

OECD Proposes Revisions to Tax Treaties to Prevent “Treaty Abuse”

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On March 14, 2014, the OECD released a [discussion draft \[PDF\]](#) for public consultation, *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* [PDF] (the Discussion Draft), as action item 6 in the OECD's *Action Plan on Base Erosion and Profit Shifting* [PDF] (the [BEPS Action Plan](#)). (For further details on the BEPS Action Plan see our [Osler Update dated July 19, 2013](#).)

The Discussion Draft addresses similar issues to those in the 2014 Canadian Federal Budget. However, in contrast to Canada's proposed domestic treaty override rule that looks only to the main purposes of a transaction without asking whether allowing treaty benefits would be in accordance with the object and spirit of the relevant treaty and treaty provision, the OECD suggests a treaty-based approach, with a main rule based on U.S. style comprehensive limitation on benefits (LOB) clause and a more limited purpose test added as a supplementary backstop. The Discussion Draft notes that domestic rules otherwise overriding treaties may violate the *Vienna Convention on the Law of Treaties*. (For further details on the 2014 Canadian Federal Budget see our [Budget Briefing 2014](#).)

The Discussion Draft delivers on the commitment by the OECD to the G20 to take actions to prevent the granting of treaty benefits in inappropriate circumstances, notably, developing rules to prevent the use of treaties within tax-planning strategies that result in base erosion and/or profit shifting (BEPS).

The OECD can influence the extent to which tax treaties may be used to achieve BEPS since OECD member states (including Canada) generally base their bilateral tax treaties on the provisions of the OECD Model Tax Convention (the OECD Model) and tend to give some weight to the OECD's commentary on the provisions of the OECD Model (the Commentary) in interpreting the provisions of their own bilaterally negotiated treaties. Thus, any changes to the OECD Model and Commentary that the OECD eventually adopts can have a direct impact on the negotiation of new treaties or treaty provisions. In addition, in some circumstances these changes may have an indirect impact on the interpretation of existing treaties by countries that are party to a bilateral tax treaty based on the OECD Model (Contracting States).

The Discussion Draft

The Discussion Draft contains three parts, with most of the detail in the first part: (A) treaty provisions and/or domestic rules to prevent the granting of treaty benefits in inappropriate circumstances; (B) clarification that tax treaties are not intended to be used to generate double non-taxation; and (C) tax policy considerations for countries to consider before deciding to enter into a tax treaty with another country.

A. Proposed Anti-Treaty Abuse Rules

The Discussion Draft presents separate proposals to address (1) cases where a person tries to circumvent limitations provided by the treaty itself, and (2) cases where a person tries to abuse the provisions of domestic tax law using treaties.

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

(a) *Treaty shopping*

Section A(1)(a) of the Discussion Draft recommends that to address perceived “treaty shopping” abuses, bilateral tax treaties be revised to include two substantive provisions that are new to the OECD Model. Firstly, the Discussion Draft recommends that treaties include an objective LOB provision similar to that included in most U.S. treaties (including the U.S.-Canada Convention). Secondly, the Discussion Draft recommends that the LOB provision be supplemented with an anti-abuse rule that looks to the main purposes of the relevant arrangement or transaction (the Treaty GAAR).

The proposed LOB provision is intended to address treaty shopping situations based on the legal nature, ownership in, and general activities of, treaty residents. Following a framework that is comparable to Article XXIXA of the U.S.-Canada Convention, the provision generally restricts treaty benefits to treaty residents who are “qualified persons”:

(i) individuals; (ii) governmental agencies; (iii) nonprofits, certain pension funds and their investment vehicles; (iv) (a) publicly traded companies,¹ and (b) companies 50%-owned by five or fewer publicly traded companies; and (v) entities 50% owned by persons described in (i)–(iv)(a), subject to a “base erosion” test.

Treaty residents that are not qualified persons may nonetheless be entitled to treaty benefits by meeting an “active trade or business” test with respect to an item of income or by being granted benefits by competent authority.

The Discussion Draft notes that the OECD working group considered including a “derivative benefits” clause similar to (but broader in scope than) the provision contained in Article XXIXA(4) of the U.S.-Canada Convention. The Discussion Draft expresses concern, however, that such a provision could result in benefits being granted in situations that give rise to BEPS concerns. As a result, the OECD has requested comments regarding the manner in which these concerns could be addressed in the event that a derivatives benefit clause were to be included in the OECD’s proposed LOB rule.

