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March 20, 2014

OECD Outlines Plans to Prevent Double-Tax Treaty Abuse

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On March 14, 2014, the Organisation for Economic Co-operation and Development (OECD) published a discussion draft report on preventing double-tax treaty abuse (the Treaty Report). The OECD supplemented this release on March 19 with a discussion draft report on neutralizing the effects of hybrid mismatch arrangements from a double-tax treaty perspective (the Treaty Hybrid Report).[1] These proposals are in connection with the deliverables pledged under the OECD's Action Plan on Base Erosion and Profit Shifting (BEPS).[2]

The Treaty Report focuses on three key areas:

1. Development of model treaty provisions and recommended domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. These include the addition of:

   – a limitation of benefits provision (LOB Provision) into the OECD Model Tax Convention (Model Treaty), similar to that found in many U.S. double-tax treaties, that seeks to prevent treaty shopping;

   – a broad general anti-abuse rule into the Model Treaty (Treaty GAAR) that prevents the application of treaty benefits where it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main purposes of the transaction/arrangement that resulted directly or indirectly in that benefit; and

   – targeted anti-abuse rules into the Model Treaty (Treaty TAARs) to deal with a number of specific avoidance situations where a person seeks to circumvent treaty limitations, including in relation to dual resident companies, having the question of residence decided in the first instance by the mutual agreement procedure (MAP) and the removal of the place of effective management test: and

2. Clarification that double-tax treaties are not intended to be used to cause double nontaxation. This includes:

   – changes to the title and preamble of the Model Treaty, supplemented by certain other changes to its introduction, to clarify that the treaty is for eliminating double taxation on income and capital without creating opportunities for nontaxation and reduced taxation through tax evasion and avoidance.

1 On March 19, 2014, the OECD also released a discussion draft report on neutralizing the effects of hybrid mismatch arrangements from a domestic law perspective, which is not covered in this briefing.

2 *See* "International Taxation – OECD Reboot for the 21st Century" (July 19, 2013), *available at* http://www.skadden.com/insights/international-taxation-oecd-reboot-21st-century.

3. Identification of the tax policy considerations that states generally should consider before deciding to enter into a double-tax treaty with another state. These include consideration of:

   – the existence of risks of double taxation resulting from the interaction of the tax systems of the two states involved, especially where one state levies low or no tax, and whether such risks would justify a double-tax treaty (it may be that domestic provisions could eliminate double taxation risk);

   – whether there are elements of the other state's tax system that could increase the risk of nontaxation; and

   – the risk of excessive taxation that may result from high withholding taxes in the source state that exceed the amount of tax normally levied on profits in the state of residence.

The Hybrid Treaty Report focuses on three key areas (while also recognizing that a number of proposals set out in the Treaty Report will play an important role):

1. Ensuring that dual resident entities are not used to obtain treaty benefits unduly. This includes:

   – incorporation into the Model Treaty the proposal by the Treaty Report to deal with dual-resident companies by MAP only (and removal of place of effective management from the residence tiebreaker provision), thus allowing states to deal with residence on a case-by-case basis;

   – incorporation into domestic rules either a Domestic GAAR or a rule deeming an entity as not resident in a state if an applicable double-tax treaty treats it as resident in another state (this latter approach is already taken by the U.K.).

2. Ensuring that transparent entities are not used to obtain treaty benefits unduly. This includes:

   – incorporation into the Model Treaty of a provision dealing with the income of entities or arrangements that one or both states treaty as wholly or partly fiscally transparent for tax purposes, whereby the Model Treaty will apply to the extent that the domestic rules of the relevant state treat the income of the entity or arrangement as the income of a resident of the state (a similar provision exists in the U.S./U.K. double-tax treaty).

3. Interaction between the OECD's domestic law recommendations to neutralize the effects of hybrid mismatch arrangements and the provisions of double-tax treaties. This includes:

   – recognition that, depending on how states decide (if at all) to amend their domestic rules to deal with hybrid mismatches (for example, denying deductions in the payee state, forcing inclusion in the recipient state or taxing the recipient in the payee state), states may need to amend their double-tax treaties.

The deadline for comments on the discussion draft of the Treaty Report is April 9, 2014, and a public consultation will be held on April 14-15, 2014. The deadline for comments on the discussion draft of the Treaty Hybrid Report is May 2, 2014, and a public consultation will be held on May 15, 2014.

Background

Double-tax treaties are bilateral agreements between two states that allocate taxing rights between the two states in relation to income and capital gains derived in one State by a resident of the other state. Traditionally, the aim of a double-tax treaty is to prevent double taxation. However, over the years double-tax treaties have been used by some taxpayers as part of tax minimization strategies.

The OECD originally published its far-reaching and ambitious Action Plan on BEPS on July 19, 2013. The OECD sees treaty abuse, such as using double-tax treaties to create double nontaxation, as one of the most important sources of BEPS concerns.

