Irish Tax Institute

Leaders in Tax

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Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Committee on Fiscal Affairs
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Submitted by Email to taxtreaties@oecd.org

9 April 2014

Dear Sir/Madam

Submission in response to OECD Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Please find enclosed our submission in response to the Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances that was released on 14 March 2014.

We welcome this Public Consultation and trust that our comments can add to the constructive debate on this important issue.

We are available for further discussion on any of the matters raised in our submission.

Yours truly,

Helen O'Sullivan

Helen O'Sullivan

President
Irish Tax Institute

Irish Tax Institute

Response to OECD Discussion Draft: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

April 2014

OECD Discussion Draft:
Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Irish Tax Institute Response

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

1. Executive Summary

Bilateral tax treaties are an important and well established feature of the international tax system. As international trade has expanded, the number of tax treaties globally has continued to grow, with more than 3,000 tax treaties now in existence worldwide.

Tax treaties play a vital role in encouraging and facilitating international and multinational trade. Well designed and properly functioning treaties will provide:

- protection for businesses against the risk of double taxation arising; and
- certainty for both business and Contracting States as to the tax treatment that applies to a range of cross border activities.

The Introduction to the OECD Model Tax Convention confirms this key objective:

> *"It has long been recognised among member countries of the OECD that it is desirable to clarify, standardise, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation."*

In developing its Model Tax Convention, the OECD has played a vital role in the establishment of a strong global tax treaty network. Whilst, fully appreciating the objectives of the OECD in tackling Base Erosion and Profit Shifting (BEPS), it is important that any changes made to tax treaties as part of this BEPS project do not put at risk the certainty within the treaty framework that currently exists and that is vital for continued strong international growth.

The Discussion Draft advocates a new form of combined test for tax treaties, comprising both

(i) a limitation-on-benefits (LOB) clause; and
(ii) a 'main purpose' general anti-abuse test.

This combination of tests raises a number of issues which are of concern to the Irish Tax Institute. We believe the tests will result in increased uncertainty for international businesses as to:

- Their entitlement to the benefits of double tax treaties; and
- The application of the treaty provisions to their business activities.

(i) LOB clause

The LOB clause proposed in the Discussion Draft contains both ownership and activity elements and derives from a model generated in, and suitable for, the US economy. Ownership conditions, by their nature, will be inherently more difficult to fulfil for companies in small open economies with high volumes of international trade, in jurisdictions with smaller capital markets and where cross border ownership of entities is more common, such as in the EU. Furthermore, the activities test envisaged in the LOB clause is subjective, based on established US jurisprudence and likely to create uncertainty in interpretation across Contracting States which have limited experience in the application of LOB.

Critically, if an LOB clause is ultimately adopted, it is essential that a “Derivative Benefits” provision is included. This is to provide some protection against the LOB applying in an unduly restrictive manner in circumstances where there is no treaty shopping at issue. Further explanation on this matter is contained below.

(ii) “Main purpose” test

This test is framed so that if “one of the main purposes” of any arrangement or transaction is to obtain a treaty benefit, the benefit is thereby denied. This is a very widely drawn test that would lead to uncertainty for businesses seeking to conduct international activity. In order to obtain any form of certainty, businesses will have to seek Competent Authority rulings in many instances – leading to an increase in the compliance burden on business and additional cost and delay for Contracting States.

(iii) Use of a combined test

Paragraphs (i) and (ii) above outline our specific concerns with each of the two tests. However, the combination of the tests will further add to the complexity and uncertainty as to how they will apply. We are particularly concerned about the adverse impact this uncertainty will have upon international trade.

We therefore recommend that the OECD study in detail the impact of the proposed measures on international trade flows.

(iv) Importance of consultation on the Commentary to the Model Tax Convention

The new approach outlined in the Draft represents a fundamental shift in the way tax treaties will have to be interpreted. There could well be disagreement as to interpretation of the clauses between jurisdictions which must be avoided if international trade is to be encouraged. In this environment, the role of the Commentary to the OECD Model Tax Convention is vital to help minimise confusion, explain the intentions of the OECD and assist tax authorities and businesses in interpreting the provisions.

The Commentary should be made available for public consultation prior to being finalised.

There follows a more detailed explanation of the Institute’s concerns on the two tests contained in the OECD Paper.

2. Limitation-on-Benefits (LOB) clause

Ownership and the Importance of a Derivative Benefits clause

The ownership element of the LOB test as set out in the Draft, requires a corporate taxpayer to be owned predominantly by eligible persons resident in that Contracting State in order to qualify for treaty benefits. The reason is to prevent treaty shopping. However, this imposes an unduly narrow ownership test and in smaller countries, with less developed capital markets, companies could be denied treaty access because they have sourced capital from investors resident in countries outside the Contracting State. It is important that any LOB clause takes into account the way international business is currently financed and will be financed in future.

Certain types of business (such as collective investment vehicles) would be particularly affected by a LOB. For example, within the European Union, investors from multiple EU jurisdictions are facilitated to invest in single collective investment vehicles in one jurisdiction. This can result in cost savings from economies of scale and this consolidation helps to increase the efficiency of the EU's capital markets. Notwithstanding that investors would be entitled to access treaty benefits if investing directly, if they invest through a collective investment vehicle they would find themselves unable to access treaties because the investment funds will typically be unable to meet the ownership requirement in the LOB clause.

