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Treaty Shopping – OECD Releases Revised Discussion Draft on BEPS Action 6

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On May 22, 2015, as part of its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD released for comments a revised discussion draft on "BEPS Action 6: Prevent Treaty Abuse" (the 2015 Treaty Draft [PDF]). While not final, the proposals and conclusions in the 2015 Treaty Draft appear to indicate what some of the final BEPS recommendations will be regarding changes to tax treaties to prevent treaty shopping and other perceived forms of treaty abuse. If enacted, these changes could significantly restrict access to treaty benefits for many corporations, investors and funds and may lead to a significant increase in international tax disputes. Comments on the 2015 Treaty Draft will be accepted until June 17, 2015.

Key proposals and conclusions in the 2015 Treaty Draft include:

- An alternative "simplified" limitation-on-benefits (LOB) rule
- Recommendation on entitlement to treaty benefits of collective investment vehicles (CIVs)
- Further work to be done on when treaty benefits should apply to non-CIV funds, such as pension funds, sovereign wealth funds, REITs, private equity funds and hedge funds
- Further consideration of derivative benefits rule and other issues related to the LOB rule
- Examples on when treaty benefits should be denied under the proposed principal purpose test (PPT) rule
- Examples on application of alternative "conduit-PPT rule" to back-stop an LOB rule
- Denial of certain treaty benefits on income that is eligible for a special tax regime
- Ability to rescind treaty benefits following certain changes in domestic law
- Additional work on rules to deny treaty benefits where a permanent establishment (PE) is in a third country

Background

The BEPS Action Plan, published in July 2013, identified 15 actions to address BEPS and set deadlines to implement these actions. Action 6 of the BEPS Action Plan is to design treaty rules and recommend domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. In September 2014, the OECD released a report on Action 6 [PDF] (the 2014 Report) recommending that G20/OECD countries adopt certain measures in their bilateral tax treaties to counter treaty abuse, including a comprehensive and detailed LOB rule and/or a PPT. See Osler Update of September 16, 2014 for further information. The

2014 Report provided model LOB and PPT rules and draft commentary on the rules, noting that there was consensus that, as a "minimum standard," countries should agree to:

1. include in their tax treaties an express statement that their common intention is not to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements; and

2. implement that common intention through either the combination of an LOB rule and PPT rule, or only one of those rules but with a standalone LOB rule being supplemented by an "anti-conduit" mechanism.

The 2014 Report was released in draft form, as the OECD noted that further work was required in certain areas.

In November 2014, the OECD released a discussion draft on "Follow-up work on BEPS Action 6: Preventing Treaty Abuse" (the 2014 Treaty Draft), which followed up on some of the principal outstanding items identified in the 2014 Report. See our Osler Update on the implications of the 2014 Treaty Draft for CIV and non-CIV funds. Taxpayers and other stakeholders provided extensive comments to the OECD on both the 2014 Report and the 2014 Treaty Draft. Canada, together with other G20 countries, has committed to completing work on the BEPS project in 2015.

Separate from the OECD developments on measures to counter treaty abuse, Canada's 2014 Federal Budget had proposed a domestic anti-treaty shopping rule that would have denied treaty benefits in certain circumstances. However, after engaging in consultations on the proposed domestic rule, Canada announced on August 29. 2014 that it will instead await further work from the OECD/G20 on the BEPS Project. Canada's 2015 Federal Budget emphasized that preserving the competitiveness of the Canadian tax system remains the government's priority, so that any future actions taken by the government in this area will seek to further Canada's tax competitiveness while maintaining its ongoing commitment to international tax fairness.

2015 Treaty Draft

The 2015 Treaty Draft contains a new proposed simplified LOB rule and, in addressing specific issues identified in the 2014 Treaty Draft, also contains proposals, and in a few cases conclusions, on how to deal with the outstanding items identified in the 2014 Report.