Action 6 of the Action Plan is to prevent treaty abuse by the development of model treaty anti-abuse rules and recommendations for model domestic rules to neutralize treaty abuse, and the discussion draft has been produced in light of this.

Comment

Inclusion of a Treaty GAAR was largely viewed as inevitable. Not all states have a domestic general anti-abuse rule (Domestic GAAR) that deals with tax avoidance generally, though some are considering adopting such a rule. It is not always clear whether such a Domestic GAAR can be used to prevent treaty abuse, as such Domestic GAARs can in certain circumstances be overridden by a double-tax treaty, whilst in other circumstances they can override a double-tax treaty. Clearly this is an issue to certain states: On February 11, 2014, Canada announced a Domestic GAAR that is targeted at treaty abuse and is intended to override double-tax treaties. Further, the European Commission has recommended that EU member states adopt both a "subject to tax" clause in their double-tax treaties (so that the income of a resident of one state has to be subject to tax in that state for the resident to obtain treaty relief on that income in the other state), and a Domestic GAAR into their national laws.

The Treaty GAAR is deliberately broad so as to catch arrangements where the person who has the treaty benefit motive is not a party to the arrangements, for example if A wants to acquire loans from B, but makes the acquisition via a subsidiary C, which is in a better withholding tax position than A due to a treaty between B and C's home states.

Given its breadth, states will need to be extremely careful as to how the Treaty GAAR is enforced. By the OECD's own admission, Treaty TAARs generally will provide greater certainty to taxpayers and to tax administrations than a Treaty GAAR, which while providing flexibility to states, can provide uncertainty to taxpayers. Because of the objective assessment of the reasonableness test, different states could view the Treaty GAAR differently, and so a coordinated approach will be needed to make the Treaty GAAR effective and workable. Such an approach should mean that unilateral general anti-treaty abuse rules, such as the one recently proposed by Canada, will be unnecessary.

In light of these factors, very detailed guidance will be needed from the OECD as to how the Treaty GAAR is to apply in practice, so as to minimize uncertainty and increased administrative burdens for taxpayers. The discussion draft contains some helpful examples, and from these it appears that the choice to use a particular jurisdiction for commercial reasons, even where tax is a consideration, is acceptable. For example, if a company in State A has two choices where to establish a new subsidiary to run a local manufacturing plant, State B and State C, and the decision is made to locate it in State B as the State A/State B double-tax treaty has lower withholding tax rates than the State A/State C double-tax treaty, then the Treaty GAAR should not be triggered. This is a helpful clarification, but an inevitable one, as the OECD will have had to take into account EU member states, which must respect the freedom of establishment of EU persons.

Given this breadth of the proposed Treaty GAAR, some may question the need for the LOB Provision as well. Whilst the LOB Provision looks at the ownership structure of the person claiming treaty benefits and not motive (such that a person can be denied treaty benefits in relation to a transaction that is wholly for commercial purposes), the Treaty GAAR looks to motive. The Treaty GAAR can apply even where arrangements have passed through the filter of the LOB Provision. This makes sense as certain categories of taxpayers, such as publicly traded companies, generally will always satisfy the LOB Provision and without additional rules could abuse double-tax treaties. But the Treaty GAAR should always capture such behavior, and so the LOB Provision seems superfluous.

While a number of Treaty TAARs are included in the discussion draft, one worth highlighting relates to the treaty tiebreaker rule for dual resident companies. The OECD proposes removing the place of effective management test that appears in a number of treaties, and having the question of residence decided in the first instance by the MAP. If this is to be implemented then the MAP must be greatly streamlined, otherwise taxpayers are likely to be left with uncertainty for a number of years, as well as increased administrative burdens. While the streamlining of the MAP also is an aim of the Action Plan, this proposal will add a further burden to the MAP by significantly increasing the number of cases going to MAP. It may be that the accelerated competent authority process used by the U.S. and a few other countries has to be strengthened and used more broadly to allow for an "advanced MAP" to deliver certainty to multinational groups.

States will need to be careful how they seek to counter hybrid mismatches in their domestic law. For example, a state's domestic law solution of imposing tax on a nonresident recipient with no permanent establishment in that state could be overridden by double-tax treaties that the state has concluded with other states, unless they are amended. In addition, where a state is party to a double-tax treaty that provides for a participation exemption for distributions, it may wish to amend that double-tax treaty to ensure that the exemption is denied if the payer obtains a tax deduction for the distribution in the source state.

Ultimately, some of what has been proposed by the OECD could be viewed as somewhat harsh, especially in the context of double-tax treaties. However, much of what the OECD proposes is not without precedent (for example, the U.K. has a number of double-tax treaties that contain provisions aimed at denying treaty benefits where persons have a main purpose of taking advantage of a treaty's provisions), and so it may be that states are willing to incorporate the measures proposed by the OECD.

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