Update on BEPS Work: Preventing Treaty Abuse

Panel

Chair Richard Vann (Australia)

Panel Members

Peter Blessing ('PB') (USA)

Andrew Dawson ('AD') (UK, Chair of WP1)

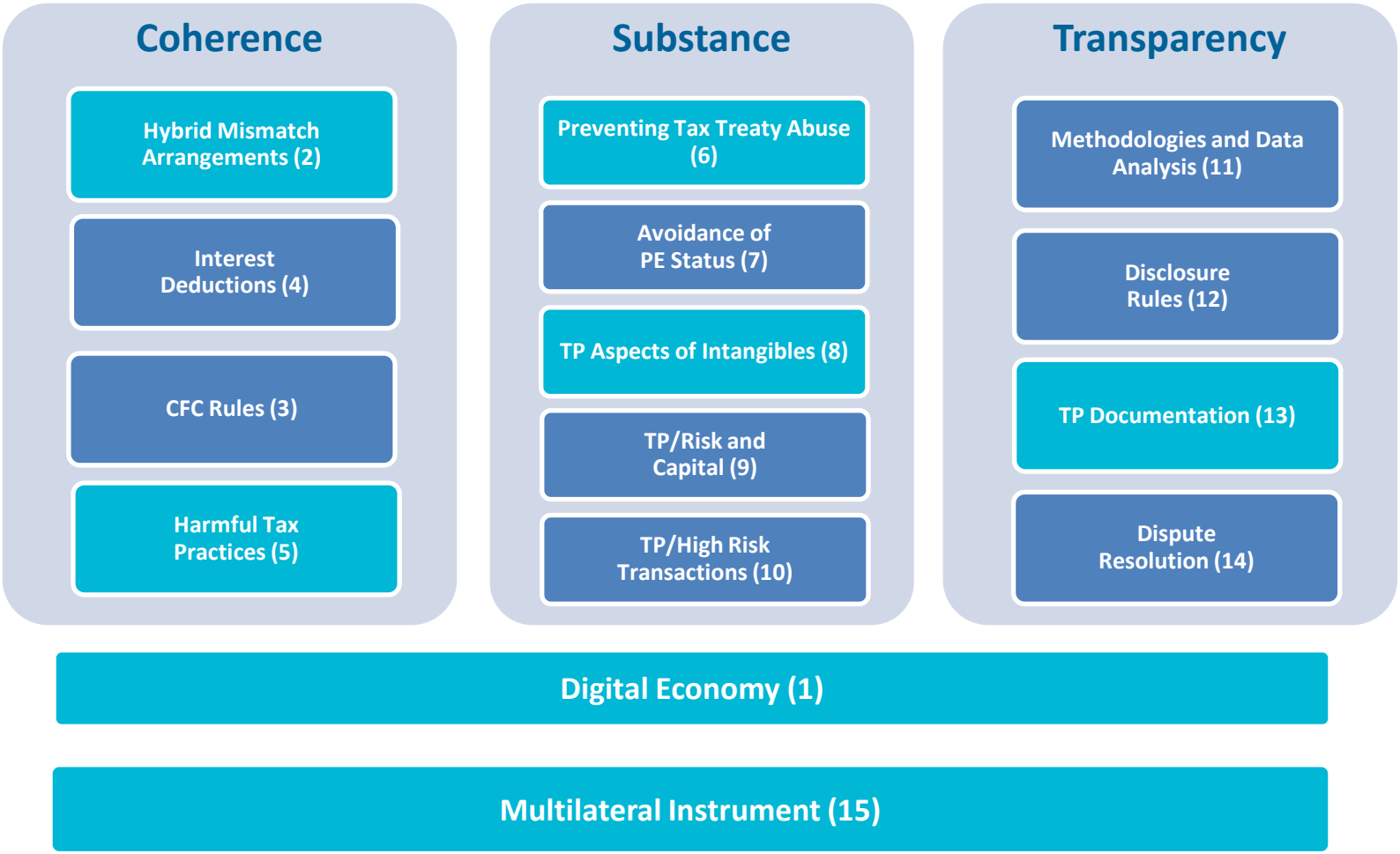
Paresh Parekh ('PP') (India)

Carmel Peters ('CP') (New Zealand)

Jacques Sasseville ('JS') (OECD)

