaties to the extent that their provisions are unsuitable or inadequate. Hence, evaluation of the proposals under this Action should consider whether the rules they propose are appropriate for rapid implementation, especially by developing countries.

The form proposed for anti-abuse provisions

The report under Action 6 of September 2014 put forward two types of provision to deal with treaty-shopping:

(i) a principal purpose test (PPT), and

(ii) a more targeted limitation of benefits (LoB) provision with detailed definitions of the 'qualified persons' who should be entitled to treaty benefits.

It also proposed changes to the Preamble to make it clear that the purpose of tax treaties includes preventing evasion and avoidance, and discussed some other forms of treaty abuse, proposing specific provisions for dealing with some of them. It suggested (in para. 14) a minimum standard for treaties, which should include the general statement of purpose, plus either

(i) a combination of a PPT and an LoB provision, or

(ii) a PPT provision alone, or

(iii) an LoB rule plus some mechanism for dealing with conduit arrangements which are not already covered by other treaty provisions.

This minimum standard is now articulated, although not very clearly, in para. 1 of the draft Commentary to proposed Article X in the Annex of this report.

The Follow Up report of January 2015 put forward a number of further detailed questions for consultation on both the PPT and the LoB; and the present RDD presents the conclusions reached by Working Party 1 on most of these for further comment. A few matters remain to be dealt with at its meeting in June, although it is anticipated that some of the work (on the

treatment of collective investment vehicles) may extend beyond that, but 'should in any event be concluded before the December 2016 deadline for the negotiation of the multilateral instrument that will implement the conclusions of the work on Action 6' (RDD para. 24). This last reference is the only mention of the multilateral instrument in the RDD. Considering the importance that this multilateral instrument should play in this treaty abuse area, it is regrettable that this report focuses on the model treaty, and does not discuss how the proposed provisions might be dealt with in that instrument.

In our previous submissions on the proposals under this Action, as well as others, we have stressed the importance of achieving simplicity and clarity. On this Action we were specifically concerned that the proposals might leave a wide range of options for negotiation on a bilateral basis, which would (i) make it harder for small, especially developing countries to conclude suitable treaties, and (ii) result in a kaleidoscope of different provisions, very likely leaving a continued wide scope for treaty shopping.

We are disappointed that these concerns have not been addressed, indeed these revised proposals in some respects exacerbate the difficulties. In particular, although the RDD proposes a 'simplified' LoB provision, the actual draft treaty article it puts forward in the Annex consists of only a bare outline with a direction to include whatever wording each pair of negotiating states believe might be relevant to their particular relationship and individual needs. It is apparently intended to include the full detailed wording of an LoB article only in the Commentary, for use by states which prefer not to include a PPT provision.

Not only does this encourage significant variation in treaties, but there will be treaty negotiating teams from many countries which will have difficulty determining what inclusions in the LOB will be important and relevant for their respective countries. We believe that greater standardization would be beneficial for both tax authorities and taxpayers who do *not* have BEPS motivation. On the other hand, we fear that the greater variation that will result from this approach will continue to provide many opportunities for treaty-shopping.

Moreover, the RDD provides no explanation of whether or how an LoB provision might be included in the planned multilateral convention. An effective anti-abuse article is an essential element of this convention, since there are many treaties with developing countries which do not include any anti-abuse provision at all. Although some countries have begun to re-evaluate and renegotiate their treaties, this process would take time. Since the RDD does not propose an LoB provision in standard form, it seems that the multilateral convention might include only a PPT clause. Although this might be acceptable and indeed preferable for some countries, it begs the question of whether some leading OECD states, especially the United States, would be willing to accede to such a convention, in view of its strong policy preference for the LoB approach. Worst of all would be if the multilateral instrument did not include an immediately applicable provision against treaty shopping, but left it to parties to negotiate.

Regarding PPT provisions, we emphasize that these should be included in such a way that they apply to all treaty benefits. At present, if tax treaties include a main purpose test, such a provision is usually included with regard to selected treaty articles only, for example only articles 10 (Dividends), 11 (Interest) and 12 (Royalties). However, treaty abuse may also occur with regard to other treaty benefits, including the elimination of withholding tax on capital gains, under article 12 (Capital gains), or on management fees, as implied by article 21 (Other income). This is of particular relevance to developing countries, as evidenced by the new ActionAid report *An Extractive Affair*.

B. SPECIFIC COMMENTS

Part 1 - Alternative 'Simplified' LoB Rule and Presentation of the LoB Rule in the OECD Model

The full LOB provision as set out in the March 2014 BEPS Action 6 Discussion Draft included a base erosion test in Clause e) ii) of Paragraph 2. This base erosion test is missing from paragraph 2 of the simplified LOB rule set out in Paragraph 3 of the RDD.

