Analysis

BEPS treaty abuse-related actions

SPEED READ **Traditional treaty principles that allocate taxing rights between residence and source states which have long formed the cornerstone of international tax consensus are undergoing rapid re-evaluation. Debate is driven by digital economy challenges identified in BEPS Action 1. Action 6 proposes changes to deny treaty benefits in circumstances now regarded as inappropriate. Action 2 contains treaty changes to eliminate double reliefs from hybrid instruments and entities. Action 7 changes the definition of permanent establishment to prevent the avoidance of PE status as presently defined. A multilateral instrument proposed in Action 15 will allow collective implementation of BEPS treaty measures.**

Jonathan Schwarz is a barrister at Temple Tax Chambers. He focuses on international tax disputes as counsel and as an expert and advises on solving cross-border tax problems. Jonathan is the author of *Schwarz on Tax Treaties* (CCH 2013) among other publications. Email: jonathan.schwarz@taxbarristers.com; tel: 020 7936 3988.

The impact of BEPS on future tax treaties cannot be underestimated. Traditional principles for the allocation of taxing rights between residence and source states, which have formed the cornerstone of international tax consensus for almost a century, are undergoing rapid re-evaluation.

At its core, Action 6, headlined as preventing treaty abuse, sets out a catalogue of proposals designed to prevent the granting of treaty benefits in circumstances now regarded by the drafters as inappropriate. This is underscored by Action 2, which aims to eliminate the double non-taxation, double deductions and long-term deferral that arise through hybrid instruments and entities, by changes to the OECD Model Tax Convention. A key challenge of the digital economy is identified in Action 1: the ability of a company to have a significant 'digital presence' in the economy of another country without being liable to taxation in that country. Several rules to capture these revenues are proposed in Action 7, which sets out changes to the definition of permanent establishment, so as to prevent the avoidance of permanent establishment (PE) status as presently defined. Action 15 proposes the development of a multilateral instrument to allow states that wish to do so to collectively implement measures developed in the course of the work on BEPS.

Action 6 identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. A discussion draft released on 16 September 2014 proposed:

- model treaty provisions and domestic rules designed to prevent the granting of treaty benefits in inappropriate circumstances;
- clarification that tax treaties are not intended to be used to generate double non-taxation; and
- tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

What's proposed?

Treaty shopping: A number of the proposals come as no surprise. The two key measures to prevent treaty shopping are a US style limitation on benefits (LOB) article and a UK style GAAR article (now styled as a principal purpose test (PPT)). Significantly, the BEPS style LOB contains no derivative benefits provision, unlike its US antecedent. The main effect of this omission will be to preclude finance or IP holding companies from benefiting from treaties, even though their ultimate parent companies would be entitled to the same benefits. Derivative benefits language is, however, included in the proposed Commentary on the LOB as an option, subject to exclusion for conduit transactions. The discussion draft describes these measures as addressing cases where a person tries to circumvent limitations provided by the treaty itself. It is implicit in the proposals that indirect access to the benefits of a treaty between two states by third state residents is abusive, even where the residence requirements of the relevant treaty are met.

This view of abuse is found throughout the document. In essence, the document reflects dissatisfaction with the outcomes that flow from the existing language found in the OECD Model Tax Convention, rather than the misuse of those provisions. The proposals are of general application and are not restricted to legally recognised standards of abuse; that is, where the sole purpose of the arrangements is to circumvent a particular rule. They reflect policy changes aimed at removing treaty benefits in circumstances now viewed as inappropriate, rather than abuse of existing treaties.

The document is as much political as it is technical. The political context driving BEPS both requires the OECD to demonstrate that it is addressing tax avoidance and enables it to motivate changes in treaty policy by reference to abuse, rather than an objective analysis of the suitability of existing treaties in light of the 21st century economy and modern business practices. The Action 7 paper recounts past OECD work going back to the 1977 OECD Model Tax Convention and the 1986 studies on conduit and the base companies. Indeed, there are few fresh ideas. The technical proposals are mostly a repackaging of ideas that have appeared in some treaties but are not widely adopted.

Specific situations where treaty limitations are circumvented: Other non-treaty shopping situations are identified in Action 6, where treaty limitations are said to be circumvented. There is some overlap with these and other actions:

- Splitting up contracts among different companies to fall outside the 12 month threshold for a construction or building site permanent establishment in art 5(3) overlaps with Action 7.
- Transactions intended to avoid dividend characterisation, and proposals to replace the 'place of effective management' tie-breaker rule for determining the treaty residence of dual resident persons other than individuals in art 4(3) by ad hoc agreement by tax administrations, overlap with

The temperature of the debate makes rational analysis resulting in an enduring international tax dispensation extremely difficult

BEPS Action 4 on hybrids.

- Hiring out of labour cases in art 15(2) and the 'economic employer' concept were adopted in the 2008 Model Tax Convention.