The Discussion Draft proposes that the LOB provisions would be accompanied, within a single new Article of the OECD Model, by a Treaty GAAR, intended to address perceived treaty abuses that are not otherwise addressed by the LOB provision. The Treaty GAAR would deny treaty benefits where “one of the main purposes” of an arrangement or transaction is to secure treaty benefits, unless allowing treaty benefits in such case would be “in accordance with the object and purpose” of the relevant treaty provisions. The Discussion Draft cites conduit financing arrangements (not caught by the LOB provision) as one of the targets of the Treaty GAAR.

With regard to whether an arrangement or transaction has, as “one of [its] main purposes” securing treaty benefits, the Discussion Draft recognizes that the Treaty GAAR should not apply to what are fundamental business decisions, noting that an arrangement “inextricably linked to a core commercial activity” whose “form has not been driven by [treaty] considerations” is “unlikely” to have as “its main purpose” obtaining treaty benefits. Practically, in the context of taxpayers who are well-informed as to the tax consequences of

their activities and who have the flexibility to choose among alternative structuring options, it may be difficult to distinguish between “main” and secondary purposes under this standard. Helpfully, in one proposed example, the Discussion Draft provides that a company that has made the business decision to establish a manufacturing plant in a low-cost jurisdiction and selects among possible locations based on which state has a favorable tax treaty, would not be considered to have as one of its main purposes obtaining treaty benefits.

The second requirement of the Treaty GAAR, that providing benefits be “in accordance with the object and purpose” of the treaty, is intended to be interpreted in light of new recommended language to be included in the title and preamble of tax treaties regarding the prevention of tax avoidance and treaty shopping, discussed below. The Discussion Draft describes the purpose of tax treaties more generally as being “to provide benefits in respect of *bona fide* exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose main objective is to secure a more favourable tax treatment.”

The Treaty GAAR is somewhat similar to the anti-treaty shopping rule proposed in Canada’s 2014 Budget (see our [Budget Briefing 2014](#)), with two significant differences. Firstly, in contrast to the OECD, Canada is proposing to adopt a Treaty GAAR as a domestic rule overriding all of Canada’s treaties, rather than a rule to be negotiated and included in each tax treaty. Secondly, unlike the Treaty GAAR or Canada’s domestic general anti-avoidance rule, the proposed Canadian treaty shopping rule does not require a finding that the relevant transaction or arrangement is inconsistent with the object and purpose of the relevant treaty provisions.

(b) Situations where a person seeks to circumvent treaty limitations otherwise than through “treaty shopping”

Section A(1)(b) of the Discussion Draft addresses “other situations where a person seeks to circumvent treaty limitations.” This part of the Discussion Draft focuses on transactions that are entered into by a taxpayer in order to obtain treaty benefits in circumstances where it is considered inappropriate to grant treaty benefits. Examples of abusive arrangements or circumstances provided in the Discussion Draft, and the proposed manner of addressing them, include the following:

Splitting of Contracts: One area of concern is the splitting of contracts by enterprises (usually by contractors or subcontractors) into several parts and among different companies in order to avoid the twelve-month permanent establishment threshold for construction or installation projects in Article 5(3). The Discussion Draft concludes that such arrangements should be examined as part of the work on action 7 of the BEPS Action Plan – Prevent the artificial avoidance of PE status.

Hiring-Out of Labour: Some taxpayers have attempted to obtain the benefits of exemption from source country taxation provided for in Article 15(2) by using foreign workers employed by an intermediary. The Discussion Draft found that the treaty abuse resulting from such hiring out of labour cases is already adequately addressed by the guidance in the Commentary to Article 15.

Avoidance of Dividend Characterization: Taxpayers have entered into transactions intended to avoid dividend characterization of certain income under domestic rules and thereby allow a characterization of that income (e.g. as a capital gain) that relies on provisions of a treaty to prevent source country taxation. The Discussion Draft notes that this problem is closely related to the issue of hybrid mismatch arrangements and will therefore be examined as part of the work on the treaty aspects of action 2 of the BEPS Action Plan – Hybrid Mismatches.

Dividend Transfer Transactions: Taxpayers have entered into transactions that seek to obtain a reduced dividend rate (5% or 0%) under Article 10(2)(a) by, for example, increasing a corporate shareholder's holding in a dividend payor primarily for the purpose of obtaining the reduced withholding rate, or by establishing certain tax-advantaged intermediary entities in the source state to take advantage of treaty provisions that lower the source taxation of dividends, or are used to make indirect portfolio investments and avoid being taxed on dividends received from other domestic companies. To address these types of transactions, the Discussion Draft concluded that (a) a minimum shareholding period should be added to the conditions in Article 10 of the OECD Model that must be satisfied in order for the 5% rate of withholding tax on dividends received by corporations to apply, and (b) additional anti-abuse rules should be included in Article 10 to deal with the inappropriate use of intermediaries.