We believe that the omission of this base erosion test from the simplified LOB rule creates a very big hole for back-to-back and other conduit arrangements through an unrelated person who will qualify as a 'person other than an individual, if residents of that Contracting State that are qualified persons own, directly or indirectly, more than 50 per cent of the beneficial interests of the person' under Paragraph 2.e) of the simplified LOB rule.

The explanation for this omission seems to be in paragraph 5, which states:

> A number of delegates considered that this alternative version of the LOB rule would address different concerns raised by the LOB rule included in the Report on Action 6 and would provide a simpler way to address the most obvious cases of treaty-shopping, *other cases being dealt with under the PPT*. …

The idea is that the PPT would be used for conduit companies. While we agree that simpler rules will often be better, this will not be true at all for this situation.

Where there is reliance on a PPT that involves judgment, MNEs will continue to use structures that push the envelope to achieve BEPS objectives. They will rely on the audit lottery that will be highly skewed in their favour.

- Tax authorities will normally have to be examining a specific taxpayer during which time they must recognize that a structure being used is a potentially abusive conduit arrangement. Often, with an unrelated party masking the existence of a back-to-back arrangement, tax authorities will most often fail to recognize such structures.
- Tax authorities will have to gather all facts and circumstances regarding the structure and the participants. This is a difficult and time- and resource-consuming task.
- Tax authorities will have to analyze the information they have gathered and present a comprehensive case supporting the abusive nature of the structure. In addition, some countries may require a presentation of the case to a central authority that must clear any action taken when the PPT is applied.

With all this effort, there will be very few potentially abusive conduit and other similar structures pursued by tax authorities under PPT rules.

Where, however, there is a bright line rule for base erosion to prevent abusive back-to-back and other conduit arrangements, MNEs will not be able to push the envelope beyond the bright line. This bright line will set a minimum standard so that tax authorities will have no need to look for and spend considerable time and effort on applying the subjective PPT to highly abusive tax structures. The recent news that Amazon has decided to initiate reporting sales through branches of its Luxembourg operating sales company in some number of European countries into which it sells is clear proof of this.

For reasons expressed in the above General Comments section of this submission, we have recommended that this simplified approach be withdrawn with only the more comprehensive LOB being included. If this simplified LOB rule is retained, then the base erosion mechanism must be included in this simplified LOB.

If our suggestions are not accepted, there is clearly a need to deal more effectively with conduit and other structures where countries do choose this simplified LOB rule along with the PPT as a backup. We therefore suggest that the final recommendation include that countries adopting the simplified LOB approach along with the PPT (or a PPT alone) impose informational reporting for any conduit arrangements that do not meet some minimum base erosion test. The terms of such a test could mirror the base erosion rules in the full LOB rule.

Although there is a separate section in the Revised Discussion Draft covering intermediate ownership (Paragraph 46 that would amend Paragraph 2 e) of the draft simplified LOB rule), in our view this is an additional example where there must be clear requirements in the simplified LOB rule. The countries that would likely choose this simplified approach will be those most incapable of monitoring intermediate ownership and of challenging tax-motivated structures through only the principles of the PPT provision.

Part 2 – Issues Identified in the November 2014 Discussion Draft

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

We agree fully with the concerns expressed in Paragraph 24 and look forward to seeing what is drafted.

3. Commentary on the discretionary relief provision of the LOB rule

We reiterate that the discretionary relief provision of the LOB rule must be accompanied by a standard for public transparency. As paragraph 65 of the proposed changes to the Commentary notes, the paragraph on discretionary relief '*grants broad discretion to the competent authority'*. The possibility for discretionary relief could give rise to undue pressures on tax officials and create an enabling environment for corruption. Exchange of information on discretionary relief decisions among competent authorities would not help to create the necessary domestic checks and balances. To discourage corrupt practices, and to create more clarity for tax payers, the OECD should strongly recommend that tax authorities publicly disclose their decisions regarding requests for discretionary relief, including explanations of the decision. These could if necessary be anonymised. Various OECD countries, including the US, already have such a system in place for tax rulings in general.

4. Alternative LOB provisions for EU countries

Paragraph 40 involves an additional provision for pension funds under the LOB rule. We have no problem conceptually with this additional provision, but it certainly could be said that the difficulty of administratively trying to comply with the newly drafted 90% test where the 50% test cannot be met may well be insuperable for any pension fund that has more than five or ten members. We cringe at the information gathering and paperwork effort that would be necessary for any such fund of an MNE employer that includes employees in the fund from the many different countries in which it operates.

We are not aware of the extent of union based funds that include union members from multiple countries, but if there are any such vehicles, they would simply not have the resources for the information gathering and analysis to attempt meeting this 90% test.

Rather than forcing a 90% rate (or whatever rate the two contracting states agree to) when the basic 50% rule cannot be met, perhaps a better approach would be to allow treaty benefits under the LOB rule but only to the extent that a pension fund can demonstrate that its membership does qualify under Conditions A and B.

