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Prevention of treaty abuse

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Summary

This policy brief makes the following key points:

- The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15-point plan, and the 2021 Pillar One and Pillar Two consensus proposals.
- Many instances of BEPS rely on the use of provisions, or loopholes, in tax treaties between jurisdictions, enabling tax treaty benefits to be accessed by taxpayers who were never intended to have those benefits.
- BEPS Action 6 – Prevention of Treaty Abuse aims to address tax treaty abuse as a fundamental objective in the goal to eradicate BEPS, reflected in its designation as a “minimum standard”.
- BEPS Action 6 introduces the Principal Purpose Test (**PPT**), or an alternative limitation of benefits rule, as a minimum standard for all members of the Inclusive Framework on BEPS and all signatories to the Multilateral instrument (**MLI**) that amends bilateral tax treaties to implement the BEPS Actions.
- BEPS Action 6 also adds the PPT and other provisions addressing specific aspects of tax traty abuse in an update to the OECD Model Tax Convention.
- The PPT has been widely adopted by the MLI in tax treaties around the world.
- In complying with the MLI and BEPS Action 6, Australia has chosen to incorporate the PPT into its tax treaties and expects 32 of its tax treaties to be modified in this way.
- The PPT is novel and untested, and its interpretation is unclear. Its implementation is flexible but this also leads to uncertainty about its application. Steps are needed to promote uniform interpretation of the PPT in tax treaties around the world.

Introduction

The G20/OECD Base Erosion and Profit Shifting (**BEPS**) Project is an international initiative intended to strengthen the international tax system through the adoption of a 15-point plan, and the 2021 Pillar One and Pillar Two consensus proposals.

This Policy Brief discusses Action 6, the Prevention of Tax Treaty Abuse, one of the 15 Actions developed in the G20-OECD BEPS project. Action 6 is a minimum standard that all members of the Inclusive Framework have agreed to implement. It is motivated by the major problem of taxpayers abusing tax treaty provisions to obtain benefits that they were not intended to obtain. This brief will discuss Action 6 including its inclusion in the Multilateral Instrument (**MLI**) as a minimum standard and its implementation globally and in Australia. It then explores the impact of Action 6 and some issues and developments regarding its implementation.

1 What is BEPS?

The G20 declared the era of bank secrecy over in 2009 and later called for action to strengthen international taxation standards. The OECD responded with a 15-point Action Plan to address taxation issues with digitalisation (Action 1); and reform the international tax system to bring cohesion (Actions 2-5), restore substance (Actions 6-10), improve transparency (Actions 11-14), and develop a multilateral instrument (Action 15). This launched the international project to prevent Base Erosion (or double non-taxation) and Profit Shifting from jurisdictions where profitable activities take place: the BEPS Project.

OECD working groups developed technical policy proposals (released October 2015), recommending updates to the model tax convention, OECD-issued guidance, and domestic policy. From November 2016, the Multilateral Instrument would update more than half of the world's bilateral tax agreements.

Participation in the G20-OECD BEPS project is now widespread, including through the launch of multiple global forums and the Inclusive Framework (now 141 jurisdictions), membership of which requires commitment to the BEPS four 'minimum standards'. Having broadly addressed its mandate to implement the proposed package, the Inclusive Framework delivered in October 2021 Pillar-One (on a new nexus approach) and Pillar-Two (on a minimum global tax) as consensus proposals to tackle the digitalising global economy.

2 Action 6: Prevention of Treaty Abuse

What is the issue?

As economies globally began to see greater interaction with one another, jurisdictions encountered the significant and harmful by-product that is double taxation – where the same taxpayer is taxed in two different jurisdictions on the same transaction. The solution to discrepancies between tax systems, as well as other obstacles to cross-border trade and movement of capital, was for these jurisdictions to conclude bilateral tax treaties. These treaties ultimately built up to a global network of between 3000 and 4000 in force worldwide.