Martin Zogg ('MZ') (Switzerland)

The BEPS Project



Timetable- Discussion Drafts

• 7 – Artificial PE status	• 31 October 2014
• 6- Follow up on Treaty Abuse	• 21 November 2014
• 8 to 10 – Low value adding services/ commodity transactions/Profit splits/ Risk characterization	• 3 November/ 16, 16, 19 December 2014
• 1- VAT B2C	• 18 December 2014
• 4- Interest Deductions	• 18 December 2014
• 14- Dispute Resolution	• 18 December 2014
• 12- Disclosure Rules	• Late March 2015
• 11- Economic Analysis	• Late January 2015
• 3- CFC Rules	• Early April 2015
• 8 to 10- CCAs/Intangibles – ownership; hard to value	• Early April 2015

Action 1
Digital Economy

- Not possible to ring-fence digital economy for tax purposes
- Key features and "new" business models that exacerbate BEPS risks identified
- BEPS risks will be addressed by other work in BEPS project, notably:
  - Action 3 (**CFC rules**)
  - Action 7 (**Artificial Avoidance of PE**)
  - Actions 8-10 (**Transfer Pricing**)
- Broader tax challenges
  - Broader direct tax challenges of digital economy (nexus, characterisation, and data)
    - Options discussed (including modifications to nexus rules and withholding tax on digital goods/services)
    - Agreement on framework for evaluation
  - Indirect tax issues: VAT collection in B2C

Action 2: Hybrid mismatches

- What is a hybrid mismatch arrangement
- Objective of the work
  - Recommendations for domestic law changes and changes to OECD Model
  - Clear, automatic rules that neutralise the tax mismatch without disturbing the commercial or regulatory consequences
- Achievements
  - Consensus on:
    - Linking rules as a concept and their detailed application
    - Scope to ensure rules are comprehensive but still administrable by taxpayers and tax administrations

ACTION 5: Countering harmful tax practices

- Progress report
  - Update on work on substantial activity as it would apply to IP regimes
    - Primary focus on nexus approach
  - Framework for exchanging information on taxpayer specific rulings
    - Rulings broadly defined, also cover pre and post transaction
  - List of member and associate regimes under review

ACTION 8:
Transfer Pricing Aspects of Intangibles

Final guidance:

- Chapter I of the Transfer Pricing Guidelines expanded (Location savings and other local market features, assembled workforce, group synergies)
- New Chapter VI contains guidance on identifying intangibles and on determining arm's length conditions (Comparability, transfer pricing methods and use of valuation techniques, examples)

Interim guidance on allocation of returns derived from intangibles

- Legal ownership and contractual arrangements are starting point
- But parties contributing to development, enhancement, maintenance, protection, and exploitation must be appropriately remunerated

ACTION 13: Transfer pricing documentation and country-by-country reporting

- 3-Tiered Approach
  - Master file
  - Local file
  - Country by country report
    - Aggregate, jurisdiction-wide information on global allocation of income, taxes paid, indicators of economic activity
    - Useful for transfer pricing risk assessment and for evaluating other BEPS-related risks
- Implementation issues (e.g. filing and dissemination mechanisms) to be addressed

Action 15: Multilateral Instrument

- Focus on feasibility of use of a multilateral instrument to implement BEPS measures and modify bilateral tax treaties
- Report drafted with help of experts
- Approved by government representatives in CFA
- Key Conclusions
  - Based on non-tax precedents: feasible
  - Annex to report contains examples
  - Goal is to expedite and streamline the implementation of the measures developed to address BEPS and amend tax treaties

Panel comments (PB)

Action 2 (Hybrid Mismatches):	Action 5 (Harmful Tax Practices):	Action 8 (Transfer Pricing for IP):	Action 15 (Multilateral instrument):
continues to be very ambitious - attempt to confront hybrids head on via linking approach - but difficult to articulate a timetable or feel any certainty of broad "success" **because it depends on domestic law implementation**	- the "nexus" approach for "substantial activities" to bless special R&D regimes looks to actual activities in a country, not mere cash funding	- the BEPS-centric issues remain (e.g. excessive capitalization, mere contractual allocation of risk, treatment of passive funding)	- a lot hanging on overcoming procedural issues as this could mean meaningful action in foreseeable time; but on which issues could parties agree?

