BEPS Action 6 – Treaty vs Domestic Anti-Abuse Rules - Policy Proposals

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1. Action 6 of the Base Erosion and Profit Shifting (BEPS) Plan

1.1 Background

In October 2015[1], the OECD released its final deliverable on Action 6 that is dedicated to prevent the granting of treaty benefits in inappropriate circumstances. In order to determine the most appropriate manner to prevent the granting of treaty benefits, the final deliverable differentiates between two situations. The first situation deals with cases where a taxpayer tries to abuse tax treaty provisions, for example, by engaging in treaty shopping schemes. For such cases, the final deliverable suggests the adoption of treaty anti-abuse rules. The second situation deals with cases where a taxpayer tries to avoid the application of domestic anti-abuse rules (anti-abuse rules which counter treaty abuse as well as domestic law abuse), by arguing that the provisions of tax treaties preclude the application of such rules. For such cases, clarification changes are proposed in the OECD Commentary.

1.2 Treaty anti-abuse rules

The final deliverable suggest a three-prong approach to counter abuse of treaty provisions, in particular, treaty shopping[2]. Firstly, the title and preamble of tax treaties is modified to reflect that when States enter into tax treaties their intention is not to create opportunity for tax avoidance or evasion including treaty-shopping arrangements[3]. Secondly, the inclusion of a treaty specific anti-abuse rule (SAAR) i.e. a limitation of benefit (LOB) clause is suggested[4]. Lastly, a treaty general anti-avoidance rule (GAAR) in the form of a principal purpose test (PPT) is proposed[5]. The report acknowledges that all countries may not find it necessary to adopt the three measures. Thus, a minimum standard is recommended wherein it is suggested that States should change the title and preamble of the tax treaties and include either: i) the LOB clause and PPT rule; ii) the PPT rule only or iii) the LOB clause with an inbuilt narrow PPT rule or domestic anti-abuse measures[6]. Moreover, other treaty SAARs are proposed, for instance, to restrain rule-shopping schemes with respect to dividends[7]; to stop non-payment of taxes on capital gains with

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respect to sale of shares in a real estate company[8]; to prevent tax avoidance schemes that could be achieved through dual resident entities[9] or by using permanent establishment situated in third States[10].

1.3 Domestic anti-abuse rules countering treaty abuse or domestic law abuse and their interaction with tax treaties

Judicial anti-abuse rules (such as sham, simulation, step transaction, substance over form, economic substance or business purpose tests), domestic statutory GAARs or domestic SAARs (source State measures such as anti-treaty shopping rules/ anti-rule shopping rules or residence State measures such as switch over clauses or extended tax liabilities) can be used to prevent abuse of tax treaties i.e. granting of benefits flowing from a tax treaty. Similarly, judicial anti-abuse rules, domestic statutory GAARs or domestic SAARs (source State measures such as thin capitalization rules or residence State measures such as controlled foreign company (CFC) rules or exit taxes) can be used to counteract domestic law abuse. In many cases, taxpayers argue that such domestic measures conflict with tax treaties as treaties rank higher than domestic law[11]. However, by referring to the comments made in the OECD 2003/2014 commentary to Article 1, in particular, Paras 22, 22.1 and 9.5[12], it is clarified that in *most cases* a conflict does not arise between such domestic anti-abuse rules and tax treaties[13]. Moreover, it is explicitly clarified that CFC rules[14] or immediate exit taxes[15] do not conflict with treaty provisions.

2. Authors opinion – Policy proposals

2.1 Countering treaty abuse – treaty anti-abuse or domestic anti-abuse rules?

The BEPS project states that treaty anti-abuse rules as well as domestic anti-abuse rules can be used to counter treaty abuse. In the author's opinion, treaty abuse (treaty shopping, rule shopping or other similar schemes) should be counteracted only by treaty measures such as the PPT rule, LOB clause or other targeted SAARs. This is because such rules, when incorporated in tax treaties, express the common intentions of the treaty partners. On the other hand, domestic anti-abuse rules should not be used to counter treaty abuse. This is because such rules express unilateral application of domestic rules by States. Such unilateral application could reallocate taxing rights and lead to double taxation (juridical or economic). Consequently, the application of tax treaties becomes less certain and more controversial when domestic anti-abuse rules are applied. Accordingly, it is recommended that only treaty anti-abuse rules be used to counter treaty abuse.

The treaty anti-abuse rules that are proposed by the BEPS plan is not flawless too. For instance, the PPT rule raises several issues with respect to its subjective element, objective element, burden of proof and outcome of denial of treaty benefits[16]. This reduces certainty for taxpayers. On the other hand, the LOB clause, could provide certainty if the taxpayer objectively satisfies its conditions. However, the clause seems complicated and problematic to apply, especially, by States that do not have the appropriate capacity to administer such a provision. Accordingly, States have two tough choices to choose from when they incorporate the minimum standard. In the author's opinion, the structural characteristics of the PPT rule and the LOB clause need to be reconsidered[17]. If they are not rethought, a reasonable statement can be made that States with large tax administrations should choose the LOB clause whereas smaller States should adopt the PPT rule[18].

