

TREATY SHOPPING

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Abstract

The paper would focus on tax treaty abuse through treaty shopping. The paper would focus on rules and legislation that prevent treaty shopping. It would analyze Action 6 of Base Erosion and Profit Shifting (BEPS), further the second part of the paper mention about the relationship between domestic anti avoidance rules and tax treaties. Third part of the paper talks about targeted abuse as well as targeted anti-abuse. Next the paper would identify the problem that would be faces in the implementation of LOB and PPT by drawing a comparison between LOB and PPT, and which one is more effective.

Introduction

Double tax avoidance treaties are generally bilateral, and tax concessions granted under these treaties are intended to benefit only persons who are resident of one of the countries.¹ Many multinational companies have started abusing double taxation avoidance treaties by the method of 'treaty shopping'. Treaty shopping means analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of particular treaty, where a person is not resident in either of the treaty states.²

The paper would focus on rules and legislation that prevent treaty shopping. It would analyze Action 6 of Base Erosion and Profit Shifting (BEPS) by OECD, further the second part of the paper mention about the relationship between domestic anti avoidance rules and tax treaties.

¹ Miller Angharad and Oats Lynne, (2014), Principles of International Taxation, Bloomsbury.

² Daurer Veronika, (2014), Tax Treaties and Developing Countries.

Third part of the paper talks about targeted abuse as well as targeted anti-abuse. Next the paper is a comparison between LOB and PPT, and which one is more effective.

Anti-avoidance Legislation

Double taxation agreements are devices that serve to eradicate double taxation and which later can be replaced by unilateral measures. Though the principal purpose of a tax treaty is to prevent double taxation it should also prevent fiscal evasion and tax avoidance. Treaty shopping is categorized as a method of tax avoidance, which can be tackled through domestic anti-avoidance legislation, or through targeted provisions in double tax treaties.³

The three principle form of provisions limiting treaty shopping which have been found in treaties are 'beneficial ownership clauses', 'specific anti-conduit clauses' and 'limitation of benefits provisions'.⁴

Beneficial Ownership

It is one of the most commonly used instrument for reducing treaty benefits to those for whom these benefits were not indented; the 'beneficial ownership' is a obligation which is usually applied in tax treaties for the payment of dividends, interest, and royalties. The wordings of model convention are that 'the beneficial owner must be a resident in the state to which payment is made, and not that the beneficial owner should be the direct beneficiary'. Importance of lack of beneficial ownership was tested in the case of *A Holding ApS v Federal Tax*⁵, here the court relied on the OECD Commentary on Article 1 (that is the 'scope of treaty'); the state do not have to give the benefits of a double taxation convention where provisions of the convention have been abused to entered into an arrangement.

Anti-conduit

³ *supra* 1

⁴ *supra* 1

⁵ *supra* 2

Conduit arrangements, even where the conduit medium could be seen as to have beneficial ownership of its income, are disliked by the government as they are usually artificial arrangements entered into with the main purpose of accessing the benefits of a tax treaty to which the party would not be entitled in the absence of the conduit medium. OECD Report 1987 points out two main type of conduit medium that are direct conduit⁶ and stepping stone conduit⁷.

Such rules usually supplement national abuse rules, which differ from country to country. It depends on a county's treaty policy whether anti-abuse rules are implemented directly into the tax treaty or national anti-abuse rules. In most counties abusive structure and sham transactions are disregarded or re-characterized so that the 'true' facts of the case are subjected to taxation. OECD commentary states abuse of tax treaty as "guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions"⁸

OECD model double tax convention does not directly deal with the question of treaty abuse as it expects that domestic laws would deal with it. In 2013, OECD issued extensive revisions to commentary dealing with the relationship between tax treaties and domestic anti avoidance rules in the context of treaty abuse. Review of treaty abuse is part of the OECD's BEPS agenda, specifically Action 6, its Final Report came out in October 2015.⁹

Action 6: Preventing the Granting of Treaty Benefits

⁶ Direct conduit – the company in which the conduit company is set up does not tax the conduit company on its income to any significant extent. Eg. Under a particular arrangement whereby dividends received from subsidiary companies are exempted from corporation tax.

⁷ Stepping Stone conduit – the distinguishing feature of this type of arrangement is that the country whose tax treaties are being taken advantage of is a relatively high tax country, but the conduit company set up there has low net profits due to a high level of tax deductible payment to the third country.

⁸ *supra* 1.

⁹ OECD, (2016) *Final Report*. Available at:

[http://www.ey.com/Publication/vwLUAssets/OECD_releases_final_reports_on_BEPS_Action_Plan/\\$FILE/2015_G_CM5818_OECD%20releases%20final%20reports%20on%20BEPS%20Action%20Plan.pdf](http://www.ey.com/Publication/vwLUAssets/OECD_releases_final_reports_on_BEPS_Action_Plan/$FILE/2015_G_CM5818_OECD%20releases%20final%20reports%20on%20BEPS%20Action%20Plan.pdf) [Accessed 23 Apr. 2016].

