The BEPS Action Plan in the Light of EU Law: Treaty Abuse

Philip Baker QC

Abstract

In September 2015 the OECD unveiled proposals to counter treaty abuse as part of the Base Erosion and Profit Shifting (BEPS) Project. This article considers whether the derivative benefits provision in the proposed Limitation on Benefits clause is needed, and whether it is too narrow. It also considers whether the Principal Purpose Test meets the requirements of legal certainty. Finally, it considers the proposed preamble to all tax treaties relating to double non-taxation, and the EU approach to tax avoidance in general.

Action 6 of the Action Plan on BEPS (BEPS Action Plan) provides as follows:

> **"Action 6—Prevent treaty abuse**
>
> Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids."[1]

This is one of the elements of the Action Plan for which the initial outcome was delivered in September 2014, the proposals being contained in the Report *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (September 2014 Report).[2] It is therefore possible to consider the specific proposals unveiled by the OECD in 2014, and to discuss any questions of compatibility or incompatibility with EU law. A discussion draft relating to follow up work on preventing treaty abuse was issued on November 21, 2014,[3] and a revised discussion draft was issued on May 22, 2015 (Revised Discussion Draft), after the seminar in Munich.[4] The discussion draft mentioned briefly the possibility that adjustments might need to be made to the proposals

[1] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *http://dx.doi.org/10.1787/9789264202719-en* [Accessed July 15, 2015].

[2] OECD, *OECD/G20 Base Erosion and Profit Shifting Project. Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. Action 6: 2014 Deliverable* (September 16, 2014), available at: *http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances_9789264219120-en* [Accessed July 15, 2015].

[3] OECD, *Public Discussion Draft, Follow Up Work on BEPS Action 6: Preventing Treaty Abuse: 21 November 2014–9 January 2015* (Paris: OECD, 2014), available at: *http://www.oecd.org/ctp/treaties/discussion-draft-action-6-follow-up-prevent-treaty-abuse.pdf* [Accessed July 15, 2015].

[4] OECD, *Revised Discussion Draft, BEPS Action 6: Prevent Treaty Abuse 22 May 2015–17 June 2015* (Paris: OECD, 2015), available at: *http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf* [Accessed July 15, 2015].

to ensure compatibility with EU law, and the revised discussion draft contained the text of a "simplified" Limitation on Benefits (LOB) rule.

Perhaps the core conclusion of the September 2014 Report is contained in an agreed minimum standard on combatting tax treaty abuse set out in paragraph 14 of the Report as follows:

> "At a minimum, however, countries should agree to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements (see Section B); they should also implement that common intention through either the combined approach[[5]] described in paragraph 11 (subject to the necessary adaptations referred to in paragraph 6 above), the inclusion of the PPT rule or the inclusion of the LOB rule supplemented by a mechanism (such as the alternative provision included in paragraph 15 of the Commentary on the PPT rule that appears in subsection A.1(a)(ii) below or domestic anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties."[6]

The elements of the minimum standard are, therefore, three proposals:

1. an express statement included in all tax treaties to eliminate double taxation without creating opportunities for non-taxation or reduced taxation;
2. an LOB clause; and
3. a Principal Purpose Test (PPT).

States are to implement the common intention not to create opportunities for non-taxation or reduced taxation by *either* including the LOB and the PPT, *or* the PPT, *or* the LOB (which must then be supplemented by anti-conduit-arrangement provisions). This short article focuses on the EU law aspects of certain of the proposals, specifically the LOB provision, the PPT, and the proposed amendments to the preamble.[7]

The LOB provision

The compatibility of LOB provisions with EU law is a relatively well-trammelled topic that has been discussed for over a decade.[8] The compatibility of a specific and relatively limited form of LOB clause was also discussed by the CJEU in *Test Claimants in Class IV of the ACT Group*

[5] The combined approach involves both the adoption of an LOB clause and also the Principal Purpose Test.