2.2 The interaction of domestic anti-abuse rules with tax treaties

The conclusion reached by the OECD that a conflict does not arise between domestic anti-abuse rules (rules which prevent treaty or domestic law abuse) and tax treaties is highly questionable. In the author's opinion, the application of judicial anti-abuse rules, domestic statutory GAARs or domestic SAARs could have several "*effects*". For instance, when applied from a source State perspective such rules could i) re-determine the taxpayer to whom an item of income is attributed ii) re-characterize of an item of income for tax purposes; iii) deny treaty benefits to a taxpayer; or iv) deny deductions for payments made to non-resident associated enterprises. Likewise, when applied from a residence State perspective such rules could deem non-residents to be residents of that jurisdiction so as to impose worldwide taxation; ii) impute income derived by an offshore taxpayer to a resident taxpayer; iii) deem a taxpayer to dispose of his assets prior to its migration; and iv) deny relief from double taxation to a taxpayer, in particular, the exemption method as provided in the tax treaty. Whether or not such "*effects*" of applying domestic anti-abuse rules conflict with a tax treaty depends on the wording and purpose of the relevant treaty provision. If the domestic

law effect does not square with the terms of the tax treaty then the latter will prevail pursuant to Article 26 of the Vienna Convention on the Law of Treaties which contains the "*pacta sunt servanda*" principle. If States wish to avoid such conflicts then it is suggested that they include a provision in their treaty network that preserves the application of domestic anti-abuse rules[19] (with appropriate limits so that an extensive application of such rules is prevented). This suggestion was already made in the 1977 OECD Commentary to Article 1[20] and is reproduced partly in the final deliverable[21]. Such an approach will be preferable over confusing clarifications in the Commentary.

3. Way forward – Treaty disputes

In light of the several treaty (and commentary) related changes proposed by Action 6 and other Actions of the BEPS plan viz., Action 2 (Hybrid Mismatches)[22] & Action 7 (Permanent Establishments)[23], it can be asserted that, when such changes are incorporated by States in their treaty network (mostly through a multilateral tax instrument[24]), tax treaty disputes will be on the rise. Consequently, Action 14 (dispute resolution), which proposes to improve the mutual agreement procedure[25], is of paramount importance for taxpayers.

1. OECD/G20, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, 05 October 2015 (hereafter 2015 OECD, Final Report on Treaty Abuse).
2. 2015 OECD, Final Report on Treaty Abuse, Para. 19.
3. 2015 OECD, Final Report on Treaty Abuse, Para. 72.
4. 2015 OECD, Final Report on Treaty Abuse, Para. 25.
5. 2015 OECD, Final Report on Treaty Abuse, Para. 26.
6. 2015 OECD, Final Report on Treaty Abuse, Para. 22.
7. 2015 OECD, Final Report on Treaty Abuse, Para. 36 and Para. 40.
8. 2015 OECD, Final Report on Treaty Abuse, Para. 44.
9. 2015 OECD, Final Report on Treaty Abuse, Para. 48.
10. 2015 OECD, Final Report on Treaty Abuse, Para. 52.
11. 2015 OECD, Final Report on Treaty Abuse, Para. 54.
12. 2015 OECD, Final Report on Treaty Abuse, Paras. 56-57.
13. 2015 OECD, Final Report on Treaty Abuse, Para. 59.
14. 2015 OECD, Final Report on Treaty Abuse, Para. 61.
15. 2015 OECD, Final Report on Treaty Abuse, Paras. 65-67.
16. See Luc De Broe, Joris Luts, BEPS Action 6: Tax Treaty Abuse, in 43 Intertax 2 (2015), pp. 122-146.
17. See Vikram Chand, The Guiding Principle and Principal Purpose Test, in International Taxation, Taxmann, June 2015 2016, pp. 486-488.
18. Further research needs to be done on this point.
19. See Vikram Chand, The Interaction of Domestic General Anti-Abuse Measures with Tax Treaties, in Robert Danon (ED.), Base Erosion and Profit Shifting (BEPS) – Impact for European and International Tax Policy, Tax Policy Series, Geneva/ Zurich 2016, Schulthess, p. 283.
20. 1977 OECD Comm. Art. 1, Para. 7.
21. 2015 OECD, Final Report on Treaty Abuse, Para. 59, Commentary in Para. 25 and Para. 26.4.
22. OECD/G20, BEPS, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, 05 October 2015.
23. OECD/G20, BEPS, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7, 05 October 2015.
24. OECD/G20, BEPS, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15, 05 October 2015.
25. It is argued that the current MAP process is ineffective as many cases go unresolved. Action 14 of the BEPS plan revisits the dispute resolution mechanism and seeks to make the MAP process more effective. The final report provides for implementation of minimum standards through a peer-based monitoring mechanism. In addition to committing to the minimum standard, several countries have also expressed their interest to implement mandatory arbitration clauses in their tax treaties. OECD/G20, BEPS, Making Dispute Resolution Mechanisms More Effective, Action 14, 05 October 2015, pp. 9-10.