Transactions that Circumvent the Application of Article 13(4): Article 13(4) allows a Contracting State to tax capital gains realized by a resident of another state on shares that, at the time the gain is realized, derive more than 50% of their value from immovable property situated in the first state. According to the OECD, this rule is being circumvented by structuring the ownership of immovable property through other entities, such as partnerships or trusts, or by arranging for other assets to be contributed to an entity shortly before a sale in order to dilute the proportion of value derived from immovable property situated in the Contracting State below the 50% threshold. The Discussion Draft concludes that Article 13(4) should be amended to apply to interests in other entities, such as trusts and partnerships, not only gains from the disposition of shares. It also concludes that Article 13(4) should be amended to apply to situations where shares or other interests derive their value from immovable property at any time during a specified period, not only at the time of disposition.

Tie-Breaker Rule for Treaty Residence (other than individuals): The OECD is concerned that the place of effective management test as a tie-breaker rule for determining treaty residence of dual resident persons (other than individuals) has been a source of treaty abuse. The Discussion Draft proposes to eliminate the tie-breaking rule for such persons based on place of effective management and to replace it with a mutual agreement process that takes into account place of effective management, place of incorporation and any other relevant factors. If an agreement cannot be reached, treaty relief or exemption would not be provided except as agreed by the competent authorities. The Discussion Draft also proposes replacing parts of the Commentary to reflect the concerns with a tie-breaker rule based solely on the place effective management and provides guidance on the other relevant factors to be taken into account.

Permanent Establishments situated in third countries: Another area where treaties are considered to be used inappropriately to reduce source taxation involves transactions that seek to establish permanent establishments in third countries in order to obtain the benefit of an exemption or lower rate of tax on profits of such establishments given by the state of residence. The Discussion Draft concludes that a specific anti-avoidance rule should be included in the OECD Model to deal with triangular cases where income attributable to a permanent establishment in a third state is subject to low taxation. The Discussion Draft proposes a new rule that would deny treaty benefits in such situations if the profits of the permanent establishment are subject to a combined effective tax rate in the residence state and the third state that is less than 60% of the general rate of tax applicable in the residence state. Exceptions to this rule are made for (i) royalties paid for the use or right to use intangible property produced or developed by the enterprise through the permanent establishment, and (ii) in the case of any other income, the income derived from the source state is derived in connection with, or is incidental to, the active conduct of a trade or business carried on in the third state (other than the making of investments).

2. Cases where a person tries to abuse the provisions of domestic tax law using treaties
Section A(2) of the Discussion Draft addresses “cases where a person tries to abuse the provisions of domestic tax law using treaty benefits.” It lists the following specific areas where tax avoidance might be “facilitated by treaties” but where domestic law would be required to address threats to the tax base:

- thin capitalization and other financing transactions that use tax deductions to lower borrowing costs;
- dual residence strategies (e.g. a company is resident for domestic tax purposes but non-resident for treaty purposes);
- transfer mispricing;
- arbitrage transactions that take advantage of mismatches found in the domestic law of one state;
- arbitrage transactions that take advantage of mismatches between the domestic laws of two states; and
- transactions that abuse relief of double taxation relief mechanisms (by producing income that is not taxable in the state of source but must be exempted by the state of residence or by abusing foreign tax credit mechanisms).

The Discussion Draft does not make the recommendations referenced in the BEPS Action Plan regarding the design for domestic rules in these key areas. Rather the Discussion Draft notes that many of these particular transactions will be addressed through other aspects of the BEPS Action Plan.² Instead, the key recommendation in Section A(2) is geared towards delineating the circumstances in which any particular state is *permitted* to circumscribe its treaty obligations by way of a domestic anti-abuse provision.

The Discussion Draft³ notes the potential for conflict between a domestic anti-abuse rule and the provisions of a treaty, and states that under the principles of public international law in such circumstances it is the *treaty provisions that should prevail*. As a result the Discussion Draft proposes a new provision which would allow a state to override a treaty with general or specific domestic anti-abuse rules in circumstances where a taxpayer might otherwise try to rely on a treaty to limit the tax imposed by the State of which the taxpayer is a resident.