Bilateral tax treaties lead to the potential for access by taxpayers which are resident or investing in third jurisdictions that may seek to obtain the benefit of a tax treaty. This leads to the potential for loopholes or planning opportunities and engages the potential for treaty shopping. The OECD refers to treaty abuse as being one of the "most important sources" of BEPS-related concerns. Treaty shopping involves a taxpayer attempting to indirectly access treaty tax benefits, such as lower withholding tax rates or exemptions, despite not being a resident or having substantive investment in either jurisdiction that is party to the treaty.

Treaty shopping could be done, for example, by establishing a conduit company that would be treated as a resident in a treaty jurisdiction, and therefore able to access the treaty benefits. The conduit company may then be included in contracting arrangements so that it would derive income from the other party jurisdiction, which may be lower taxed because of the treaty. The conduit company then pays all or a substantial part of that income to another entity which is not a resident of either party jurisdiction.

Taxpayers may be able to undertake a range of possible actions to obtain treaty benefits that are ordinarily only available to residents of one of those jurisdictions (as intended by the treaties themselves), usually resulting in a decrease in tax collected in the source or investment jurisdiction. Besides a loss in tax collected, the OECD lists the following consequences as being most deserving of concern:

- Tax treaty benefits being extended to residents of another jurisdiction in a way unintended by the states party to the treaty, breaching the underlying principle of reciprocity behind international agreements.
- The income of a taxpayer abusing treaty benefits may go completely untaxed or be insufficiently taxed; neither of which would have been intended by the treaty parties.
- The taxpayer's jurisdiction of residence has less incentive to enter a tax treaty with the jurisdiction in which treaty benefits are abused, as it can indirectly receive treaty benefits from that jurisdiction without the need to provide reciprocal benefits. This is particularly problematic if the treaty abuse method becomes well-known and remains unfixed.

What does the OECD Recommend?

In the 2015 OECD Final Report on Action 6, the OECD proposes several new treaty provisions which it nominates as changes to the OECD Model Tax Convention. The Model Convention is a model document that contains provisions recommended by the OECD to be included by parties looking to conclude bilateral tax agreements.

Action 6 first proposes an express statement to be included in the preamble, or statement of purposes of a tax treaty. In the preamble, states would declare that the particular tax treaty, as well as tax treaties generally, is entered into with the aim of eliminating problems such as double taxation, without intending to create opportunities for non-taxation, or reduced taxation through evasion or avoidance. This includes when such opportunities are found through the practice of treaty shopping.

The second component of Action 6 is the implementation of several provisions that aim to implement the common intention of parties to the treaty to address abusive practices like treaty shopping. Because of the highly specific nature of bilateral treaties, it was agreed that flexibility in the implementation of Action 6 would be allowed, as the choice of provision would need to be adapted to each jurisdiction's specific circumstances and allow for the conditions of negotiation of tax treaties.

The Action 6 report provides three alternative recommendations. Parties to a treaty may choose to implement one of these recommendations. The three alternative recommendations are:

1. **Principal Purpose Test** (**PPT**). The PPT provision states that if one of the principal purposes of a cross-border transaction is to obtain treaty benefits, then the benefits would be denied unless it is established that granting the benefits would be in accordance with the objects and purposes of that treaty.
2. The combination of a PPT in the form of (1) in addition to a simplified **Limitation on Benefits Rule** (**LOB**). Such a rule would ensure that entities may only receive benefits under a tax treaty if they have a sufficient presence in one of the party jurisdictions, determined not only with reference to the entity's formal incorporated location or residence status, but also by its shareholder ownership and substantive activities in the jurisdiction.
3. A **detailed LOB Rule** combined with a **specific treaty rule to address conduit arrangements**. This could take the form of a PPT specifically for conduit arrangements, or domestic anti-avoidance legislation or judicial doctrines amounting to the same.

The Action 6 Final Report places most emphasis on the above changes, which are minimum standards. However, it also recommends the addition of several treaty provisions that deal with issues including structures that artificially lower taxes payable on dividends, and provisions ensuring that the tax treaty does not interfere with the application of domestic anti-avoidance rules.