[6] September 2014 Report, above fn.2, para.14.

[7] In addition, the September 2014 Report, above fn.2, also identified several specific amendments to tax treaties to combat treaty abuse, including: the splitting of contracts to avoid construction site PE, and the hiring out of labour, etc. Many of the proposals with regard to these specific aspects are not new. This article does not focus on the specific anti-abuse provisions.

[8] See, for example, P. Essers, G.de Bont and E. Kemmeren (eds), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law* (The Hague: Kluwer, 1998); F.A.V. Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* (The Hague: Kluwer, 2006); A. Martin-Jimenez, "EC Law and Clauses on 'Limitation of Benefits' in Treaties with the US after Maastricht and the US-Netherlands Tax Treaty" (1995) 4(2) *EC Tax Review* 78; T. O'Shea, "Limitation on Benefit Clauses and the EU part 1" (October 2008) *International Tax Report* 1, available at: *http://www.law.qmul.ac.uk/docs/staff/ccls/oshea/52155.pdf* [Accessed July 15, 2015].

Litigation v IRC (*Class IV ACT*),[9] both the Court and the Advocate General concluding that such a provision was not incompatible with the freedom of establishment or free movement of capital.

An LOB provision operates, of course, by identifying qualified persons who are primarily individuals resident in a Contracting State and companies owned by those individuals. One of the issues with EU law is the danger of a restriction on the freedom of establishment or free movement of capital where residents of one EU Member State establish an entity in another EU Member State and that entity is denied treaty benefits because it is not owned by residents of the Contracting State itself. Issues also arise where the LOB provision seeks to combat base erosion where payments are made to companies or other persons in another State, and treaty benefits are denied because of these payments.

The proposed LOB provision itself is lengthy and detailed, and is perhaps not the best topic for a discussion. The "simplified" draft published in May 2015[10] does not make a full discussion much easier.

What is more interesting to discuss in this context is whether a derivative benefits provision is necessary to include in the LOB clause in order to ensure EU compatibility, and whether the derivative benefits provision proposed by the OECD meets this objective. That provision is as follows:

> **"Derivative Benefits Provision**
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> [4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if, at the time when that benefit would be accorded:
>
> a) at least 95 per cent of the aggregate voting power and value of its shares (and at least 50 per cent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and
>
> b) less than 50 per cent of the company's gross income, as determined in the company's State of residence, for the taxable period that includes that time, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.]"[11]

The narrow limitation on benefits provision under discussion in the *Class IV ACT* case[12] contained a form of derivative benefits clause whereby the dividend tax credit was denied to a company controlled by another company resident in a third State, *unless* there was a tax treaty with that third State that contained an equivalent provision granting the right to a tax credit. The issue in

[9] *Test Claimants in Class IV of the ACT Group Litigation v IRC* (C-374/04) [2006] ECR I-11673; [2007] STC 404. The issue is discussed in the judgment at [75]–[94], and in the Opinion of Advocate General Geelhoed at [97]–[102].
[10] Revised Discussion Draft, above fn.4.
[11] September 2014 Report, above fn.2, 55.
[12] *Class IV ACT* (C-374/04), above fn.9, [2007] STC 404.

that case was essentially whether it was compatible with EU law for tax treaties to discriminate between companies controlled by a parent company that was or was not entitled to similar treaty benefits. Thus the necessity for a derivative benefits clause was only indirectly at issue in that case, as the central issue was the impact of just such a clause.

The OECD's proposed derivative benefits provision has two limbs, both of which require to be satisfied. The first is that at least 95 per cent of the aggregate voting power and value of the company's shares is owned by seven or fewer persons that are equivalent beneficiaries. This term is defined in the LOB provision as a resident of any other State, but only if that resident would be entitled to all the benefits of a similar comprehensive treaty that has a similar LOB provision which they would satisfy. Additionally, with respect to dividends, interest and royalties, that they would be entitled under that Convention to a rate of tax which is at least as low as the rate applicable under the treaty under consideration.