Panel comments

PP	MZ	RV
Action 13 - Country-by-country reporting - To be used for transfer pricing purposes? - Implementation? **General comments from a developing country perspective** - Process - Multilateral instrument	**Action 13 - Country-by country reporting:** - compliance burden **Action 5 – Harmful Tax Practices** - Changes in Switzerland - Patent boxes and R&D regimes	**Action 8 –** - OECD work on transfer pricing and developing countries - Implementation issues

Action 6

A. Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances

B. Clarify that tax treaties are not intended to be used to generate double non-taxation

C. Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country

A minimum standard to prevent treaty shopping

- Agreement on a minimum level of protection against treaty shopping
- Countries agree that, as minimum, their treaties should include
  - An express statement that their common intention is to eliminate double taxation without creating opportunities for treaty shopping, and,
  - Either
    - The general treaty anti-abuse rule
    - The LOB rule supplemented by a mechanism that would deal with conduit arrangements, or
    - Both the general treaty anti-abuse rule and the LOB rule

C. Tax policy considerations that should be considered before entering into a tax treaty

- Paragraphs to be added to the introduction of the Model Tax Convention
- Only deal with tax policy; other factors may be relevant
- Will help justify a decision not to enter into a tax treaty with a low- or no- tax jurisdiction
- Also relevant with respect to the question of whether a treaty previously concluded should be maintained, changed or terminated, especially after substantial changes to domestic law of a treaty partner

Panel comments

PP	MZ	PB	RV
• Treaty relationship between India and Mauritius / Cyprus	• Shift from original tax policy objective of treaties which was to eliminate double taxation • What is "low taxation"?	• Treaties with low- or no- tax jurisdictions - Tax policy of US, which has LOB in its treaties - Tax policy of Canada, which does not have LOB • These are only tax policy factors; countries also take account of non-tax factors when deciding to negotiate a treaty	• Australia has publicly identified treaties that may need to be reviewed

B. Clarify that tax treaties are not intended to be used to generate double non-taxation

- Preamble:

  Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

  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)***

Panel comments

PB	PP	MZ	RV
• Could be significant for some countries' jurisprudence	• What does that mean in practice if the words of the treaty are clear? • Would the result have been different in *Union of India v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)*	• When will the title/preamble be relevant? - Treaties that do not comply with the minimum standard - Treaties that comply but which have the LOB - Treaties that comply but which have the PPT	• *Lamesa Holdings BV* v *FC of T*, 97 ATC 4229 "I do not see how it can be argued that the object and purpose of this treaty is to ensure that tax is paid in one of the two contracting states. In that event, the "object and purpose" test is not of any assistance in this case quite simply because neither party's suggested construction of Article 13 would conflict with this agreement's only clear object and purpose of avoiding double taxation."

A. Rules to prevent the granting of treaty benefits in inappropriate circumstances

When is it inappropriate to grant treaty benefits?

1. When a person tries to circumvent the limitations provided by the treaty itself
   - Treaty shopping arrangements
   - Dividend/share transfer transactions to get to reduced rate of 5% in Art. 10(2)*a)*
   - Hiring-out of labour cases to benefit from Art. 15(2)
   - Others
2. When a person tries to abuse the provisions of domestic tax law using treaty benefits