3 How has the Action Been Implemented Globally?

As part of the BEPS project, Action 6 had been designated as one of the four minimum standards. This means that a state which becomes a member of the BEPS Inclusive Framework must commit to implement this Action. This means that the member must include in its tax treaties one of the recommended approaches to address treaty shopping, to ensure a minimum level of protection against treaty abuse.

To facilitate the implementation of Action 6 as well as other BEPS measures related to treaties, the **Multilateral Instrument** (the "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting") (**MLI**) was concluded under Action 15 of the BEPS Action Plan. The MLI enables governments to modify existing bilateral tax treaties to implement minimum standards to counter treaty abuse, along with providing improvements to dispute resolution mechanisms in relation to these matters. See further Policy Brief 13/2021.

The OECD reported that by October 2022, the MLI has modified 910 tax treaties between 77 ratifying jurisdictions to comply with the Action 6 minimum standard. Once the MLI is ratified by all 99 signatories, it would have modified a total of 1,850 treaties worldwide. As a minimum standard, the global monitoring of this Action includes annual peer review of country implementation. The peer review process began in 2018, to investigate implementation, common issues and difficulties. The 2021 peer review saw compliance with the MLI double since 2020. In total, it expected that about 2,330 out of 2,400 tax treaties between member jurisdictions are either compliant or soon to be compliant.

The peer review process is conducted in accordance with the terms of reference and methodologies released by the OECD. These were updated in April 2021, with modifications in both the criteria and the procedure for assessing implementation. These modifications were based on data collected during the first three years of peer review in accordance with the terms of the original guidelines from 2017, and aimed to enable jurisdictions to report on progress in greater detail. One key revision is that assistance is now to be given to member jurisdictions to bring non-compliant agreements up to the standard, closing more treaty-shopping opportunities.

4 How has Australia Implemented the Action?

Adoption of the Multilateral Instrument

As part of its BEPS Project implementation package, Australia signed the MLI on 7 June 2017, and it entered into force on 1 January 2019. In so doing, Australia has undertaken the obligation to implement Action 6 as a minimum standard and modify its existing bilateral tax treaties to address treaty abuse concerns. To achieve this, Australia has adopted the first alternative above of the PPT.

The specific terms of the PPT adopted by Australia are included in Article 7(1) of the MLI as follows:

> "Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that 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 in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement."

Australia expects to modify 32 of its tax treaties to implement the PPT and other treaty anti-abuse rules. This includes the clarification in the treaty preamble that tax treaties are not intended to create opportunities for tax evasion or avoidance, including through treaty shopping arrangements.

Australia has indicated that it will adopt the approach in its recent bilateral tax treaty with Germany, concluded in 2015, as a model for future tax treaties or treaty modifications. In this treaty, Australia has adopted the PPT directly, rather than by modification through the MLI. The PPT has been adopted in Article 27(1) of the Australia-Iceland tax treaty signed on 12 October 2022 and it is expected that Australia will therefore adopt the PPT in future treaties in its expanded treaty negotiation program announced in November 2022, including Portugal, Slovenia, Greece, Luxembourg, Bulgaria, Colombia, Croatia, Cyprus, Estonia, Latvia and Lithuania.

Administrative response

Following Australia's adoption of the PPT, the Australian Taxation Office (**ATO**) published guidance about how the PPT will administered. This guidance can be found in Law Administration Practice Statement PS LA 2020/2 *Administering general anti-abuse rules, such as a principal or main purposes test, included in any of Australia's tax treaties.* The Practice Statement sets out instructions and administrative processes for ATO staff, to ensure consistent and correct decision-making.

Practice Statement PS LA 2020/2 addresses the following anti-abuse purpose tests:

- The PPT as recommended by the OECD and included in the MLI under paragraph 1 of Article 7, as it applies to tax agreements that are covered by the MLI (i.e. both parties are signatories to the MLI and will have their treaty modified by it).
- A PPT adopted in Australia tax treaties that are not covered by the MLI. For example, the 2015 tax treaty with Germany falls under this category, as it has already implemented treaty abuse prevention measures before adoption of the MLI.