New Simplified LOB Rule

Part 1 of the 2015 Treaty Draft presents a proposed alternative "simplified" LOB rule. Both the long-form and simplified LOB rules are generally modelled on the LOB provisions found in most U.S. tax treaties, and are intended to deny treaty benefits where a resident of a treaty country does not have a sufficient nexus to that country based on objective criteria (such as majority ownership by persons resident in the country or a sufficient business connection to the country). The simplified LOB rule retains most of the basic architecture of the long-form LOB rule, such as including a list of "qualified persons" who qualify for all applicable treaty benefits and some alternative ways of qualifying for more limited treaty benefits, including an active business test, a derivative benefits test and competent authority relief. Beyond those similarities there are some important differences highlighted in the following chart:

		Long-Form LOB	Simplified LOB
(a)	Qualified person status of publicly-traded entities	Requirement that the principal class of shares/equity be regularly traded on a recognized stock exchange throughout the applicable taxation year	Similar requirement, but with no specific measurement period
		Stock exchange must be located in the entity's country of residence, or the country where the entity's primary place of management and control is located	Stock exchange must be in either contracting state, or such other stock exchange as may be agreed to by the competent authorities
(b)	Qualified person status of subsidiaries of publicly-traded entities	At least 50% of the voting power and value of the shares/equity (and of any "disproportionate class of shares") in the entity is owned directly or indirectly by 5 or fewer publicly-traded entities satisfying the above test, with a possible further requirement that any intermediate owner(s) be resident of either contracting state	Qualified persons must own, directly or indirectly, more than 50% of the beneficial interests of the person (the Indirect Ownership Test) Unlike the long-form LOB, the simplified LOB allows the eligible owners to be any type of qualified person – not just publicly-traded entities

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		Long-Form LOB	Simplified LOB
(c)	Qualified person status of other entities	Entities not satisfying the tests in (a) or (b) under "Long-form LOB" can be qualified persons if they satisfy a detailed ownership and base erosion test (or fit one of the special categories in (d), (e) or (f))	Indirect Ownership Test applies No ownership/base erosion category of qualified persons
(d)	Qualified person status of non-profit organizations (NPOs)	Placeholder for contracting states to insert types of NPOs that will be qualified persons	Not addressed – unless NPO issues beneficial interests the ownership of which can be tested under the Indirect Ownership Test
(e)	Qualified person status of pension funds and their investment vehicles	Entities operated exclusively to administer/provide pension benefits and at least 50% owned by individuals resident in either contracting state, as well as their investment vehicles, are qualifying persons	Not specifically addressed, but presumably tested under the Indirect Ownership Test
(f)	Qualified person status of CIVs	Optional: contracting states may insert conditions for CIVs to be qualified persons	Not specifically addressed, but presumably tested under the Indirect Ownership Test

		Long-Form LOB	Simplified LOB
(g)	Active business test for non-qualified persons	Detailed test under which non-qualified person can obtain limited treaty benefits if engaged in the active conduct of a business and meets certain other conditions. Activities of connected persons are attributed to taxpayer being tested	Similar test but for "carrying on a business" (rather than being "engaged in the active conduct of a business"). No attribution of activities of connected persons
(h)	Derivative Benefits for non-qualified persons	2014 Report contained bracketed derivative benefits test which is satisfied if: • taxpayer is a company • at least 95% by vote and value of its shares is owned directly or indirectly by 7 or fewer "equivalent beneficiaries", and • a base erosion test under which deductible payments to persons other than equivalent beneficiaries must remain below a specified threshold	Derivative benefits applies to all persons other than individuals (not just companies). Test is satisfied if equivalent beneficiaries own, directly or indirectly, more than 75% of the equity of the person. Unlike long-form LOB, no requirement that all intermediate owners (if any) be equivalent beneficiaries.

Since the simplified LOB rule seems to have gathered support within the OECD as a viable alternative to a more detailed LOB, the 2015 Treaty Draft proposes that when the OECD model tax convention is to be amended to include a new LOB article, the text of the convention will not include any actual model treaty language. Instead, the model convention will contain only bracketed placeholders providing a brief indication as to the types of LOB provisions that contracting states could adopt – with the actual, OECD-endorsed alternative versions of such provisions being set out in the OECD commentaries to the convention (the OECD Commentaries). This unusual approach to "drafting" an entire article for the OECD model tax convention reflects the lack of consensus among OECD member states on the appropriate design and level of detail for an LOB clause.

Issues Identified in the 2014 Treaty Draft

Part 2 of the 2015 Treaty Draft presents the outcome of the OECD's follow-up work on issues identified in the 2014 Treaty Draft and also includes new proposals relating to special tax regimes and changes to domestic law made after the conclusion of a treaty.