For example, if a pension fund can only show the two conditions are met for 40% of the fund members, then 40% of the relevant income would receive treaty benefits and 60% of the

income would be fully taxed under the domestic law of the source contracting state. This seems economically fairer and leaves the pension fund to decide how much effort to make to establish qualification for treaty benefits.

In order to avoid trying to micro-manage how pension funds should operate, if this suggested alternative approach is adopted, we suggest that there be no requirement for pension funds to track the treaty benefits to the qualifying fund members. Accordingly, funds could choose to either track such benefits causing qualifying members to receive higher benefits or benefit all fund members equally for any allowed treaty benefits.

6. Issues related to the derivative benefits provision

Given the intent of Proposal 1 to allow a source country to apply its domestic law when a taxpayer resident in the other contracting state is subject to a special tax regime in that state, this Proposal 1 should apply as well to provisions in the treaty governing business profits (including the definition of permanent establishment), dividends, and capital gains.

Regarding Proposal 2 (new general treaty rule intended to make a tax treaty responsive to certain future changes in a country's domestic tax laws), since the domestic law changes contemplated must apply to substantially all foreign source income, the elimination of source country benefits must also be applied to the Article 5 definition of permanent establishment (PE). The source contracting state domestic definition should apply unless prior to the change the country of residence did not tax its residents on the income of foreign PEs.

Despite this change to Article 5, it seems sensible to leave Article 7 in place to have agreement between the contracting states on how income of the PE will be calculated. Of course, it should be made clear that the reference in Article 7 to a PE would be treated as a reference to a PE or whatever concept or term is used under domestic law (e.g. 'Engaged in a Trade or Business in' the country concerned).

10. Clarification of the 'active business' provision

Paragraph 72 amends Paragraph 3 of the LOB rule with subparagraph b) reading as follows. The one change is in **bold**.

> If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a related person, the conditions described in subparagraph a) of this paragraph shall be considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or **a** related person in the other Contracting State. ...

The added 'a' should be changed to read 'the' to clearly indicate that the related person from which the resident is receiving income is the *same related person* that is carrying on a trade or business in the other Contracting State. As the provision reads now, the related person from which the resident is receiving income could be a different related person from the related person that is carrying on a trade or business in the other Contracting State.

15. Whether some form of discretionary relief should be provided under the PPT rule

New paragraph 8 sets out a procedure under which certain reduced treaty benefits would be provided following a disallowance of treaty benefits under the PPT rule. The first sentence of the new paragraph reads as follows:

> 8. Where a benefit under this Convention is denied to a person under paragraph 7, the competent authority of the Contracting State that would otherwise have granted this

> benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 7.

We are very concerned about this paragraph because *it will have the counterproductive effect of actually encouraging continued treaty abusive behaviour*. This is because taxpayers will see that they will be no worse off if their abusive treaty planning is disallowed than they would have been had they not conducted the abusive planning. We recommend the following amended wording for paragraph 8:

> 8. Where a benefit under this Convention is denied to a person under paragraph 7, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless consider treating that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, in its discretion, determines that such benefits should be granted to that person on the basis that the transaction or arrangement referred to in paragraph 7 had not occurred.

This new wording makes it clear that the decision to grant or not grant the relevant benefits is at the discretion of the competent authority.

Discretion was discussed in paragraph 17 of the Commentary as follows:

> The determination that benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 7 and the determination of the benefits that should be granted are matters that are left to the discretion of the competent authority to which the request is made. The paragraph grants broad discretion to the competent authority for the purposes of these determinations.

This 'discretion', though, is not discretion regarding whether to grant any benefits, but only as to how the benefits will be calculated.

Appropriate changes to reflect this changed language in paragraph 8 should be made to paragraph 16 in the Commentary. We suggest the following language for paragraph 16:

> 16. Paragraph 8 provides that where a person is denied a treaty benefit in accordance with paragraph 7, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless consider treating that person as being entitled to this benefit, or to different benefits with respect to the relevant item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, in its discretion, determines that such benefits should be granted to that person on the basis that the transaction or arrangement referred to in paragraph 7 had not occurred. In making his determination, the competent authority may take into account all facts and circumstances including the intentions of the person in entering into the transaction or arrangement referred to in paragraph 7.

The newly drafted Commentary provides the following example:

> 18. The following example illustrates the application of the paragraph. Assume, for example, that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that

> company to another company resident of State R which owns more than 10 per cent of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for in subparagraph a) of paragraph 2 of Article 10. In such a case, if it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 7, the competent authority of State S shall, under paragraph 8, grant the benefit of the reduced rate provided for in subparagraph b) of paragraph 2 of Article 10 if it determines that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.