The second limb is that less than 50 per cent of the company's gross income is paid to persons who are not equivalent beneficiaries in the form of deductible payments. That is, no base erosion by payments to persons who are not entitled to treaty benefits.

There are various EU law-related issues that one could raise in connection with this derivative benefits provision.

1. First, is it too restrictive? Requiring at least 95 per cent of the voting power to be owned by a small number of equivalent beneficiaries makes this is a relatively narrow provision. This provision would, of course, cover wholly-owned subsidiaries of EU companies in other Member States, as well as companies owned by a European consortium of seven or fewer companies. There may, however, be situations where a company is owned by a larger number of companies, or less than 95 per cent is owned by equivalent beneficiaries. In that case, the provision is prima facie restrictive of the freedom of establishment or free movement of capital, and would need to be justified and proportionate.
2. Secondly, is the definition of "equivalent beneficiaries" too narrow, particularly when it requires that the rate of tax on dividends, interest and royalties should be at least as low? Suppose that a resident of EU State A enjoys a maximum withholding tax under the treaty between that State and State X of 15 per cent. That resident establishes a company in State B in a genuine exercise of the freedom of establishment. The treaty between State X and State B, however, has a 10 per cent maximum withholding tax on interest: the company that is established is not able to benefit from the derivative benefits provision.
3. Thirdly, is the base erosion provision that less than 50 per cent of the company's income be paid away in deductible payments too restrictive? There is a potential negative impact on treaty benefits where payments are made to recipients in other Member States.

If there is a view that this derivative benefits provision is too restrictive, then what is the alternative? Does that alternative need to contain a broader provision granting benefits where the company (or other person or entity) that is seeking the benefit of the treaty has been established in a genuine exercise of the freedom of establishment or the free movement of capital by citizens

or companies of other EU Member States? Such a provision would ensure that the treaty benefits were never denied where there has been a genuine exercise of a fundamental freedom. There is no concrete guidance one can point to as to the best way to ensure compatibility of a derivative benefits provision, if it is necessary to ensure that an LOB provision is not incompatible with EU law.

The PPT rule

Either in addition to or in place of the LOB provision, the OECD has proposed the following wording for a PPT:

> "Notwithstanding the other provisions of this Convention, a benefit under this Convention 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 this Convention."[13]

This restriction on treaty access can be seen as deriving from UK treaty practice, where "main purpose" provisions have been included in the dividend, interest and royalty articles of some treaties in recent years. There are significant differences, however, from UK practice: this is a *principal* purpose test, as opposed to a main purpose test (though that may be a rather fine distinction). Perhaps more significantly, this is intended to govern *all* elements of the treaty and not simply the reduced withholding tax on dividends, interest or royalties.

One of the main issues of compatibility of the proposed PPT with EU law concerns the issue of legal certainty and whether the wording of this provision is sufficiently clear. In two tax cases recently the CJEU has held that the wording of domestic anti-avoidance legislation in the countries concerned was insufficiently precise to meet the requirement of legal certainty. In *Itelcar - Automoveis de Aluguer Lda v Fazenda Publica* (*Itelcar*)[14] the Court said as follows:

> "… the rules in question do not make it possible, at the outset, to determine their scope with sufficient precision. Accordingly, they do not meet the requirements of legal certainty, in accordance with which rules of law must be clear, precise and predictable as regards their effect, especially where they may have unfavourable consequences for individuals and companies. As it is, rules which do not meet the requirements of the principle of legal certainty cannot be considered to be proportionate to the objectives pursued …"[15]

The Court referred to a similar conclusion it had reached in *Societe d'investissement pour l'agriculture tropicale SA (SIAT) v Belgium* (*SIAT*).[16]

[13] September 2014 Report, above fn.2, 12.
[14] *Itelcar - Automoveis de Aluguer Lda v Fazenda Publica* (C-282/12) (judgment of October 3, 2013) ECLI:EU:C:2013:629.
[15] *Itelcar* (C-282/12), above fn.14, ECLI:EU:C:2013:629 at [44].
[16] *Societe d'investissement pour l'agriculture tropicale SA (SIAT) v Belgium* (C-318/10) [2012] STC 1988; [2012] 3 CMLR 35 (judgment of July 5, 2012) at [58] and [59].