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A. LOB Issues

1. Collective investment vehicles: application of the LOB and treaty entitlement

CIVs are funds that are widely held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. In a 2010 report on "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" (the CIV Report), the OECD provided several tests for ensuring that treaty benefits are not denied to CIVs that are largely held by, generally speaking, investors who themselves would be entitled to equivalent treaty benefits. The CIV Report was complemented by the OECD's Treaty Relief and Compliance Enhancement (TRACE) project, which is intended to facilitate certification to payors of withholdable payments (e.g. dividends and interest) of the treaty status of ultimate beneficial owners in circumstances where chains of intermediaries (such as brokers and depository/clearing agencies) stand between the payor and beneficial owners.

The 2014 Report contained an optional "qualified person" category for CIVs that countries could include, or not, depending on how clear they thought it was that CIVs in their jurisdictions would otherwise be qualified persons. For those countries that would wish to expressly address CIVs in the LOB, the 2014 Report offered several alternative LOB clauses that mirrored the alternative residence clauses for CIVs presented in the CIV Report.

Since issuing the 2014 Report, the OECD reviewed the alternative approaches to CIVs and considered the feasibility and advisability of a single preferred approach to the question of the treaty entitlement of CIVs (whether in an LOB or more generally), taking into account the TRACE project.

The 2015 Treaty Draft concludes that there is no need for additional changes to the 2014 Report in order to address treaty entitlement for CIVs, since the 2014 Report dealt with the application of the LOB to CIVs in a way that reflected the conclusions of the CIV Report, for which there was broad public support. This is less a conclusion on a single approach than an endorsement of the general principle that income of CIVs should be eligible for treaty benefits where the income would have generally been entitled to similar treaty benefits if earned by the CIV's investors directly, and an expression of support for the menu of options offered by the CIV Report and 2014 Report to contracting states for implementing that broad principle. The OECD notes that the implementation of the TRACE project recommendations by countries is important for the practical application of those options.

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

Non-CIVs include a wide variety of funds, including pension funds and sovereign wealth funds (and the subsidiary investment entities of both), REITs, private equity funds and hedge funds. The OECD has not yet concluded on issues related to treaty entitlement for non-CIVs. The 2015 Treaty Draft makes the following comments:

- Reference to a 2008 OECD report on treaty entitlement for REITs should be added to the OECD Commentaries for contracting states considering how to address questions of treaty residence and LOB status of widely held funds.(The 2008 REIT report had generally endorsed treating a REIT as a resident for treaty purposes even if the REIT paid no tax in its country of residence because its income would be distributed to and taxed in the hands of the REIT investors.The report provides little guidance on whether foreign ownership of the

REIT ought to affect its entitlement to treaty benefits.)

- Language should be added to the OECD model tax convention to clarify that (taxable and tax-exempt) pension funds are residents of contracting states.

- The OECD recognises the economic importance of non-CIV funds and the need to ensure that treaty benefits be granted where appropriate, and therefore work should continue on exploring solutions to issues related to the treaty entitlement of non-CIV funds.

- Such work however will need to address two general concerns that governments have about granting treaty benefits with respect to non-CIVs: the potential use of non-CIVs to provide treaty benefits to investors that are not themselves entitled to treaty benefits, and the potential deferral by investors of recognition of income on which treaty benefits have been granted.

3. Commentary on discretionary relief provision of the LOB rule

The LOB rule in the 2014 Report includes a provision that grants to the competent authority of a contracting state the discretion to grant treaty benefits in some situations where a resident of a contracting state would otherwise be denied treaty benefits under the LOB rule (the Discretionary Relief Provision). The 2015 Treaty Draft notes a number of public comments on the drafting and administration of the Discretionary Relief Provision that would have rendered its application more clear and circumscribed its scope. By and large, the 2015 Treaty Draft defers consideration of these proposals to a later date.

The 2015 Treaty Draft does propose limited changes to the proposed OECD Commentaries on the Discretionary Relief Provision, including:

- Ownership of a treaty resident by a resident of a third country that would (if it had earned the income directly) have been entitled to similar or more favourable treaty benefits will not by itself suffice to make discretionary relief available.

- Requests for discretionary relief should be processed expeditiously.

- As long as a competent authority has exercised its discretion to consider a request for relief in accordance with the requirements of the Discretionary Relief Provision, it cannot be considered that the decision of the competent authority is an action that results in taxation not in accordance with the provisions of the applicable treaty.

The third change above seems to be intended to preclude a taxpayer attempting to invoke the regular mutual agreement procedure in Article 25 after relief has been denied under the Discretionary Relief Provision. This seems somewhat unfair, as the Article 25 MAP will generally involve both competent authorities, whereas the residence country competent authority might not have been involved in a denied request for relief under the Discretionary Relief Provision.