To provide useful and appropriate guidance in light of the changed wording in paragraph 8, this example needs to be expanded, otherwise the message being provided to governments and taxpayers alike is very counterproductive and would only encourage BEPS behaviour.

We suggest the following amended language for Paragraph 18:

> 18. The following example illustrates the application of the paragraph. Assume, for example, that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that company to another company resident of State R which owns more than 10 per cent of the capital of the paying company. One of the principal purposes of making the assignment was obtaining the reduced rate of source taxation provided for in subparagraph a) of paragraph 2 of Article 10. In such a case, if it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 7, the competent authority of State S shall, under paragraph 8, consider any request made by the individual that the competent authority grant the benefit of the reduced rate provided for in subparagraph b) of paragraph 2 of Article 10. Upon receiving such a request, the competent authority would examine all the facts and circumstances. In doing so, the competent authority would determine whether there were any compelling non-tax principal purposes that would have made the assignment worth executing even in the absence of the requested tax benefit (in this case the lower level of dividend withholding tax). If the competent authority determines that such compelling principal purposes exist, then it can choose to grant the benefit that would have been granted in the absence of the assignment to another company of the right to receive dividends. If the competent authority determines that no such compelling principal purposes exist, then no benefit would be granted under the treaty.

This amended wording makes clear that abusive arrangements will be treated in a manner that makes them worse off than if they had not conducted the abusive planning.

16. Drafting of the alternative 'conduit-PPT rule'

Example C reads, in part:

> TCO later realises that it can avoid the withholding tax on interest levied by State S by assigning the note to its wholly-owned subsidiary RCO, a resident of State R (the treaty between States R and S does not allow source taxation of interest in certain circumstances).

Such an assignment of an existing loan is at the extreme of black and white situations where a conduit arrangement exists. A somewhat more nuanced example would be more instructive and provide better guidance to tax authorities and taxpayers. Further the use of such an extreme black and white example give aggressive taxpayers the ability to argue that any arrangement that is not so black and white as Example C should qualify as not being a conduit.

The following amends Example C to attempt to provide such a more nuanced example.

> Example C: TCO, a company resident of State T, which does not have a tax treaty with State S, wholly owns SCO, a company resident of State S, and RCO, a company resident of State R. All three companies conduct active businesses. SCO needs to raise 1,000,000 for use in its business. TCO is aware that the lack of a T-S tax treaty means that interest paid by SCO to TCO would be subject to State S's high level of withholding tax. To avoid this result by making use of a favourable R-S tax treaty which does not allow source taxation of interest in certain circumstances, TCO lends 1,100,000 to RCO under a note at 6 per cent interest and RCO lends 1,000,000 under a note to SCO a month later at 7 per cent.
>
> The transaction in which TCO routed funds through a back-to-back loan through RCO to SCO constitutes a conduit arrangement because it was structured to eliminate the withholding tax that TCO would otherwise have paid to State S.

Example F involves what is clearly a back-to-back loan from a parent company to a subsidiary company through a group finance company. The regular business of the group finance subsidiary is to coordinate the financing of the parent company and all subsidiaries. The example makes clear that the group finance company conducts its group financing activities in an active manner through its own personnel.

Example F's conclusion includes:

> Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement.

We believe that the conclusion for this Example F is incorrect and misleading. We suggest the following more nuanced conclusion:

> In this example, RCO appears to be carrying on a real business performing substantive economic functions, using real assets and assuming real risks; it is also performing significant activities with respect to the transactions with TCO and SCO, which appear to be typical of RCO's normal treasury business. RCO also appears to be bearing the interest rate and currency risk. Based on these facts, TCO intended and directed that its 15,000,000 in currency A lent to RCO would be on-lent by RCO to SCO in currency B with RCO managing the relevant interest rate and currency risks through forward contracts. As such, this constitutes a conduit arrangement. On the other hand, if TCO had transferred excess funds to RCO as a loan prior to any specific need by SCO, and RCO later lent required funds to SCO, then in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement.

17. List of examples in the Commentary on the PPT rule

We believe that the examples added to Paragraph 14 are an excellent addition.

We suggest the following could be added at the end of Example H to provide further useful guidance:

> On the other hand, if TCO supplied to RCO a substantial portion of the additional capital necessary for RCO's capitalization of SCO, and/or if this indirect ownership of

a subsidiary was an anomaly with respect to the TCO group's organizational structure, then Paragraph 7 would apply to these transactions.

19. The design and drafting of the rule applicable to permanent establishments located in third States

The bracketed 60% is simply too low to prevent BEPS focused structuring. We suggest that the bracketed amount be no less than 90%.

By using a low bracketed percentage such as 60%, the rules are merely giving a little guidance to aggressive MNEs and other taxpayers that they should continue to shift profits, ‘but please don’t be quite so greedy’.