There is no obvious reason to believe that the requirement of legal certainty should not be equally applicable to provisions in tax treaties as to provisions in domestic law. Assuming the requirement of legal certainty does apply, does the PPT wording satisfy the requirements of clarity, precision and predictability?

It may be important in this context that the rule has two elements. The first element is that

> "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 ..."[17]

This has both an objective and a subjective element: the test is applied by looking at the facts and circumstances and asking whether it would be reasonable to conclude (an objective test) that obtaining the benefit was the principal purpose of any arrangement or transaction (purpose being a subjective issue). The second limb is purely objective and asks whether the granting of the benefit will be in accordance with the object and purpose of the relevant provisions of the Convention. Neither of these limbs may be satisfied with absolute certainty in cases that fall close to the borderline. However, the fact that there may be borderline cases, in respect of which the application of the provision may only be resolved by litigation, does not of itself imply a lack of legal certainty.

It is interesting to contrast the wording proposed with the wording of the general anti-avoidance rule recently inserted[18] into the Parent-Subsidiary Directive[19]:

> "In Article 1, paragraph 2 is replaced by the following paragraphs:
>
> 2. Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements that, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage which defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances.
>   An arrangement may comprise more than one step or part.
> 3. For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.
> 4. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse."

This anti-avoidance rule, having been adopted by the Council, is not immune from challenge under EU law. However, there is at least an assumption that such wording would be regarded as compatible. This is a main purpose test, which also has regard to the facts and circumstances, and which contains both subjective and objective elements. It is a reasonable observation that

[17] September 2014 Report, above fn.2, 66.

[18] By Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2015] OJ L21/1.

[19] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L345/8.

the proposed PPT is not significantly less precise or clear than this general anti-avoidance rule inserted into the Parent-Subsidiary Directive.

There are two further points that may arise in connection with the PPT rule and EU law. The first concerns a requirement of proportionality which gives the taxpayer an opportunity, without subjecting him or her to undue administrative constraints, to provide evidence of any commercial justification for the transaction. The draft rule says nothing about the burden of proof, or the opportunity that the taxpayer may have to show all relevant facts and circumstances which may lead to the conclusion that obtaining the benefit was not one of the principal purposes. Ideally, to be compatible with EU case law in this area, the initial burden of establishing a prima facie case that a taxpayer is not entitled to the benefits should rest upon the revenue authorities, with the taxpayer then having the opportunity to bring evidence that would justify entitlement to the treaty benefits.

The final issue concerns the consequences of non-compliance with the PPT rule. The consequence would appear to be the total denial of treaty benefits. However, the CJEU has emphasised (again, the *SIAT* case[20] is a good example of this) that benefits should only be denied so far as it is necessary to prevent the abuse. Might there be situations where it is consistent with the object and purpose of relevant provisions that the taxpayer obtains some (but perhaps not all) benefits of the Convention? In a conduit arrangement, for example, should it be the case that treaty benefits are denied entirely, or only denied in respect of that part of the amount received that is paid on under the conduit arrangements? The point might be made, however, that the general anti-avoidance rule inserted in the Parent-Subsidiary Directive also denies the benefit of the Directive to abusive arrangements.