4. Requirement that each intermediate owner be a resident of either Contracting State

There are two places in the LOB rule presented in the 2014 Report where indirect ownership of an entity by certain persons can allow the entity to satisfy a “qualified person” or derivative benefits test but only if each intermediate owner in a chain of ownership itself satisfies certain conditions relating to treaty residence. In each case, the proviso relating to intermediate owners was presented in square brackets since some states believed that the further requirements were too restrictive.

Although the OECD received public comments suggesting that the provisos relating to intermediate owners be removed or relaxed, the OECD believes the provisos are necessary to prevent the granting of treaty benefits to structures with tax haven-domiciled intermediaries.

5. Issues related to the derivative benefits provision

The LOB rule in the 2014 Report contained a detailed derivative benefits provision outlined in the table above, pursuant to which a non-qualified person would generally be entitled to certain treaty benefits where it is owned by a limited number of investors entitled to the same or more favourable treaty benefits. The derivative benefits clause was placed in square brackets as the OECD had concerns about potential treaty abuse.

The 2015 Treaty Draft details a large number of public comments that, if implemented, would have made it easier to satisfy a derivative benefits clause. The 2015 Treaty Draft is largely unresponsive to these comments and instead presents two proposed new treaty provisions presented by the United States (and included in its proposed changes to the US model treaty released recently) that are intended to allay tax authorities' concerns with derivative benefits and treaty abuse. The two proposals, which remain under review, are for new treaty provisions that would:

- deny treaty benefits where interest or royalties, and income not specifically dealt with in the applicable treaty (Other Income) is earned by a treaty resident that is subject to a residence country "special tax regime" under which the relevant income is taxed at a very low effective tax rate or not at all; and

- authorize one contracting state to terminate the provisions of a bilateral treaty dealing with interest, dividends, royalties and Other Income in certain cases where the other contracting state amends its laws in such a way as to exempt its companies or individuals from taxation on substantially all foreign source income.

6. Clarification of the "active business" provision

The 2015 Treaty Draft notes a number of public comments requesting greater clarification of certain concepts and conditions in the provision in the LOB rule that allows an entity that is not a "qualified person" to nonetheless obtain certain treaty benefits if that entity (and/or connected persons) is engaged in the active conduct of a business (the Active Business Exception). Some of the comments related to the ineligibility for the Active Business Exception for certain entities engaged in the active conduct of an investment business. In response to the many comments on the Active Business Exception, the 2015 Treaty Draft simply registers its agreement that the OECD Commentaries on the "active business" provision should clarify the concept of "business" in order to deal with situations where, for example, the same company carries on both investment and manufacturing operations.

7. Other Issues related to LOB provision

The 2015 Treaty Draft also includes a discussion of various other matters, including the interaction of an LOB provision with EU law (suggesting that alternatives could be included to broadly address EU law without requiring specific EU exceptions), provisions dealing with "dual-listed company arrangements" (to be further considered by the OECD), timing issues (which can generally be addressed by competent authorities), and the conditions for applying the LOB provision on publicly-listed entities (with suggestions on potential requirements for a stock exchange to qualify as a "recognized stock exchange").

B. PPT Issues

In general, the PPT rule proposed in the 2014 Report would deny treaty benefits when it is reasonable to conclude that one of the principal purposes of an arrangement or transaction is to secure a benefit under a tax treaty – unless it is established that obtaining the benefit would be in accordance with the object and purpose of the relevant treaty provision(s). The 2015 Treaty Draft continues to take a very broad approach to a proposed PPT rule, which, together with the OECD's proposed interpretation of that rule, resembles a "smell test" that would allow tax authorities broad discretion to challenge the availability of treaty benefits. If enacted into treaties as proposed, this will almost certainly lead to a significant increase in international tax disputes.