The Discussion Draft addresses the interaction between treaty rules and domestic anti-abuse rules that are applicable to residents of the state that enacted the domestic anti-abuse rule. The Discussion Draft states that it concluded that for the vast majority of the provisions of the Model Convention, that state should retain the right to tax its own residents.⁴ The Discussion Draft proposes to add a new clause to the OECD Model clarifying that a treaty does not affect the taxation by a Contracting State of its residents, except in the case of certain specific exceptions.

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

The second part of the Discussion Draft involves changes to the title and Preamble of the OECD Model, as well as the Commentary, that are intended to bolster the role of tax treaties in combating tax avoidance and evasion. These recommendations are motivated by a desire to emphasize that “tax treaties are not intended to be used to generate double non-taxation.” Rather, according to the OECD’s current thinking they are intended to prevent double taxation while at the same time not encouraging tax avoidance or evasion. These parameters are said to be grounded in the text of the OECD Model and the Commentary, but the OECD is proposing a more explicit articulation of these overriding treaty principles.

In particular, the following specific recommendations are proposed:

1. The title of the OECD Model will be amended to add an express reference to the

- prevention of tax avoidance and evasion as a purpose of the treaty.
2. Express language will be added to the Preamble of the OECD Model. To date, the wording of preambles to treaties had been negotiated in its entirety by the Contracting States without guidance from the OECD. Going forward, the Discussion Draft proposes that the Preamble of the OECD Model will instead make reference to the Contracting States' desire that the tax treaty not give rise to "opportunities for non-taxation or reduced taxation through tax evasion or avoidance". Moreover, it will make specific mention in this regard of "treaty shopping arrangements [generating indirect benefits to] residents of third States."
 3. The introduction of the Commentary is proposed to be amended in light of foregoing changes to the text of the OECD Model – in particular, to emphasize that the purpose of a tax treaty is not limited to the mere elimination of double taxation. Rather, curtailing double non-taxation, as well as tax avoidance and evasion, are equally important purposes. Moreover, given the BEPS impact of treaty shopping arrangements, the revised introduction to the Commentary will explicitly identify such tax planning as "one example of tax avoidance that should not result from tax treaties."

Since tax treaties are intended to be interpreted in light of their context and purpose, and since some domestic anti-abuse provisions applicable in a treaty context (such as Canada's general anti-abuse rule) take into account the purpose of the treaty, in some cases these changes could impact whether treaty benefits will be allowed by a country or not.

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

The final part of the Discussion Draft proposes adding guidance to the introduction to the OECD Model to help countries decide whether to enter into a tax treaty or terminate an existing tax treaty with another country. In general, these proposals seem to be aimed at discouraging OECD member countries from entering into tax treaties with low- or no-tax jurisdictions, a phenomenon which has been considered to be a source of BEPS.

Conclusion

Treaties based on the OECD Model have long been used by persons who qualify as "residents" of a Contracting State, subject to any restrictions on benefits which vary widely from treaty to treaty. Other than where a treaty LOB restriction applies, it generally has been part of treaties' well-understood basic "architecture" that mere reliance on a treaty benefit by a resident of a Contracting State was not a misuse or abuse of the relevant treaty. The proposals in the Discussion Draft seek to create evidence or signposts – within treaties themselves and in surrounding documentation – for a new understanding of the role and purpose of tax treaties.

The OECD is approaching this issue by recommending various changes in tax treaties – to be negotiated directly between Contracting States. In contrast, Canada's proposed domestic treaty override rule would unilaterally override Canada's tax treaty obligations in a manner that may violate the *Vienna Convention on the Law of Treaties*.

The OECD stresses that the proposals in the Discussion Draft do not represent the consensus views of the relevant OECD bodies, but rather are intended to provide stakeholders with

substantive proposals for analysis and comment. Comments on the proposals are being accepted until April 9, 2014.

¹ Notably, the test for determining whether a publicly traded corporation is a “qualified resident” diverges from the U.S.-Canada Convention by imposing the requirement that the corporation then be “primarily traded” or have its “primary place of management and control” in the Contracting State in which it is a resident. The U.S.-Canada Convention by contrast, requires that the corporation be traded on a “recognized stock exchange.”

² Paragraph 58 of the Discussion Draft notes, in particular, action 2 (Neutralise the effects of hybrid mismatch arrangements), action 3 (Strengthen CFC rules), action 4 (Limit base erosion via interest deductions and other financial payments) and actions 8, 9 and 10 dealing with Transfer Pricing.

³ Footnote 12, page 21 of the Discussion Draft.

⁴ Consistent with the “savings clause” in the U.S. Model.