Final Report of Base Erosion and Profit Shifting's (BEPS's) Action 6 recognizes treaty abuse, and treaty shopping, as one of the causes of BEPS concerns. Taxpayers undermine tax sovereignty by engaging in treaty shopping or other type of treaty abuse. They do so by claiming treaty benefits where the benefits were not intended to be given, by depriving the countries of tax revenues. Due to this states have agreed to introduce anti-abuse provisions and minimum standard to counter treaty shopping in their treaties. As these provisions would be adapted according to each country's specificities, all the countries have agreed that there needs to be some flexibility in the implementation of minimum standards; this would also help while negotiating a bilateral conventions.

Section A of the Action plane specifies new treaty anti-abuse rules, which offer protections against the abuse of treaty provisions and offer flexibility in how to do so. These rules safeguards tax sovereignty from a person who is not a resident of a state but obtains benefits from its tax treaty by establishing a letterbox company in that state.

Following are the recommendations.

“First, a clear statement that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements will be included in tax treaties (this recommendation is included in Section B of the report).¹⁰

Second, a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model Tax Convention. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such limitation-on-benefits provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies.¹¹

¹⁰ *supra* 9

¹¹ *supra* 9

Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or “PPT” rule) will be included in the OECD Model Tax Convention. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.”¹²

US uses LOB in its tax treaties to address the issue of treaty shopping.¹³ Under it, for a taxpayer to be eligible for a treaty benefits, she should not only be a resident of one of the countries (entering into the treaty) but should also meet one of the several relatively objective tests. The tests establish has a nexus to the country of residence. On the other hand PPT, works by consenting a tax authority to deny treaty benefits if the sole purpose of the transaction was to obtain benefit of the treaty.¹⁴ OECD was not able to reach consensus on whether to apply LOB or PPT, therefore they agreed on including a ‘minimum standard’.¹⁵ Minimum standard for treaties, consist of Limitation on Benefits clause in addition to anti-conduit rules, Principle Purpose Test (PPT), or both.¹⁶ The report also suggests that the state that intends to follow both LOB and PPT should use the simplified version, so that the flexibility of the treaty is maintained. Currently no state is using both, and most of the countries are using PPT; in one’s view PPT is of a highly subjective nature that would result into a level of uncertainty, therefore defying the basic aim of tax treaties. On the other hand LOB is highly complicated but fulfills the object of its application without any uncertainty.¹⁷ Therefore a simplified LOB might prevent treaty shopping without causing trouble to the

¹² *Base Erosion and Profit Shifting (BEPS) Action Plan. (2016). [online] PwC. Available at: <http://www.pwc.com/gx/en/services/tax/tax-policy-administration/beps.html> [Accessed 23 Apr. 2016].*

¹³ *supra 9*

¹⁴ (2016) Available at: <https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-beps-action-6-report-on-preventing-treaty-benefits.pdf> [Accessed 25 Apr. 2016].

¹⁵ *OECD releases final report under BEPS Action 6 on preventing treaty abuse. (2016). [online] Ey.com. Available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-releases-final-report-under-BEPS-Action-6-on-preventing-treaty-abuse> [Accessed 24 Apr. 2016].*

¹⁶ *Ardous, R. (2015). BEPS- Action 6 (Prevent Treaty Abuse): To be or not to be, that is the question.....* | Let’s Talk Tax. [online] Blogs.mazars.com. Available at: <http://blogs.mazars.com/letstalktax/2015/05/26/beps-action-6-treaty-abuse/> [Accessed 25 Apr. 2016].*

¹⁷ *supra 15.*

taxpayers. LOB provides set of tests to determine whether an entity is formed, acquired, or operated for treaty shopping purposes where as PPT is a transaction-oriented and allows a Contracting States to deny treaty benefits on the bases of subjective determination as to whether a transaction or arrangement is done for the purpose benefiting from the treaty. The report also maintains the chance of Derivative Benefits ¹⁸article to evade LOB restriction in cases where an investor can get same benefits of a treaty by directly investing in the source state. This is mainly because absence of Derivative Benefits article would increase European union law issues in EU context.¹⁹

One of the likely results of LOB formation is an increased need of an effective mechanism to obtain a discretionary grant of treaty benefits where a person fails the objective test but could establish that the company was not established, acquired, or operated for the purpose of obtaining treaty benefits. The report suggests a discretionary relief that compiles with the standards for discretionary relief given in the Report; but the Report fails to explain as to how this critical factor can be satisfied.

Targeted Anti-abuse

As all of the methods to counter treaty abuse could potentially affect innocent taxpayers not involved in conduit operations, therefore some supplementary tests are required. Though these tests have not been included in the Report they have been recognized by the international law.

Business activity test, it looks at the business activity of the suspect conduit to see whether it is really a genuine and active business.²⁰

¹⁸ Derivative Benefits – benefit that a foreign person derives from using an entity that is resident in another treaty jurisdiction.