The following are the principal recommendations of the 2015 Treaty Draft that relate to the PPT rule:

- Commentary clarifies that a person may have a "principal purpose" to obtain benefits under a particular tax treaty regardless of whether benefits are also obtained under another tax treaty or under domestic law;

- Countries may wish to follow a similar process for applying a PPT rule to that generally followed with respect to domestic general anti-abuse rules, such as internal elevation to senior administration officials or review by an advisory panel (such as the approach used in Canada with a GAAR Committee that considers the circumstances in which the Canada Revenue Agency should apply the Canadian general anti-avoidance rule);

- A majority of countries supported the application of a PPT rule being subject to treaty arbitration clauses, but the issue will be considered further as part of BEPS Action 14 on dispute resolution;

- A number of countries were of the view that greater consistency could be provided between the explanations of the purpose test used in the LOB discretionary relief rule and the PPT rule.Others noted that the discretionary exception in the LOB rule has a narrower focus, and some believed that no alignment is required (since those countries do not support the inclusion of a PPT rule at all);

- A number of countries were of the view that there should be a PPT discretionary relief rule, but others noted that under their country's legal system a competent authority could not be given the requisite discretion;

- The Commentary will focus on general principles regarding the application of an anti-conduit PPT rule to backstop an LOB rule, together with various examples, allowing countries flexibility on the actual design of such rules (including as part of a treaty or domestic law).Examples are to include those used in an exchange of letters between the United States and the United Kingdom; and

- Additional examples were provided to "clarify" when a PPT rule should apply.Unfortunately, these examples highlight the significant uncertainty inherent in a rule that effectively requires a taxpayer to prove that none of their principal purposes was to obtain a particular tax benefit – when tax will at least be a consideration in virtually any transaction.The conclusion in one of the examples involves assuming that a business is a "real business... using real assets and assuming real risks" – without any guidance to suggest when a business, assets or risks would not be "real".

C. Other Issues

The following are the principal "other issues" addressed in the 2015 Treaty Draft:

- Treaty Tie-Breaker – The application of the treaty tie-breaker rule (which addresses treaty residence of a person who would otherwise be resident in both contracting states) will be clarified to confirm that a person may still be a "resident" of a country for certain tax treaty purposes (such as for determining whether salaries are paid by a treaty resident) even if tax treaty benefits may otherwise be denied (such as where the competent authorities cannot agree on treaty residence).It was also agreed that competent authorities should be encouraged to address treaty residence issues "expeditiously";

- Third Country PE Rule – The proposed treaty benefits denial rule for third country PEs should be revised.The 2014 Report had proposed a draft anti-abuse provision that could be included in tax treaties to protect the source country from having to grant treaty benefits where income earned through a PE situated in a third country is (a) exempt from taxation in the residence country, and (b) taxed in the PE country at a rate that is less than 60% of the rate that would apply in the residence country (if no residence country exemption applied).The draft rule contained exemptions for income that was either from an active business conducted through the PE or that consisted of royalties for the use of intangible property produced or developed at the PE.The 2015 Treaty Draft makes two changes to the proposed rule: (i) the 60% test referred to above will compare the *effective* tax rate in the PE country to the *general corporate* rate in the residence country; and (ii) out of a concern for potential abuse, the exemption for royalties will be eliminated.The 2015 Treaty Draft also mentions a number of other issues relating to the third country PE rule, but defers consideration of these issues to a later date; and

- Interactions with other areas – Clarification with respect to the interaction of tax treaties with domestic anti-abuse rules, including any new rules that may be enacted to take into account recommendations in BEPS Action 2 (hybrid mismatch arrangements), Action 3 (CFC rules), Action 4 (interest deductions and other financial payments), and Actions 8, 9 and 10 (transfer pricing) is to be considered further at an OECD meeting in June 2015.

Conclusion

Similar to the prior work by the OECD on BEPS Action 6, the 2015 Treaty Draft continues to propose broad rules to deny treaty benefits in many cases without much apparent regard for the negative impact that the uncertainty created by these changes will have on cross border investments and tax disputes. While a proposed simplification of the LOB rules is welcome, other important issues (such as the application of treaty benefits to non-CIV funds) continue to be unresolved. Also, the various technical examples provided on the operation of the PPT rule foreshadow the difficulty taxpayers will have in proving the requisite facts to prevent denial of treaty benefits. As a result, it will be virtually impossible for most arm's length parties to determine whether reduced withholding rates may apply under a particular treaty. It is important to continue to monitor progress in this area – as the final report on BEPS Action 6 in September 2015 will likely recommend significant changes to the tax treaties of Canada and other countries. Hopefully, as noted in the 2015 Federal Budget, Canada will ensure that any future actions taken by the government of Canada in this area will foster an environment in which business can thrive and compete in the global economy.

For further information on the OECD's BEPS project and Canada's international tax regime, please contact any member of our Tax Department.