Analysis

Preventing treaty abuse

Speed read

The report on Action 6 (Preventing treaty abuse) has further developed the alternative limitation of benefit (LoB) and principal purpose test (PPT) provisions. On the LoB, the draft article may cause problems for common structures; the commentary recognises EU law sensitivities; further work on simplified and detailed articles and commentary is to be done in 2016. The PPT is widely formulated and the absence of standard application procedures is disappointing. The report further develops existing trends towards ensuring that tax treaties do not encroach on domestic anti-avoidance rules and are not a tool for residents of a state to reduce their tax burden in their home state.

Michael McGowan
Sullivan & Cromwell
Michael McGowan is a partner at Sullivan & Cromwell. His practice covers a broad range of corporate tax matters, with particular focus on corporate restructuring, mergers and acquisitions, offshore mutual funds, real estate financings, structured finance, securitisations, project finance and derivatives. Email: mcgowanm@sullcrom.com; tel: 020 7959 8444.

Andrew Thomson
Sullivan & Cromwell
Andrew Thomson is a European counsel at Sullivan & Cromwell. His practice covers a broad range of corporate tax matters, including cross-border transactions and structuring, mergers and acquisitions, financing and capital markets transactions. Email: thomsona@sullcrom.com; tel: 020 7959 8501.

Emma Hardwick
Sullivan & Cromwell
Emma Hardwick is a senior associate at Sullivan & Cromwell. Her practice covers a broad range of corporate tax matters, with particular focus on cross-border transactions and structuring, mergers and acquisitions, financing and the tax aspects of employee benefits and executive compensation. Email: hardwicke@sullcrom.com; tel: 020 7959 8401.

At the core of the Action 6 report are proposed anti-treaty shopping provisions for tax treaties:

- a clear statement in the treaty title and preamble that the contracting states wish to prevent tax avoidance;
- plus:
  - a limitation on benefits (LOB) rule plus a principal purpose test (PPT); or
  - the PPT on its own; or
  - a limitation on benefits rule plus an anti-conduit mechanism (possibly in the form of a restricted PPT).

An LOB rule is intended to be relatively certain, but is complex and can be uncertain or unpredictable at the margin. A PPT is less complex but is inherently uncertain. From the taxpayer's perspective, combining the two gives the worst of both worlds, particularly if tax authorities are not resourced to give advance, or at least real time, rulings on whether treaty benefits are available.

Limitation on benefits

The US has been the most prominent advocate of LOB provisions, and the Action 6 LOB article is based on the article in the US model treaty and more recent US practice. Just before publication of the May 2015 Action 6 discussion draft, the US Treasury published proposed changes to its own model LOB article. To accommodate the US, the OECD has decided to wait for that Treasury consultation to finish before finalising the Action 6 LOB article.

The May 2015 discussion draft included a simplified version of the LOB article for use alongside the PPT. This is shorter and generally less restrictive than the detailed version, omitting some of its anti-avoidance provisions. Those gaps are to be plugged by the PPT.

The LOB provision restricts treaty benefits to:

- '**qualifying persons**':
  - individuals;
  - the contracting states, their political subdivisions and entities wholly owned by them;
  - certain publicly listed entities and their affiliates;
  - certain charities and pension funds (not in the simplified version);
  - other entities that meet certain ownership and base erosion tests; and
  - certain collective investment vehicles (not in the simplified version);
- entities engaged in the '**active conduct of a business**' in the relevant jurisdiction;
- certain entities owned by 'equivalent beneficiaries' (the '**derivative benefits**' provision) – this remains optional in the detailed version, unlike the simplified version, which also has a more generous ownership threshold; and
- entities successfully applying to the relevant tax authority for **discretionary relief**.

Problem situations

The limitations of the first three categories may cause problems for reasonably common corporate structures, as shown below:

Example 1: An infrastructure joint venture (JV) has sponsors from different countries, not all of which have favourable treaties with country P, in which the project will be operated. The sponsors want the JV company to be set up in a non-sponsor jurisdiction outside country P which has a favourable investment treaty with country P. They also want a favourable tax treaty. The JV company will fail the qualifying person test because it is not publicly listed; it is not owned by equivalent beneficiaries for the purposes of the derivative benefits provision; and it is not engaged in the active conduct of a business in its home jurisdiction. To obtain discretionary relief, the JV company must satisfy the tax authority that obtaining any relevant treaty benefit is not one of the principal purposes of its existence or operations: the core of the PPT. (Example G in the draft commentary on the PPT may be helpful (see below), although there is a question mark over whether it can be applied here.)

Example 2: A group has been put together by a private equity fund using a buy and build strategy. The result is a complex structure, including regional headquarters companies. Again, there is no listing, so the headquarters companies are not qualifying persons. The fund holding structure does not give headquarters companies access to the derivative benefits provision either; nor do they meet the 'active conduct of a business' test. (The Netherlands/US treaty LoB article makes specific provision for multinational headquarters companies, but suggestions that the Action 6 LOB article should have such a provision were not accepted.)