The purpose of non-taxation

The third, main change that is proposed to counter treaty abuse is to insert in the preamble to all tax treaties a statement of intention that the convention should not create opportunities for non-taxation or reduced taxation through tax evasion or avoidance. The proposed wording is as follows:

> "**PREAMBLE TO THE CONVENTION**
>
> (State A) and (State B),
>
> Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)
>
> Have agreed as follows:"[21]

[20] *SIAT* (C-318/10), above fn.16, [2012] STC 1988.
[21] September 2014 Report, above fn.2, 101.

The purpose of this new preamble is to clarify the object and purpose of the Convention to assist in treaty interpretation in accordance with Article 31 of the Vienna Convention on the Law of Treaties.[22]

The inclusion of wording setting out the intention of the parties seems unobjectionable. Even if EU law takes no position on double non-taxation, there seems to be no reason why Member States when they conclude double taxation conventions should not state that their purpose is not to provide opportunities for double non-taxation or for tax evasion or avoidance.

The only issue here of EU law may be with regard to the words in brackets. If residents of one Member State, in genuine exercise of the freedom of establishment, establish a company in another Member State, why should the possibility that they may be motivated by treaty shopping prevent them from obtaining the benefits of the tax treaty, always assuming that it has been a genuine exercise of the freedom? Do the words in brackets need to be modified in the context of EU Member States (just as the LOB clause may need the derivative benefits provision), to provide for the genuine exercise of the fundamental freedoms?

The EU approach to avoidance in general

It is well established that a Member State may enact domestic anti-avoidance legislation where that legislation specifically targets

> "wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory."[23]

This formulation is frankly problematic: if it really meant "*wholly artificial* arrangements" then, in effect, legislation can only be enacted which targets shams or arrangements that are very close to shams. Equally, if "the *sole purpose*" is to avoid tax normally payable, then arrangements that have at least some non-tax purpose cannot be targeted. It seems hard to accept that the CJEU intends the scope of States' jurisdiction to legislate to combat tax avoidance to be so narrowly constrained.

There is, of course, the possibility that the CJEU may yet develop the concept, originally stated in *Marks & Spencer plc v Halsey (Inspector of Taxes)*,[24] that combatting tax avoidance might be a justification for restrictive measures, if combined with some other overriding purpose in the public interest. In the context of double taxation conventions, this could be combined with preserving the balanced allocation of tax jurisdiction between the two Contracting States, as recorded in the convention. It is possible that, in this context, "combatting tax avoidance" may take on a wider meaning than the "wholly artificial arrangements" formulation. Where Member States have concluded a convention to eliminate double taxation and, hence, remove a barrier

[22] Vienna Convention on the Law of Treaties (with annex). Concluded at Vienna on 23 May 1969. No.18232.
[23] This is cited in many cases, starting with *ICI plc v Colmer (Inspector of Taxes)* (C-264/96) [1998] STC 874; [1998] ECR I-4695 (judgment of July 16, 1988) through to some of the most recent cases, including *Test Claimants in the Thin Cap Group Litigation v IRC* (C-524/04) [2007] ECR I-2107; [2007] STC 906 (judgment of March 13, 2007) at [72] and [74].
[24] *Marks & Spencer plc v Halsey (Inspector of Taxes)* (C-446/03) [2005] ECR I-10837; [2006] STC 237 (judgment of December 13, 2005).

to trade and investment, will EU law really prevent anti-avoidance measures which are targeted at other than "wholly artificial arrangements"?

Finally, and entirely speculatively, the issue remains whether the CJEU will at some time conclude that the adoption of measures in conformity with internationally-agreed conclusions of a project such as the BEPS Project, can, of themselves, constitute overriding reasons in the public interest. The CJEU is not cut off from international developments: the judges will be aware of the concern in so many quarters about BEPS, so much so that one wonders whether compliance with an agreed outcome of the BEPS Project will become a justification of its own (subject perhaps to overview by the CJEU based on a limit to the margin of appreciation and to a proportionality test).

Base erosion and profit shifting; Double taxation treaties; EU law; Limitation-on-benefits clauses; OECD; Purpose tests; Tax avoidance

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