International Fiscal Association

Can Tax Certainty Be Achieved with a Policy of Abuse Prevention in a post-BEPS world

Focus on the new preamble to the OECD MC and the Principal Purposes Test (“PPT rule”)

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Tax treaty abuse under the MLI / 2017 OECD MC and commentaries

- **New preamble to the 2017 OECD MC (minimum standard)**: " *Intending to conclude a Convention for the elimination of double taxation with respect to taxes on* ***income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*** *(****including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States****)"*

- Reference **to *"treaty shopping arrangements"*** (i.e. conduit or abusive restructurings) **only one example** of tax avoidance that the Contracting States intend to prevent (Introduction to OECD MC, para. 16.1)

- Therefore, treaty abuse **involving residents of a contracting state** (for example *"rule shopping"* or *"round tripping"* arrangements) also covered.

- New preamble forms part of **the context of the Convention** and therefore relevant to the interpretation of post-BEPS tax treaties (art. 31(1) of the Vienna Convention on the Law of Treaties, see also introduction to the 2017 OECD MC) .

Contrasting the new policy with case law on pre-BEPS tax treaties

- **Union of India v. Azadi Bachao Andolan (2003) ITLR 6 233 279:** « *Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues.* ***Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities****. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc* »

- **Distinction with *"round-tripping"* or *"circular trading"*** *: « If a structure is* ***used for circular trading or round tripping then such transactions,*** *though having a legal form, should be discarded by applying the test of fiscal nullity"* (Vodafone International Holdings BV v. Union of India, SLP (C) No. 26529 of 2010, 20 January 2012) »

Contrasting the new policy with case law on pre-BEPS tax treaties

Re Verdannet (France)

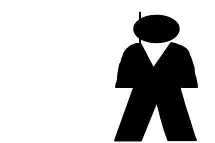
Conseil d'Etat, 25 October 2017 (20 ITLR 832)

Luxembourg

Capital gain only taxable in Luxembourg as per DTA. **But may the French GAAR apply ?**

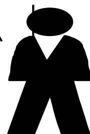
Sale

Acquisition



Mr. Verdannet

France

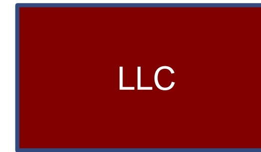


Mr. Verdannet's ex-wife

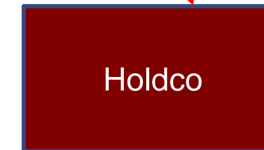
Alta Energy (Canada)

Tax Court, 22 August 2018

USA (Delaware)



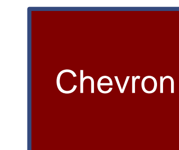
Luxembourg



Capital gain only taxable in Luxembourg as per DTA. **But may the Canadian GAAR apply ?**

Third party sale

Drilled and extracted hydrocarbons taxable property under domestic law



Verdannet (France)	Alta Energy (Canada)
Conseil d'Etat: *"The States that are parties to the Franco-Luxembourg tax treaty cannot be regarded as admitting, in the* ***distribution of the power of taxation, the application of its provisions to situations arising from artificial transactions devoid of any economic substance****"* **Reporting Judge Crépey**: *« **But the primary function of these treaties, beyond this immediate purpose, is to facilitate international economic exchanges** (…). It is, therefore, part of their very logic that they be read as **not intending to apply to taxpayers who artificially create the conditions of foreignness** allowing them to claim, according to a literal interpretation, the benefit of their clauses »"*	*"A tax treaty is a multi-purpose legal instrument. The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty,* ***this statement remains vague regarding the application of specific articles of the Treaty. Under the GAAR analysis, the Court must identify the rationale underlying Article 1, 4 and 13, not a vague policy supporting a general approach to the interpretation of the Treaty as a whole".*** *"**There is nothing in the Treaty that suggests that a single purpose holding corporation, resident in Luxembourg, cannot avail itself of the benefits of the Treaty**. There is also nothing in the Treaty that suggests that a holding corporation, resident in Luxembourg, should be denied the benefit of the Treaty because its shareholders are not themselves residents of Luxembourg"*

Conclusions under post BEPS tax treaties

- In our opinion, the new preamble to the 2017 OECD **reaffirms** that it is not possible to justify bilateral tax treaty abuse (even to attract foreign investment) when the two contracting states have concluded a tax treaty pattterned upon the OECD MC.