EU law

The OECD has recognised that EU law affects the LOB provisions that member states may sign up to. EU law arguably requires a contracting member state to ensure that:

- an LOB article includes a derivative benefits provision;
- recognised stock exchanges include exchanges in other EEA member states;
- if the residence of intermediate parent companies is relevant, they may be resident in other EEA member states;
- the 'active conduct of a business' test may be met by conducting business in other EEA member states; and
- the article allows for discretionary relief.

(See further 'BEPS: possible EU law issues' (Peter Cussons), *Tax Journal*, 20 June 2014.)

Indeed, the only substantive change to the detailed Action 6 LOB article since the interim report of September 2014 seems to have been intended to meet EU law concerns. This broadens the category of qualifying pension funds: beneficiaries in other jurisdictions who benefit from equivalent treaty rights now count towards the 50% hurdle of holdings by 'good' beneficiaries.

Modifications and multilateral instrument

The draft commentary accepts that contracting states may wish to modify elements of the model article. As the LOB article is a bespoke provision, it may be difficult to include even the simplified version in a multilateral instrument, although the final report implies that the LOB article should be included.

What next?

Several points remain to be dealt with in 2016:

- the detailed LoB provision is to be finalised after the US consultation mentioned above;
- the simplified LoB is to be refined and specific commentary produced; and
- further work is to be done on the treatment of non-collective investment vehicle (non-CIV) funds (pension funds in particular).

If the LOB provision is not included in the multilateral instrument, it will only be introduced gradually; and it is not yet clear how many states will want to adopt it. Interestingly, though, the recent China/Russia and Argentina/Chile treaties have included LOB provisions modelled on the first OECD draft.

The PPT or 'treaty GAAR'

The PPT would deny the benefit of a treaty 'if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining [a treaty] 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… would be in accordance with the object and purpose of the relevant [treaty] provisions'.

A prima facie entitlement to benefits that is not denied under the LOB provisions could still be denied by the PPT.

Scope of the PPT

The PPT requires:

- an objective assessment of the 'principal purposes' of any arrangements giving rise (directly or indirectly) to treaty benefits; and
- a subjective assessment of whether it is 'reasonable to conclude' that obtaining a treaty benefit is such a principal purpose.

The PPT also looks at the intentions of parties outside the two contracting states. Treaty benefits may be denied, for example, to a subsidiary assignee of a debt by its parent, if one of the parent's principal purposes was to secure the benefit of a zero withholding rate under the treaty between the jurisdictions of the subsidiary and the debtor (para 8 of the draft commentary).

Principal purposes

It remains to be seen how the relevant authorities would interpret the PPT. However, the examples give some comfort to taxpayers that treaty benefits should not be denied if non-tax considerations for particular structuring decisions are clearly demonstrated, such as establishing a subsidiary to act as a group service company in a jurisdiction because that jurisdiction offers:

- skilled labour;
- a reliable legal system;
- political stability; and
- sophisticated banking rules, in addition to having low withholding rates under various treaties.

This is shown in example G in the draft commentary, although specific transactions undertaken by the subsidiary would need to be considered separately under any anti-conduit provisions (see below).

Taxpayers could argue that activities ostensibly falling foul of the PPT (such as increasing a shareholding solely to qualify for treaty benefits) should nonetheless be permitted, as it falls within the 'object and purpose' of treaties to encourage cross-border investment. However, such an argument is unlikely to succeed in the absence of strong evidence of a specific commercial purpose.

Reasonableness

While falling short of the 'double reasonableness' test in the UK domestic GAAR, the report shows that the reasonableness standard in the PPT requires detailed evaluation. For example:

- it should not be 'lightly assumed' that obtaining treaty benefits was a principal purpose;
- all facts and circumstances (not just the effects of a particular transaction) should be considered; and
- where an arrangement is linked to a commercial activity 'and its form has not been driven by considerations of obtaining a [treaty] benefit', it is unlikely to fail the PPT.

Applying the PPT

While it is intended that the mutual agreement procedure (MAP) should apply to the interpretation and application of the PPT (see para 13 of the Action 14 report), it is disappointing that there is no obligation on states to standardise their approach. The report suggests that states may wish to establish a domestic approval procedure, and may wish to give taxpayers the ability to appeal to a competent authority for the discretionary application of treaty benefits, but these optional measures give little reassurance of a uniform application of the PPT.

Anti-conduit provisions

The report gives several examples of conduit arrangements that should result in the denial of treaty benefits (e.g. the assignment of an intra-group interest bearing note to a subsidiary in a treaty jurisdiction that would prima facie qualify for nil withholding on interest payments), but leaves the adoption of any rules, and the form of those rules, as a matter of discretion for states. The working group's failure to agree on provisions to tackle conduit arrangements (as had been debated previously) suggests that the implementation of a workable approach may take time.