- A "main purposes" test for Australian tax treaties that are not and will not be modified through the MLI.

5 Impact

According to the first OECD peer review, the MLI has proved to be efficient in fostering the implementation of Action 6, and was by far the tool preferred by members of the Inclusive Framework for this purpose. This is because the MLI made it simple for these provisions to take effect when the parties to the bilateral treaty are already members of the Inclusive Framework, and therefore obliged to implement Action 6 as a minimum standard.

It is notable that the terms of the PPT were formulated by the OECD for the purpose of Action 6. Unlike LOB provisions, which previously existed in some tax treaties, the PPT is a novel provision that is expressed in general terms, in contrast to the rather complex LOB rules. The LOB had been an effective method for preventing some forms of treaty shopping (conduit arrangements being a notable exception, hence the OECD's recommendation), but the PPT's efficacy remains untested to a significant degree (Valderrama, 2020).

Academic commentators seem to agree that the PPT, as outlined in the Final Report, is likely to be a strong defence mechanism against tax treaty abuse practices – especially when it is adopted by many jurisdictions, including those outside the OECD (Elliffe, 2019). However, since the PPT is rather broad, and its implementation open-ended to allow for flexibility between the circumstances of each tax treaty, there remains considerable uncertainty about its impact (Kuzniacki, 2018).

Uncertainties include whether the interpretation of the PPT is universal, or whether administrators or courts in different tax systems might interpret the idea of a 'principal purpose ' differently. This could lead to discrepancies in application of the PPT between states that are party to a particular treaty (Elliffe, 2019). Other uncertainties include how much discretion a tax jurisdiction actually has in enforcing these rules, as well as how a treaty's objects and purposes are determined for the second part of the PPT (where if gaining treaty benefits is a principal purpose, benefits may nevertheless be granted if it accords with the treaty's objects and purposes) (van Weeghel, 2019).

6 What comes next?

Looking forward, the development of Action 6's implementation will follow along two related trajectories. The first trajectory is the broader adoption of treaty abuse prevention measures. This will increasingly be done through ratification of the MLI, or regular updating of tax treaties in accordance with the updated OECD Model Treaty of 2017. Because treaty shopping is essentially a process of finding the weakest link in the global tax treaty network, effective prevention requires there to be a critical mass of treaties that have incorporated one of the Action 6 measures.

The OECD has a strong incentive to continue to carry out peer review and encourage all current signatories to the MLI to ratify it. In order to ensure this, the OECD and the G20 has reiterated their commitment not only to facilitate the modification of existing treaties to meet this standard, but also to actively assist jurisdictions with these existing non-compliant treaties through the creation of a global framework to be able to give specific recommendations for compliance. Signatories to the MLI will also be encouraged to complete the steps necessary for the MLI to take effect on their existing non-compliant treaties. The 2022 peer review began on 6 March 2022 and is currently underway.

The second trajectory concerns the evolution of processes and interpretive approaches to the PPT as it applies in practice, including how to combine the flexibility in the Action 6 Final Report and the MLI with certainty for administrators and taxpayers. Some of these issues were noted by the Conference of the Parties to the MLI; and since finalising their procedural rules last year, the Conference has started work on these questions of interpretation and implementation. To date, the Conference opinion has been adopted and published for four of these questions. It remains to be seen how effective the PPT will be in combating treaty shopping, but greater unity in its interpretation and implementation will support significant curtailment of this practice.

The prevention of tax treaty abuse also will be addressed by other developments in global taxation. Pillar 2 of the Inclusive Framework Two-Pillar Consensus, proposed to implement BEPS Action 1, seeks the creation of a global minimum effective tax rate and a subject-to-tax rule for certain tax treaty concessions. Provided that a critical mass of jurisdictions adopts the minimum tax, this would go a long way to address the worst results from treaty shopping.

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