European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on

**BEPS ACTION 6:
PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES**

At the time of writing this submission, EBIT Members included: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, INFORMA, JTI, LDC, MTU, NUTRECO, REED ELSEVIER, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCA, SCHRODERS and TUPPERWARE.

EBIT Comments on BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

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Dear Pascal,

EBIT welcomes this opportunity to provide comments on the OECD Discussion Draft entitled "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, 14 March 2014 – 9 April 2014" (hereinafter "the Discussion Draft").

General comments

EBIT supports the principle that treaties should not be used to create non-taxation or for treaty shopping and supports moves to eliminate the use of treaties in situations which were not envisaged when signed and can be considered abusive.

Treaties should, however, be available in all situations where there is a commercial transaction between parties with economic substance in both contracting states, and where one side is not a conduit to a person not entitled to treaty benefits. This is needed to ensure that international trade is not compromised by double taxation, unpredictability and uncertainty.

EBIT is particularly concerned about the OECD's proposals to introduce several new and incremental layers of Anti-Abuse tests to police treaty abuse which companies will all have to satisfy before they can get down to doing business. The combination of first a US-style limitation of benefits (LoB) test but without a derivatives benefits test, then a UK-style main purpose test (MPT) - which actually appears to be a looser "one of the main purposes" test in reality - with on top a domestic general anti-abuse rule (GAAR) and targeted Specific Anti-Abuse provisions (SAARs) will lead to "anti-abuse overkill". This would clearly create an unworkable situation which would considerably raise the potential for conflicts of interpretation and application, and leaving legitimate business for instance much more reliant on local tax rulings, which cannot be the OECD's aim.

EBIT has significant concerns that the proposals made, whilst they may reduce treaty abuse and thereby restore source taxation in some situations, will also severely limit the benefits of treaties in non-abusive situations, and lead to increased double taxation -or even triple taxation- and/or a substantial increase in mutual agreement procedure (MAP) requests (when available and when chosen by taxpayers), putting great strain on tax authorities. EBIT does hope that the OECD takes into account that there is a clear distinction between intended and unintended non-taxation. Secondly, it would be a pity if the newly stated target of preventing non-taxation through treaty abuse negatively impacted on other key and essential targets of tax treaties, i.e. the elimination of double taxation, the creation of a predictable business environment, and compromised the important work and achievements realised by

the OECD since the mid-1950s. Indeed, we believe that treaty abuse can be tackled without such negative results for cross-border commercial activity.

Whilst we appreciate that the way tax treaties should apply is changing, EBIT wishes to reiterate to the OECD and G20 that there are currently several issues in relation to the application of tax treaties (i.e. pure non application, application of tax treaties subject to such conditions that application remains uncertain, misinterpretation of clear provisions…) in important emerging economies including Brazil and India. From our daily experience, many emerging economies still lack the required sophistication and technical and juridical expertise or the legal framework to be able to apply and interpret the OECD's proposals in a correct and consistent manner. In such a context, it seems to us that the OECD's proposal to introduce a US style LoB, which can be applied much more easily in mature economies than in less mature economies, in particular is a step too soon and too far. More generally, the existing gaps in treaty application between OECD members and the abovementioned economies is establishing two different worlds for international business practitioners in terms of complexity, treaty access, treaty interpretation, certainty, the duration of procedures and enforcement. This development is undesirable and in essence undermines the level playing field and competitiveness of OECD and European businesses.

EBIT is generally also concerned that the OECD's current treaty access proposals will lead to a gap in efficiency at company level if the rules are made overly complex. For EBIT, simplification is the answer and goes at the heart of this whole exercise, which is something that the OECD has acknowledged itself.

EBIT recommends that the OECD clarify its notion of "inappropriate circumstances".

Lastly, EBIT urges the OECD to take into account that some of its current Discussion Draft proposals are not in line with EU law (as detailed below), which effectively means that the OECD is proposing international recommendations which 23 out of the 42 countries participating in the BEPS project will be unable to adopt.

A. TREATY PROVISIONS AND/OR DOMESTIC RULES TO PREVENT THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

New Model Article X - Entitlement to Benefits

1. Cases where a person tries to circumvent limitations provided by the treaty itself

EBIT is concerned that the Discussion Draft proposes various anti-abuse provisions to be inserted into the OECD Model Convention, i.e. a LoB, a MPT and a number of SAARs, which create a very complex compliance landscape for businesses in the sense that multiple anti-abuse treaty access tests will have to be fulfilled. We would like to remind the OECD that ensuring the appropriate application of the anti-abuse provisions by countries is key to providing a predictable environment to taxpayers. Due to the complexity of the anti-abuse provisions contained in the Discussion Draft, it is clear that ensuring the appropriate application of such provisions is becoming very much dependant on tax authorities' levels of technical expertise and "reasonable behaviour", and this notably so - but not only - in less mature economies. We are generally concerned that the proposals will lead to a gap in efficiency at company level if the rules are made overly complex and when they are not sufficiently targeted.