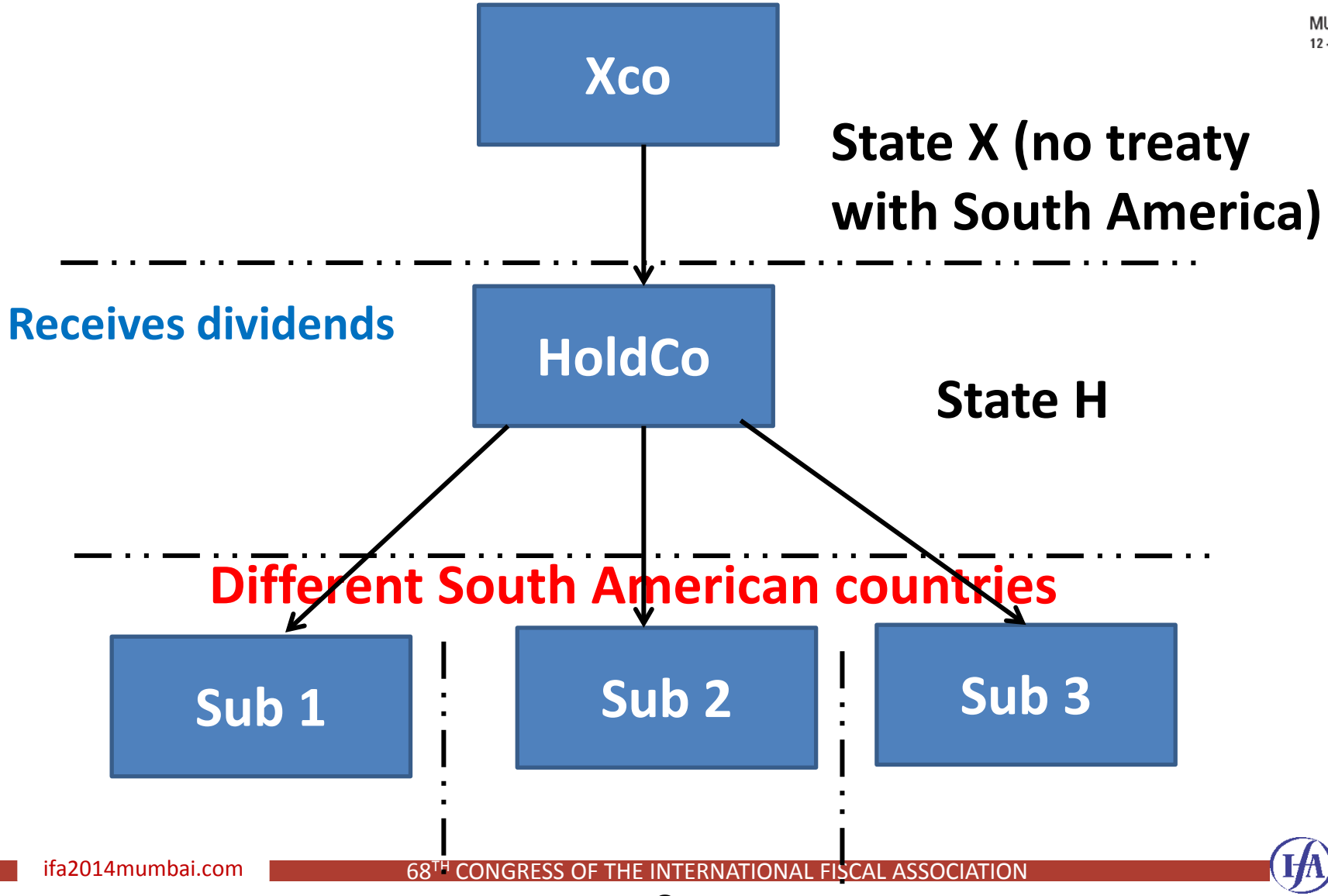
New LOB rule

- Paragraph 2 defines "qualified person". The definition applies to:
  - Individuals
  - The States and their subdivisions and entities
  - Certain publicly-listed companies
  - Non-profit organisations and pension funds
  - Companies that are at least 50% owned by residents of the same State and satisfy the 50% base erosion test
  - [Certain collective investment vehicles]

The PPT rule

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.