The PPT rule as the minimum standard policy response

Art. 29(9) 2017 OECD MC

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"***

- Aims at codifying the so-called *"guiding principle"* incorporated in the OECD Commentary in 2003 but is not drafted completely identically

- Is potentially applicable to all distributive rules and to all forms of abuse, notably **abusive restructurings and conduit situations**

The PPT rule as the minimum standard policy response

- According to the **2017 OECD Commentary** (para. 173 ad art. 29): *"Paragraph 9 must be read in the context of paragraphs 1 to 7 and of the rest of the Convention, **including its preamble**. This is particularly important for the purposes of determining **the object and purpose of the relevant provisions of the Convention"***

- In most of the examples of the Commentaries, ***"the object and purpose of the tax convention"*** is referred to in order to determine whether treaty benefits should be granted (Com. para. 182 ad Art. 29, examples A, B, C, D)

- **To deny treaty benefits**, it is contended that "*it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement*" (para. 182 ad Art. 29, example A).

- **To grant treaty benefits**, the fact that *"the general objective of tax conventions is to encourage cross-border investment"* is put forward (Com para. 182 ad Art. 29, example C).

The PPT rule and the possible policy combinations

PPT rule

Detailed LOB
Anti-conduit rules

PPT rule

Simplified LOB

Specific BEPS SAARs, for example

- Dividend transfer transactions (art. 10 OECD)
- Real estate gains (art. 13 OECD MC)
- Splitting of contracts (art. 5 OECD MC)

The PPT rule and tax certainty

- **IMF/OECD Report, July 2018, Update on Tax Certainty**:

- *“The implementation of PPT rules in bilateral treaties, while effective in reducing aggressive tax planning, is perceived as potentially increasing tax uncertainty. Various stakeholders have in fact expressed concerns on the implementation of the PPT. These concerns are expressed notwithstanding the extensive work already carried on by the OECD on tax conventions and related questions on the development on Commentary on the application of the PPT (…) To increase tax certainty in the application of the PPT,* ***the OECD has formed an informal group of interested delegates that would explore various areas where more tax certainty could be provided in the PPT, including best practices in the area of the general anti-avoidance rules and would report back with recommendations”.***

The PPT rule and tax certainty

- **Some areas requiring improvements/clarification**

- The 2017 updated OECD Commentaries note that: « *where an arrangement is **inextricably linked to a core commercial activity**, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit* » (Com, para. 181 ad Art. 29). Enhancement of the ***"nexus safe harbour"*** would be welcome with further clarifications for **IP**, **group finance** and **holding companies**

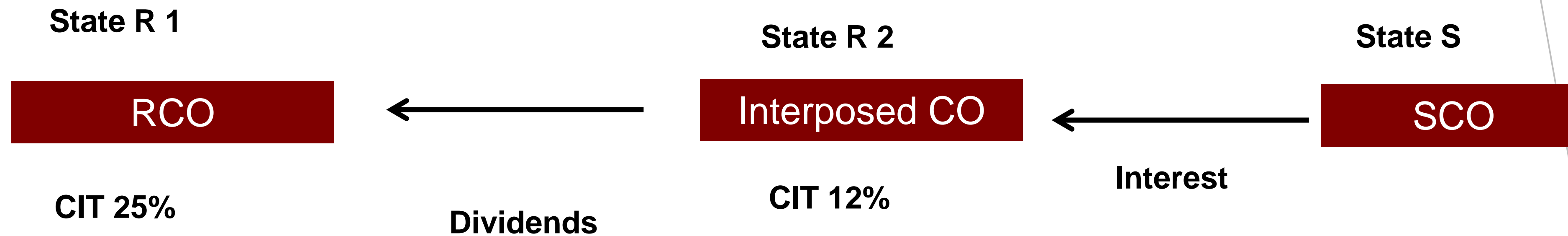
- Clarification in cases **involving absence of increase of tax treaty benefits**

- Relation between the **PPT rule and BEPS SAARs** (for example dividend transfer transactions, real estate capital gains, splitting of contracts) where these SAARs **are included and not included** in the applicable DTC.

- Relation between **the PPT rule and the beneficial ownership requirement** in conduit cases

- Clarification regarding the possibility to **grant alternative tax treaty benefits** even in the absence of a clause corresponding to art. 7(4) MLI (OECD Commentary para. N 184 ad art. 29)

Absence of increase of tax treaty benefits



- All DTCs provide for **equivalent tax treaty benefits.** However, RCO assigns its claim towards SCO to Interposed CO because the CIT is lower in State R 2 is lower than in State R 1 and if RCO receives dividends as opposed to interest such dividends will not be taxed thanks to a participation exemption in State R *1*
- Should the PPT apply ?
- Compare for instance the PPT with the 2001 US-UK conduit arrangement clause **which contains both a main purpose and an equivalent benefit test.** Issue is relevant because the conduit examples in the 2017 OECD Commentaries are directly inspired from the US-UK exchange of letters