EBIT recommends specific and targeted anti-abuse provisions over the introduction of another layer of non-targeted domestic GAARs and SAARs.

a) Treaty shopping

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i) Limitation-on-benefits provision

ARTICLE X ENTITLEMENT TO BENEFITS

EBIT notes that whilst the LoB clause and the MPT are both more general in nature and their main aim is to prevent treaty shopping, they follow fundamentally different approaches. The LoB clause is very complex but clear in the sense that it is based on objective criteria which leaves little room for arbitrary assessment, whereas the MPT, however, is more subjective and the opposite in regards to leaving room for arbitrary assessment. EBIT believes that it does not seem an even-handed approach by the OECD, and it is not desirable, to introduce such a duplicate anti-abuse treaty access test for addressing the same issue. Neither has the OECD made any case to demonstrate that both approaches to limitation of benefits are required to address abuse of treaties.

Paragraphs 13-17 of the Discussion Draft raise the issue of whether or not any LoB rule adopted by the OECD/G20 under Action 6 should include a "derivative benefits" provision, and the examples of situations that should be covered by any such provision, having regard to the paragraph 15/16 situation where IP is located in an intermediate state with a preferential rate on royalties.

However, the lack of a derivative benefits provision such as that envisaged in Paragraph 13 of the Discussion Draft will create problems for many cross-border multinational groups. Centralisation of certain functions is a reality, and is generally acknowledged not to be abusive as long as the return to the function follows genuine economic activity. A lack of a derivative benefits clause will leave groups relying on the active trade or business test or discretionary tests, where functions such as IP management and treasury have been centralised, or regional headquarters companies have been established. Both of these tests are likely to be subjectively applied by tax authorities, leading to cases of potential double taxation, which taxpayers will increasingly seek to resolve through MAP - when available, and even when available, MAP is in practice not really adapted to business needs / to all cases.

EBIT would like to draw the OECD's attention to the judgment of the Court of Justice of the European Union (CJEU) in the 2002 *Open Skies* cases (C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98 and C-476/98) of 5 November 2002, in which the CJEU held that the "nationality clauses" in eight EU Member States bilateral international air transport agreements with the US were considered to be in breach of EU law i.e. contrary to the EU's fundamental freedoms. In particular, the requirement in most of those bilateral agreements for more than 50% of the shares in their national airline to be held by nationals of that airline's home country breached the freedom of establishment of the EC Treaty (now TFEU).

Accordingly, we urge the OECD to take this important issue into account, because otherwise the OECD is proposing a form of LoB rule which 23 out of the 42 countries participating in the BEPS project will be unable to adopt, as this provision would be prohibited under EU law.

Similarly, in our view EU (and also EEA) law, in particular the *Papillon* case (C-418/07), requires EU/EEA countries to be able to trace bilateral treaty entitlement via any EU/EEA country entity, and not just via the relevant EU/EEA country and its treaty partner entities.

Likewise, the proposed paragraph 2c)i)A) requirement for shares to be traded on a local stock exchange should, to be EU/EEA law compliant, be expanded to include where they are traded on a stock exchange anywhere in the EU/EEA, in particular per the CJEU's *Royal Bank of Scotland* case (C-311/97).

ii) Rules aimed at arrangements one of the main purposes of which is to obtain treaty benefits

The case identified in paragraph 15 of the Discussion Draft is better dealt with by effective exit taxes or CFC rules. We also see no reason why OPPCO 2 should not be entitled to treaty benefits if it is genuinely managing IP and entitled to an intangible related return under OECD transfer pricing guidelines, and not acting as a conduit.

In addition to the LoB clause an MPT/ GAAR is proposed in paragraph 18 of the Discussion Draft. This is broadly similar to the UK rules on treaty abuse e.g. UK/India new Article 28C and would deny access to the treaty when there are arrangements with a main purpose of obtaining treaty benefits, unless (EU law) it was considered that those benefits were in line with the object and purpose of the treaty. The language of the MPT should be carefully crafted for it to be applicable only where a structure has been set up wholly artificially solely for the purposes of benefiting from the treaty.

In respect of paragraph 6 of the proposed Article X Entitlement to benefits, EBIT would say that there is a good case that this provision should be an "either/or" with paragraphs 1-5 rather than both being in place. However, we note the points made in paragraph 24 of the Discussion Draft and it is our view that those points made in paragraph 24 would have greater validity if a full derivative benefits provision were available.

With regard to the example given at paragraph 27 of the Discussion Draft, if State R has no withholding tax on interest, then RCo can be seen as a conduit company. However, if State R has a withholding tax on interest then it makes little sense to deny treaty benefits under the R-S treaty.

According to paragraph 28 of the Discussion Draft, if a company changes its residence and becomes fully taxable in a new state where it is carrying on economic activities, in our view it should be entitled to treaty benefits.

With regard to paragraph 29-32 of the Discussion Draft, it should be explicitly stated that just because a beneficial tax result arises from a transaction, this does not of itself mean that obtaining a tax advantage was a main purpose. Tax authorities are prone to assume that any tax benefit – however small – is a main purpose of a transaction, whatever the other commercial benefits that may arise.

