Bradley Tax Consulting

BEPS Project - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

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The BEPS project addresses forms of tax treaty abuse consisting of arrangements that "erode" the tax base or that avoid tax through profit shifting, hence "Base Erosion and Profit Shifting" (BEPS). To this end, the OECD issued a Discussion Draft on 14 March on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. The Draft proposes to deal with the problem by means of a new combined test for eligibility for treaty benefits, consisting of a "limitation on benefits" (LOB) clause and a "main purpose" general anti-abuse clause, to be included in tax treaties.

Recognising the benefits of tax treaties, Ireland has concluded more than 60 such treaties with other countries, many of them in recent years. This is part of a global trend in which the number of tax treaties in force worldwide now exceeds the 3,000 mark. Tax treaties play an important role in encouraging and facilitating international and multinational trade by protecting against the risk of double taxation but also by countering "fiscal evasion with respect to taxes on income". A key feature of a tax treaty network must always be the guarantee, within reason, of certainty as to the tax treatment applicable to cross border activities. It is in relation to this aspect that proposals included in the Discussion Draft give rise to real concerns.

The proposed LOB clause is based on such a clause first introduced in treaties to which the US is a party and hence tailored in many respects to features of the US economy. Ownership and activity requirements of the clause are likely to result in particular difficulties for economies such as the Irish economy, and indeed for those of much of the EU. With a view to preventing "treaty shopping", for example, the ownership element requires a company of a contracting state to be owned predominantly by eligible persons resident in that state, a condition that would be particularly difficult to meet in the case of smaller countries with less developed capital markets. Thus, treaty benefits could be denied to a company that sources capital from countries other than one of the two contracting states. At a minimum therefore, the unduly restrictive proposed LOB clause should be modified to take full account of the way companies involved in international business are financed, now and in the future. Where it is clear that treaty shopping is not a factor, companies should not be burdened with uncertainties arising from the presence of an LOB clause.

A company unable to meet the ownership requirement of the proposed LOB clause may still be entitled to treaty benefits if it can satisfy the “Substantial Activity” test. As suggested above, a key element of a tax treaty is a reasonable assurance of certainty as to the tax treatment applicable to cross border activities. In this connection, the subjective nature of the Substantial Activity test would almost certainly militate against this requirement. This subjectivity derives, not surprisingly, from the nature of the US judicial system and, unless the test is suitably modified (assuming this is possible at all), is likely to result in disagreement of interpretation between tax authorities in many cases, leading in turn to an undesirable additional layer of bureaucracy surrounding the increase in the number of ruling requests by companies that must follow.

Uncertainty in relation to the operation of the LOB clause could further be avoided or reduced by the inclusion of a number of suitable “safe harbour” provisions.

To avoid a denial of treaty benefits, a company must also satisfy the proposed “main purpose” general anti-abuse test. Not only must tax avoidance not be the dominant purpose of any transaction or arrangement, but it must not be one of its “main purposes”. Again, the presence of the main purpose test is bound to result in subjectivity and uncertainty. It is doubtful that even the provision of detailed guidance, to assist tax authorities as well as taxpayers in interpreting this test, would be an adequate safeguard against uncertainty. It is considered that a “dominant purpose” test would adequately meet the anti-avoidance objective in this regard and would be better calculated to prevent undue interference in legitimate transactions.

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