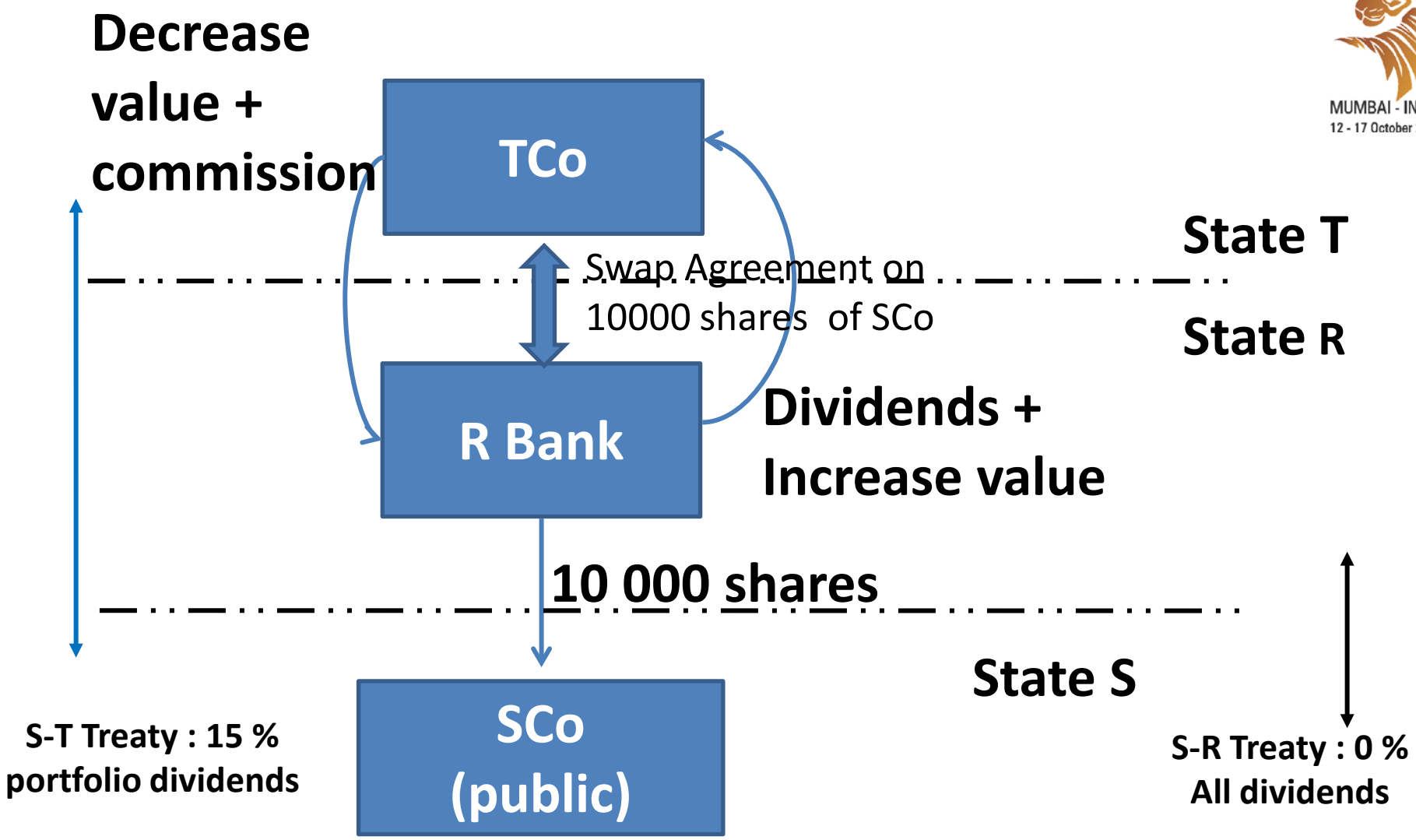
Example 1: Regional holding company



Panel comments

PB	MZ	PP
• Under US-style LOB HoldCo does not get treaty benefits • Headquarters provision in some US treaties • LOB is an objective rule • Why would treaty benefits be denied?	• The real question: how much substance should there be in HoldCo? - Need for real functions; not a shell company - Should there be minimum number of employees? - Should there be minimum amount of capital? - Should there be some other objective criteria? - Should it be a case-by-case analysis?	• PPT: - "One of the principal purposes" v. "the principal purpose" • Substance: a typical checklist • Is substance arguable? – Under LOB – Under PPT • Vodafone (India's Supreme Court, Civil Appeal no. 733, 2012)

Example 2: Total Return Swap



Panel comments

MZ	PB	PP	RV
• LOB does not address such cases • Does the PPT apply?	• Raises similar policy issue as back-to-back loan (here tied directly to underlying asset) • Concept of "economic conduit" • Does it matter that RBank has voting rights and does not have a legal obligation to hold shares of SCo? • In practice, you can do it with local entities • US has legislated to prevent these results	• What if TCo is in the business of entering into total return swaps? • What if RBank is offering the same product to a large number of clients?	• Raises design, policy and compliance issues

New minimum holding period for lower rate on dividends

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends ***throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);***

Revised immovable property company rule

4 . Gains derived by a resident of a Contracting State from the alienation of shares ***or comparable interests, such as interests in a partnership or trust,*** may be taxed in the other Contracting State if, ***at any time during the 365 days preceding the alienation***, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

Revised residence tie-breaker rule

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

Panel comments

MZ	PB	PP	RV
• Minimum holding period for dividends: exception for corporate reorganisation is welcome • Some treaties currently have a minimum holding period without such exception (especially where 0%)	• Need to be careful with the concept of "corporate reorganisation" which has a precise meaning under some domestic laws • Minimum holding period for dividends: prospective and retrospective aspects welcome	• Dual-residence rule: - What about innocent cases? - Why not "shall resolve" as opposed to "shall endeavour to resolve"?	• Revised immovable property company rule: what is the underlying policy?