Regarding paragraph 33 of the Discussion Draft, EBIT considers that the possible examples of situations presented in which paragraph 6 would or would not apply are not very helpful, as they are too extreme and they may not assist much in anticipating how it would apply to many intra-group situations. For example, many groups establish regional headquarter companies to manage enterprise tangible and intangible assets effectively. If a group is considering establishing such an entity, with significant numbers of employees of sufficient skill and expertise and appropriately capitalised; and it identifies suitable locations which have different double tax conventions with the state of the parent company, if the enterprise decides, taking other cost, economic and geographical factors into consideration, that the location that does not impose a withholding tax under the double taxation convention would be the most suitable for the investment, would the conclusion be that the provisions of paragraph 6 would apply?

b) Other situations where a person seeks to circumvent treaty limitations

iv) Dividend transfer transactions

In respect of paragraph 43 of the Discussion Draft, consideration should be given to ensuring that the 25% holding requirement takes account of holdings under common ultimate ownership. EBIT notes that the requirement to hold a qualifying percentage of 25% of the shares *before* the dividend is paid sometimes works against non-abusive and long term investment decisions. This is the case where the investment is made e.g. one month before the

dividend payment date but the qualifying percentage is maintained for 12 or more months after the purchase is made.

vi) Tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals

Paragraph 50 of the Discussion Draft includes perhaps the most far-reaching of these specific points and is a proposed change to the residence tie-breaker rule in the Model Convention for determining the treaty residence of a dual-residence person. The test would change from place of effective management to mutual agreement between the competent authorities (having regard to, *inter alia,* place of effective management). This approach already exists as an alternative in the Model Convention and in some treaties (e.g. UK/Netherlands) but a wider move would cause significant uncertainty for groups with dual resident companies.

EBIT is very concerned that the OECD proposes to substitute a 100 years old concept which works well with a US based competent authorities test which will inevitably result in an increased resource burden on tax authorities, significant delay and uncertainty for international business and many more instances of double taxation; compare the Glaxo case.

vii) Anti-abuse rule for permanent establishments situated in third States

Paragraph 54-56 of the Discussion Draft deal with PE triangulation, i.e. having a good treaty company allocate an asset to an overseas branch in a non-treaty territory. An anti-abuse provision similar to the triangulation provisions in many US treaties is one option but other suggestions should be considered according to the OECD.

EBIT believes that the OECD's proposal to require a minimum effective tax rate before a PE in a third country can be afforded treaty benefits would represent a major departure from the existing operation of most tax treaties and would seem to require justification in any particular case on the grounds of treaty abuse rather than simply by reference to an effective tax rate measure. EBIT is concerned that the OECD is proposing to include yet another (specific) anti-abuse provision in the Model Convention itself where EBIT believes that this provision is superfluous and better dealt with through the application of domestic law provisions.

b) Other situations where a person seeks to circumvent treaty limitations

2. Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits

EBIT is concerned about the Discussion Draft's anti-abuse proposals targeted at circumventing domestic tax law by using treaties (relationship treaties and domestic anti-abuse rules). Whilst we understand that it is reasonable that the OECD wants to undertake action against this type of treaty abuse, the proposed approach would be a serious departure from the hitherto widely accepted practice based on Article 27 of the Vienna Convention on the Law of Treaties. EBIT would expect from the OECD, if it is decided that this is the way forward, that the OECD will provide very clear guidance on which very specific situations would be affected and on the saving clause and its exceptions.

B. CLARIFICATION THAT TAX TREATIES ARE NOT INTENDED TO BE USED TO GENERATE DOUBLE NON-TAXATION

EBIT generally believes that it can be helpful to state clearly in the Title of and the Preamble to the Model Tax Convention that the prevention of tax evasion and avoidance and treaty shopping is also an intrinsic purpose of tax treaties as much as the elimination of double taxation is. EBIT also agrees generally with the proposed changes to paragraph 16 of the Introduction to the Convention.

C. TAX POLICY CONSIDERATIONS THAT, IN GENERAL, COUNTRIES SHOULD CONSIDER BEFORE DECIDING TO ENTER INTO A TAX TREATY WITH ANOTHER COUNTRY

EBIT considers generally that the OECD's proposed paragraphs on pages 30 and 31 of the Discussion Draft identify a number of valid points under the new proposed heading *C. Tax policy considerations that are relevant to the decision of whether to enter into a tax treaty or amend an existing treaty*. However, having said that, at the same time, it seems to EBIT that "suggesting" not to enter into a tax treaty or terminate a tax treaty because a change in circumstances raises BEPS concerns related to that treaty seems a little extreme when compared to modification of tax treaties to placate BEPS concerns.

EBIT is concerned whether the OECD's observation that: "*A large number of cases of residence-source juridical double taxation can be eliminated through domestic provisions",* which, as we interpret it, also means domestic law changes, is fully consistent with the OECD's call throughout the BEPS debate for bi- or multilaterally coordinated action, rather than for uncoordinated unilateral action by States.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss with, and remain committed to a constructive dialogue with, the OECD.

Yours sincerely,

The European Business Initiative on Taxation – April 2014

For further information on EBIT, please contact its Secretariat via Bob van der Made, Tel: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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