Observations

If the UK adopts a PPT, this will operate in addition to HMRC's guidance on the treaty meaning of 'beneficial ownership' post-*Indofood* (*Indofood International Finance Ltd v JP Morgan Chase Bank* [2006] EWCA Civ 158). Currently, a Luxembourg SPV established in order to on-lend to a UK borrower and funded by listed bonds should, notwithstanding the fact that the SPV is not strictly the beneficial owner of the interest income, still qualify for zero withholding under the UK/Luxembourg treaty. HMRC considers that 'it is unlikely that the purpose of the arrangement is the avoidance of UK withholding tax', on the basis that the borrower should have been able to pay gross under the quoted eurobond exemption, absent the interposition of the SPV (HMRC's *International Manual* at INTM332080 (example 1)). However, such an arrangement may not comply with the PPT, where the taxpayer fails to show that interposing the SPV to claim treaty benefits was not a principal purpose of the arrangement.

PPT-related uncertainties will be a particular concern for taxpayers that are required to self-assess their treaty position in light of the PPT, rather than being able to obtain certainty about their treaty position via an advance approval process, such as the UK's treaty clearance procedure. Some BEPS jurisdictions, particularly in the developing world, may simply lack the resources to implement a clearance procedure for the PPT.

Do tax treaties and domestic anti-avoidance rules actually conflict?

The report also focuses closely on situations where tax treaties can be used to facilitate wider avoidance strategies. Some of these issues are also being addressed under other Actions. Taxpayers will therefore need to adjust their planning accordingly.

The report makes it clear that there is often no conflict between a tax treaty and domestic anti-avoidance rules, such as controlled foreign company (CFC) rules, exit tax rules, and a general anti-avoidance rule. Changes to the commentary underscore these points, even where treaties do not contain an explicit PPT to counteract abuse.

Curbing the use of treaties to reduce home state taxation

A key principle is that a tax treaty should not reduce the tax burden of a resident of a contracting state in that state, subject to specific exceptions for, in particular, double taxation relief by credit or exemption, non-discrimination rules and the right to seek competent authority relief. The report proposes appropriate changes to Article 1 of the OECD model treaty.

This approach follows that of US tax treaties, which contain an explicit 'saving' clause to this effect. Increasingly, UK legislation and court decisions have pointed in a similar direction. In *Padmore v IRC* [1989] STC 493, a UK resident taxpayer persuaded the courts to apply an (old) UK tax treaty to its interest in a non-UK partnership, so as to achieve double non-taxation of partnership income. However, this result was reversed by retrospective legislation which has since been reinforced. Furthermore, as the *Huitson* litigation ([2011] EWCA Civ 893 and [2015] UKFTT 448 (TC)) has shown, the courts are increasingly hostile to attempts to bypass this legislation.

In relation to the UK CFC rules, *Bricom Holdings v IRC* [1997] STC 1179 prevents taxpayers from using a tax treaty to escape CFC taxation. It would be surprising if a court reached a different result in relation to the new 2012 CFC rules.

Exit charges

Yet another aspect of addressing double non-taxation is that a tax treaty should not prevent a state from taxing income and gains accrued at the point when the taxpayer ceases to be subject to that state's jurisdiction, e.g. by relying on a treaty to cease residence. The report makes it clear that such 'exit' taxation is consistent with the OECD model treaty. The report encourages the use of the MAP to address double taxation concerns. However, this is hardly a failsafe. Even within the EU, such issues remain unresolved. To date, the European Court has simply ruled that exit taxation can be reconciled with freedom of establishment if the exiting taxpayer has real scope to pay such taxes in (interest-bearing) instalments; and is only required to provide security where there are genuine creditworthiness concerns.

Dual residence and low-taxed permanent establishments

Two other important areas where treaties can facilitate avoidance are dual residence and low-taxed permanent establishments (PEs) in third countries. The report endorses the trend towards requiring, in cases of dual residence not involving individuals, an agreement between the contracting states in order to award exclusive residence to one state. Otherwise, the taxpayer remains dual resident and loses access to most treaty benefits. The UK has already adopted this approach in a number of treaties, notably with the US, Canada and the Netherlands, although in many UK treaties 'place of effective management' remains the tiebreaker test for such cases. The UK already has considerable experience of reaching agreements with Canada and the Netherlands to resolve dual residence cases not involving individuals. Progress with the US has so far proved harder.

The report also recommends restrictions on source state treaty relief, where the claimant is allocating income to a low-taxed PE in a third country and is not paying significant tax on that income in its home state. Some treaties already address these issues. The report proposes exceptions for certain PEs which are low-taxed but conduct genuine active business. Otherwise, treaty benefits will be denied where income attributable to the third country PE is subject to an effective rate of tax which is less than 60% of the tax, if all the relevant income had been allocated to the home jurisdiction of the taxpayer claiming relief. The taxpayer can still seek discretionary relief if it can demonstrate that its activities are non-tax motivated. This should help to ensure that any such treaty restrictions on third-country PEs remain EU law-compliant.

Conclusion

UK resident taxpayers need to think carefully before embarking on treaty-based strategies which significantly reduce their UK tax burden. ■