When a person tries to abuse the provisions of domestic tax law using treaty benefits

- Some tax avoidance strategies seek to circumvent domestic law through the use of treaties
- In these cases, it is not sufficient to address the treaty issues: changes to domestic law are also required
- **Examples**

- Thin capitalisation
- Dual residence strategies (*e.g.* a company is resident for domestic tax but treaty non-resident)
- Transfer mispricing
- Arbitrage transactions related to mismatches between the domestic laws of two States

Conclusions of the Report on the treaty issues raised by domestic anti-abuse rules

- Commentary already addresses a number of these issues, for example: CFC rules in para 23, Article 1 & Thin capitalisation rules in para. 3, Article 9
- These paragraphs conclude that a conflict would not occur in the case of the application of certain domestic anti-abuse rules to a transaction that constitutes an abuse of the tax treaty (para. 9.5)
- The inclusion of the PPT rule (which is based in the guiding principle) will confirm that treaty provisions do not apply where transactions or arrangements are entered into in order to obtain the benefit of these provisions in inappropriate circumstances
- Addition of new Commentary - interaction between treaties and
  - Specific legislative anti-abuse rules
  - General legislative anti-abuse rules
  - Judicial doctrines that are part of domestic law

Concluding comments – Panel members

- The proposed PPT rule will be extremely difficult to apply in practice.
- In the transfer pricing area, an incredible burden is placed on the shoulders of the taxpayer.
- Implementation will take time.
- The multilateral treaty will be important.
- The focus of tax directors these days is not to mitigate taxes but rather to comply with the international rules.
- There is optimism, a lot of progress is made and with the G20 on side things will happen

Panel Discussion - India perspective & Practical Aspects

Panel Members:

- Bela Sheth
- T P Ostwal
- Paresh Parekh

Panel Discussion Points

- Actions Plans 'most' relevant to India? Why?
- Treaty Abuse
  - Impact on so-called love for treaty shopping (Mauritius route) for FDI and ODI?
  - Have the bilateral treaties lost its importance? Will OECD be able to 'tinker' the rules of cross border taxation?
  - Will GAAR be successful – UK experience? UK's proposed Diverted Profit Tax / 'Google Tax'?

Panel Discussion Points

- Artificial Avoidance of PE
  - Commissionaire Model & India?
  - Necessity to expressly restrict scope of preparatory and auxiliary activities in PE article?
- TP Documentation and CBCR
  - Expected modalities and the timing?
  - Impact on Indian MNCs? Foreign MNCs?
  - Submit APAs/ rulings to which the local tax jurisdiction is not a party?

Panel Discussion Points

- CBCR
  - End of 'ALP' principle – new found love for PSM?
  - Free hand to TPO for adhoc adjustments?
  - Safeguards required?
  - Compliance burden - worth it? Readiness?

Panel Discussion Points

- Transfer Pricing Aspects of Intangibles
  - 'intangibles' – AP definition v. definition under Indian TP regulations (e.g., organised workforce)?
  - Bomb shell about to explode - Mere legal ownership or funding the development of an intangible not enough to get full royalty?

- Transfer Pricing for Low Value Intra Group Services
  - Indian safe harbour rules – any thoughts?
  - Use of PSM in a number of scenarios - more subjectivity and complexity in transfer pricing documentation and assessments?

Panel Discussion Points

- Digital Economy ('DE'):
  - Current domestic law in India already wide enough?
  - What about India's views on various aspects (eg. Website constitutes a PE, etc)
  - Is the Action Plan likely to create difficulties on various aspects such as setting threshold for creation of 'significant digital presence'?
  - Any practical issues on withholding tax on digital transactions?
  - What are your views on the new concept of bandwidth tax (tax based on number of bytes used) and practical aspects of allowing credit against the corporate income tax?

Concluding Thoughts?