The OECD's paper "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles"[1] recognises the importance of collective investment vehicles. The paper also highlights that such entities "*require certainty regarding their qualification for treaty benefits*". The position of collective investment vehicles should be specifically recognised such that they are excluded from the scope of LOB provisions and it should be ensured that CIVs are not inadvertently precluded from accessing treaties.

A 'Derivative Benefits' clause could safeguard in part against the LOB test working in an unduly restrictive manner in circumstances where there is no treaty shopping at issue.

Contracting States which are EU Member States must adhere to EU freedoms on movement of capital and establishment and cannot restrict treaty access to businesses owned predominantly by local residents. The absence of a Derivative Benefits clause risks conflict with these fundamental EU Freedoms.

The existence of a Derivative Benefits clause is therefore critical, but the drafting of that clause is equally important.

These are the key elements that the Institute would like to see considered in drafting such a clause:

[1] This paper was adopted by the OECD Committee on Fiscal Affairs on 23 April 2010. Available at http://www.oecd.org/tax/treaties/45359261.pdf

- Ownership by ‘equivalent beneficiaries’ should be taken into account, where similar benefits are provided under another treaty.
- There should not be a requirement that each intermediary company in the ownership structure is an equivalent beneficiary. This would involve a degree of unwarranted complexity and impose duplicative effort on both taxpayers and taxing authorities.
- As noted above, account needs to be taken of EU law and Freedoms for taxpayers and transactions within the EU.
- The ‘base erosion test’ should not prevent taxpayers from making payments to persons who are entitled to ‘equivalent treaty benefits’. Furthermore, any ‘base erosion’ measures must reflect the operation of the EU as a single market recognising that EU resident taxpayers should be free to make payments to other EU residents on equivalent terms to those made to local residents.
- A substance element should be considered, in order to protect genuine commercial structures where ownership or income requirements are not met under a proposed Derivatives Benefits clause.

There is a concern raised in the Discussion Draft that a Derivative Benefits clause may facilitate treaty benefits being granted in limited “base eroding situations”. We believe that any such concerns would be adequately addressed through the other BEPS Action Points and these concerns should not prevent the inclusion of the clause in the LOB test.

The “substantial activity” test

Under the proposed LOB clause, a company which would not meet the ownership criteria would still be entitled to treaty access if it met the Substantial Activity test set out in paragraph 3.

(i) The subjective nature of the test

The subjective nature of this test is likely to give rise to significant uncertainty in its application across multiple jurisdictions and to restrict the ability of taxpayers to use tax treaties. The US has built up significant jurisprudence on the meaning and interpretation of this test. Given the very disparate nature of judicial systems around the world it would be difficult to apply this jurisprudence elsewhere.

The result is likely to be disagreement on interpretation between tax authorities in many situations leading to a substantial increase in the number of ruling requests made by businesses.

(ii) The absence of a safe harbour provision

A number of existing tax treaties with an LOB clause, currently include ‘safe harbour’ provisions which allow for greater certainty as to the application of the treaty. Any proposed standard LOB clause should include safe harbour provisions to reduce some of the uncertainty for business in the application of such measures.

Quoted companies

The proposed LOB clause provides that listed companies could qualify for treaty access if they are quoted on a stock exchange in the country in which they are resident. This exception is very narrow as many companies typically opt to list in other jurisdictions in order to gain access to larger capital markets. Existing tax treaties containing LOB clauses, including the Ireland/US treaty, recognise this fact and allow companies listed on any "recognised stock exchange" to qualify for treaty access.

3. 'Main Purpose' general anti-abuse clause

A taxpayer who meets the LOB test is still required to meet an additional 'main purpose' general anti-abuse test under the proposals outlined in the Draft. Paragraph 31 expressly provides that obtaining treaty access does not have to be the **dominant** purpose of any transactions or arrangements for treaty benefits to be denied. Even if obtaining treaty access is '**one of the main purposes'** for an arrangement, treaty access may be denied. A 'dominant purpose' test would be more proportionate to ensure that legitimate transactions are not unduly denied access to tax treaty benefits.

The proposed 'main purpose' test is by its nature subjective and difficult to interpret. Different jurisdictions, with different legal traditions, are likely to apply a variety of interpretations to this test. This will result in significant additional uncertainty for taxpayers as to whether a treaty is applicable in a large number of cases.

The considerable risk of uncertainty posed by a 'main purpose' test has been recognised in the US. In 1999, the US Senate reviewed a proposed draft text of a US income tax treaty with Italy which contained wording similar to the test in the current proposals. The Senate Committee commented that:

> *"The new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty."*[2]

At a very minimum, detailed guidance would be required to assist tax authorities and taxpayers in interpreting this test. However, given the subjectivity inherent in a 'main purpose' test, such guidance may not adequately reduce the level of uncertainty.

4. Conclusion

The OECD's efforts to prevent instances of double non-taxation should not result in increased double taxation or in increased uncertainty for taxpayers. Any changes to tax treaties must be capable of being administered effectively in practice in a clear and

[2] Senate Executive Report 106-8 (1999)

consistent manner. The significant benefits of an accessible and well functioning tax treaty network in facilitating international and multinational trade must be preserved.