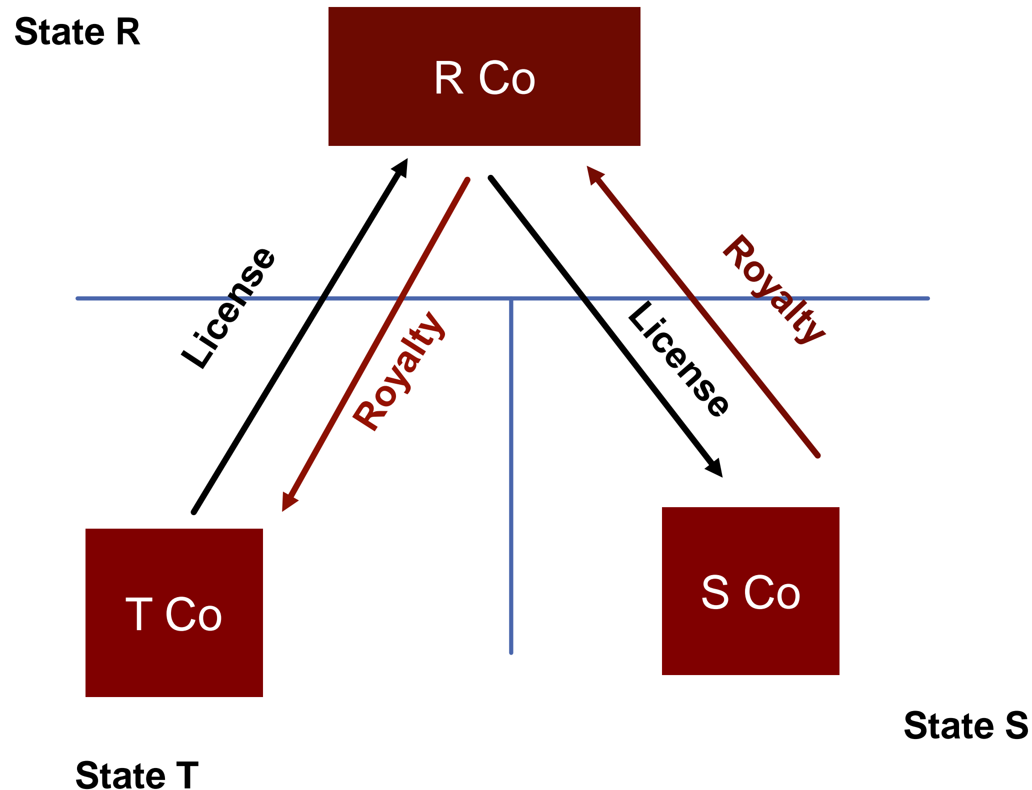
The PPT rule and BEPS SAARs

- Case in which the BEPS SAAR (for example a dividend transfer clause) ***is included*** in the applicable DTC

- Case in which the BEPS SAAR (for example a dividend transfer clause) ***is not included*** in the applicable DTC

The PPT rule and beneficial ownership

Can the PPT rule and beneficial ownership lead to different results ? (see Example E, OECD Commentary ad Art. 29 see also 2001 US-UK DTC)



- R Co, resident of State R, is a holding company for a manufacturing group
- The group conduct research in its subsidiaries located around the world.
- Once a technology is developed, R Co license it from the subsidiary and sub-licenses to other subsidiaries that need it.
- R Co keeps only a small spread so that most of the profit goes to the subsidiary.
- There is no tax treaty between State S and State T.

- According to 2017 OECD Commentary, PPT rule does not apply. **But is RCO the beneficial owner of the royalties ?**

- **Is the beneficial ownership limitation still necessary in the OECD MC ?**

Consequences of denial of treaty benefits

- What happens when the PPT rule is applicable ?
- MLI **does not provide for an automatic return to status quo**
- MLI **only includes an optional clause** (art. 7 para. 3 and 4 MLI) which States may choose to include in their covered tax agreements and which allows the State denying treaty benefits to treat the taxpayer as "*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 ».*
- In our view, when applying a PPT rule and denying treaty benefits, a jurisdiction may still grant treaty benefits on the basis of a re-characterized fact pattern, even if such jurisdiction has reserved the right not to include the discretionary relief mechanism provided under article 7(4) of the MLI in its CTAs. In fact, **this should be regarded as the best practice**. For EU member states such approach is even compulsory under EU law.

Policy outlook and conclusions