¹⁹ *BEPS Action Plan: Action 6 – Treaty abuse. (2016). [online] PwC. Available at: <http://www.pwc.com/gx/en/services/tax/tax-policy-administration/beps/treaty-abuse.html> [Accessed 24 Apr. 2016].*

²⁰ Article 27

Subject to tax test, it looks at the relative amounts of tax saved under the treaty benefits and the tax bill paid by the suspected conduit company in the state where it is resident.²¹

Stock market quotation test, this provision exempts companies quoted on a stock exchange from conduit provisions, such companies are unlikely to be operated purely for tax-avoidance purposes.

Equivalent benefits test, in this an anti-conduit clause would not apply if the person ultimately benefits from payments from the suspected conduit could have claimed benefits equally as good had she dealt directly with the state in which the suspected conduit is resident.

Targeted Abuses

The report identifies seven types of targeted abuses.

1. Splitting up of contracts

Companies could evade rules in the permanent establishment that use a threshold period of presence in a host jurisdiction, by splitting the work into two shorter period contracts. This could be classified under anti-abuse rules.²²

2. Hiring out of labour cases

Circumstances in which an employee is transferred to an affiliate's workforce to avoid taxation of employees, where the employee's payment is borne by a local company or a local permanent establishment.²³

3. Transactions intended to avoid dividend characterization²⁴

4. Dividend transfer transactions

In this case shares of a company are transferred to a person who is a treaty-benefited holder. Shares are transferred on a temporary basis in order to enjoy treaty benefits.²⁵

²¹ Article 12

²² *Treaty Abuse: BEPS Action 6* | Lexology. (2016). [online] Lexology.com. Available at: <http://www.lexology.com/library/detail.aspx?g=f723a048-1cc5-4559-b8af-ae65aa65047b> [Accessed 25 Apr. 2016].

²³ *ibid.*

²⁴ *ibid.*

5. Transactions that circumvent Article 13(4) (taxation of gain on disposition of shares of real estate holding companies)

The Report notes that countries may want to increase right of the source State to tax gain from the disposition of shares in real estate holding companies to cover partnerships and trusts. The Report also suggests countries may want to test whether an entity holds the requisite amount of real estate over a look-back period to address possible dumping techniques.²⁶

6. Tie-breaker rule for determining treaty residence for dual resident entities:

According to this dual resident are rejecting treaty benefits and that the entities should be default to one or the other residences. It clarifies that this exclusion of dual resident entities from treaty coverage only applies to claims for treaty benefits by those entities, while treating these entities as treaty residents for other purposes of the treaty. Though many treaties already have a tiebreaker that is in some cases it is Place of effective management.²⁷

7. Anti-abuse rule for permanent establishment (PE) situated in third countries (triangular cases)

The Report contains new provision that would constraint treaty benefits, in case of income being received by a treaty resident is allocable to a PE located in a third country. In case such apportionment results in a considerable tax reduction as an outcome of the country of residence excluding from its tax base income allocable to a PE. The Report identifies that one of the suggested US Model changes includes a more expansive treatment of these 'triangular' conditions and commits to analysis the issue after finalization of the US proposal.²⁸

Domestic Anti-abuse Rules

The Report analyzes relationship between treaties and domestic rules to counter tax evasion through treaty shopping. The issues that were covered are

²⁵ *ibid.*

²⁶ *ibid.*

²⁷ *ibid.*

²⁸ *ibid.*

1. Thin capitalization
2. Dual residence strategies
3. Transfer mispricing
4. Arbitrage of arbitrage of mismatches resulting from the domestic rules of one or more countries related to characterization of income, entities, or timing differences.
5. Abuse of double taxation relief mechanisms.

Report also address the concern of tax payer as treaty provisions that “treaty provisions prevent the application of domestic general anti-avoidance rules; the non-discrimination article prevents the application of domestic thin-capitalization rules and the restriction of fiscal unity rules to domestic entities; treaties prevent the application of domestic CFC rules (Controlled foreign corporation rules); and the capital gains article prevents the application of exit taxes, dividend stripping rules, and assignment of income rules.”²⁹

Therefore the Report agrees to the fact that the anti-abuse laws or rules as mentioned above are not in conflict with the treaties.³⁰

Conclusion

The conclusion that comes out is that main purpose of the treaty is to prevent taxpayers from entering into transaction or arrangement for the sole purpose of having a favorable tax position. Report also emphasizes on the fact that the treaties should include a provision that each country has the right to tax its residents without regard to the treaty, with specific exceptions. According to one’s view a simplified LOB might prevent treaty shopping without causing trouble to the taxpayers

²⁹ Anon, (2016). [online] Taxjournal.com. Available at: <http://www.taxjournal.com/tj/articles/preventing-treaty-abuse-29102015> [Accessed 23 Apr. 2016].

³⁰ Comments on BEPS Action 6: Prevent Treaty Abuse. (2015). [online] The BEPS Monitoring Group. Available at: <https://bepsmonitoringgroup.wordpress.com/2015/06/16/comments-on-beps-action-6-prevent-treaty-abuse/> [Accessed 24 Apr. 2016].

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