Abuse of domestic tax law using treaty benefits: This section advances the view that granting the treaty benefits in certain cases would be inappropriate if the result would be the avoidance of domestic tax. A number of the examples are surprising, because the elimination of domestic tax is the obvious result from the proper interpretation and application of the provisions. Several are drawn from art 24 (non-discrimination). Thus, it is said to be 'inappropriate' for art 24(5) to prevent the application of domestic rules that restrict tax group consolidation to resident entities, despite sound judicial authority to the contrary (e.g. *FCE Bank plc v HMRC* [2012] EWCA Civ 1290). A similar approach is taken in relation to art 13 (capital gains) and art 13 (5), which prevents the application of domestic assignment of asset rules (*Smallwood v HMRC* [2010] EWCA Civ 778).

Tax treaties not intended to be used to generate double non-taxation: The second part of the work mandated by Action 6 was to 'clarify that tax treaties are not intended to be used to generate double non-taxation.' This approach has become recognised in UK practice (*Smallwood* (see above); and *Bayfine UK v HMRC* [2011] EWCA Civ 304). In order to support this, it is proposed that the OECD Model Tax Convention should recommend, as an aid to interpretation, a preamble expressly stating that tax treaties intend to eliminate double taxation without creating opportunities for tax evasion and avoidance.

There is an absence of any discussion on the distinction between 'generated' double non-taxation and that which is the natural result of the interaction of a treaty and the domestic laws of the contracting states; that makes the application of this proposition difficult in practice and a likely source of future uncertainty and conflict.

Tax policy considerations for concluding tax treaties: The thrust of this proposal is to set out policy considerations that could make it easier for countries to justify their decisions not to enter into tax treaties with certain low or no tax jurisdictions. The paper contends for a narrow view of the role of tax treaties in allocating taxing jurisdiction. This, it, says is justified only where taxing jurisdiction is given up on the basis that items are generally taxed in the other state. Considerations include whether elements in the other state's tax system could increase the risk of non-taxation. It is far from clear whether, for example, the UK would be viewed as a low or no tax jurisdiction by reason of features such as the dividend, substantial shareholding and foreign permanent establishment profits exemptions. Is the OECD advocating that other states terminate their treaties with the UK?

Permanent establishments: Action 7 has the aim of preventing the artificial avoidance of PE status. It is inseparable from the work on treaty abuse. The discussion draft published by the OECD on 31 October 2014 adopts the same rhetoric. The first target, commissionnaire arrangements, is described as artificial avoidance of PE status despite consistent decisions of the highest courts in civil law countries to the contrary (*Zimmer Ltd* in the French Supreme Administrative Court (10 March 2010); *Dell Products (Europe) BV v Skatt Øst* in the Norwegian Supreme Administrative Court (2 December 2011) and *Boston Scientific* in the Italian Supreme Administrative Court (2 March 2012)). New language is proposed for art 5(5) designed to bring commissionaires and similar arrangements within agency PE, thereby reversing the effect of these Supreme Court rulings. It is proposed to exclude associated enterprises from qualifying as independent agents within art 5(6).

The second target is the exemption of preparatory and auxiliary activities from PE status. Delivery and purchasing functions are to be excluded from the exemption, which is to be redrafted to reflect that any activity must be inherently preparatory or auxiliary, rather than certain activities qualifying automatically for exemption.

Thirdly, anti-fragmentation rules aim to ensure that where complementary activity is carried on in a state by separate associated enterprises and one has a fixed place of business there, such activities may be viewed together to determine the existence or otherwise of a PE.

Follow-up work: On 21 November 2014, a public discussion draft *Follow up work on BEPS Action 6* was published by the OECD, inviting further comment. Twenty issues are identified. These raise fundamental questions, particularly on the operation of the LOB and PPT (GAAR). Problems with the application of the LOB as it applies to investment funds were recognised at an early stage. Questions remain relating to sovereign wealth funds and pension funds, as well as alternative and private equity funds, all of which typically require some form of vehicle that may be established in a state other than the state of residence of some or all of the investors in the fund.

Questions remain as to whether some form of administrative process should be established to ensure that the PPT is only applied after approval at a senior level, and whether it should be excluded from the mandatory binding arbitration provisions in art 25. These reveal concerns about the potentially unsystematic application of the rule in different countries and a desire of some countries to protect their own views from independent scrutiny. Likewise, questions relating to the interaction between domestic anti-abuse rules and treaties indicate a far from uniform view that the primacy of treaties should be subjugated to elements of domestic law.

Conclusions

A thorough and careful review of the more than 50 year-old OECD model treaty is undoubtedly due. For too long, the OECD has proceeded on the assumption that policy changes can be affected merely by amending the Commentary. The catalyst for the current partial review has raised the temperature of the debate and makes rational analysis resulting in an enduring international tax dispensation extremely difficult. ■

The discussion draft on BEPS action 7: reform of PE status (Richard Collier, 14.11.14)

BEPS discussion draft on action 10: low value-adding intra-group services (Alison Lobb, 14.11.14)

The OECD's agreed recommendations on the 2014 deliverables (Richard Collier & Philip Greenfield, 25.10.14)

BEPS: how some countries are going it alone (Chris Sanger, 24.7.14)

What does success look like for BEPS, and what is failure? (Philip Baker QC, 24.7.14)