Master Thesis

LLM International Business Taxation/ Track: International Business Tax Law

Are the LOB provisions efficient measures to prevent tax treaty hopping by taxpayers?

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List of Abbreviations

Action 6	Action 6- Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
BEPS	Base Erosion Profit Shifting
CIV	Collective Investment Vehicles
EU	European Union
DTC	Double Taxation Convention
GAAR	General Anti-Avoidance Rule
IBFD	International Bureau of Fiscal Documentation
LOB	Limitation on Benefits
MC	Model Convention
MAP	Mutual Agreement Procedure
OECD	Organization for Economic Cooperation and Development
OECD MC	OECD Model Convention
PPT	Principal Purpose Test
SAAR	Special Anti- Avoidance Rule
US	United States
US MC	United States Model Convention
VCLT	Vienna Convention on the Law of Treaties

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1. INTRODUCTION

In recent years, the business world has witnessed a constant and certainly increasing wave of restructuring processes of businesses models of multinational and medium-sized enterprises, to adapt to the demands and new challenges of the international trade arena. The decision how to structure in the most efficient possible manner the business models is often influenced by the tax benefits offered by countries seeking to attract foreign investment that will allow them to develop their respective economies in a very competitive scenario from a tax law perspective.

The decision where and how to structure commercial transactions or conduct economic activities requires the design of International tax structures, that to a large extent allows access to tax benefits conferred by international tax treaties. Apart for legitimate and strictly business related reasons, these structures have been used to abuse the tax treaty system by structuring commercial transactions with the intention to avoid or minimize tax charges.

As a response to the potentially harmful effects of the tax avoidance practices, the tax treaty system has been focused on the design of proper measures to counter avoidance practices that result in an abuse of tax conventions by persons to whom the treaties were not intended to benefit, or to access benefits that the treaties were not designed to confer.

To prevent and attack treaty abuse, countries have adopted methods such as the theory of abuse of rights; domestic judicial anti-avoidance principles; domestic legislation that includes general or specific anti-avoidance rules, to deny treaty benefits. From a tax treaty perspective, countries have implemented specific anti-avoidance provisions to limit the scope of the treaty, such as abuse of rights doctrine; the Limitation on Benefits provisions; The Principle Purpose Test which is currently been proposed to include in the OECD Model Conventions in BEPS Action 6, along with the LOB provisions.

As a general rule one can argue that with the differences that I will be explaining in further chapters, these measures are applied to deny tax treaty benefits, in situations where the taxpayer structures their tax planning with the intention of circumventing the object of a tax treaty.

In general terms, the anti-abuse tax provisions general function is to limit the scope and application of the treaty if certain criteria are not met by the resident of the contracting state invoking the benefit. For example, when it comes to the beneficial ownership concept, the OECD Model Convention limits treaty relief in respect of dividend and royalty payments paid in one treaty state to a resident of the other treaty jurisdiction in circumstances where the actual beneficiary of the dividend or royalty income is resident in a third State. Another example is the above mentioned Limitation on Benefits Provisions (LOB), which has been developed by the US in the tax treaties they have concluded, by setting rules to test the economic substance of the resident of the contracting states seeking the treaty benefits.

The treaty abuse strategies are focused basically in establishing limited business presence or nominal economic substance in a jurisdiction in order to access the tax treaty network of said jurisdiction with other countries, without having a real connection with that country. The transaction performed lack of economic substance and in most of the cases the only purpose for the structure implemented in that jurisdiction is to obtain treaty protection.

Objective

The purpose of this thesis is to give an overview of the issues regarding the instruments used by the treaty system to counter treaty abuse. The issue of preventing the improper use of a tax treaty is addressed by the OECD in the BEPS Action 6, and the objective is to describe and analyze the provisions suggested in the report.

In order to approach the rules and instruments to prevent treaty abuse and evaluate their efficiency, it is necessary to start with the study of the notion of tax treaties, the principles that rule the system, their functions and structure. It will also be essential to assess the fundamentals of the concept of double taxation in order to explore the phenomenon of tax avoidance, treaty abuse or as is explained by Professor Van Weeghel "the improper use of tax treaties"[1].

Structure

This study analyzes the concept of beneficial ownership, the Limitation on Benefits Provisions (LOB) and the Principal Purpose Test as mechanisms (set of rules) designed to counter the use of tax treaties as a tool to avoid or minimize the taxation by residents doing business in a favorable foreign tax jurisdiction. In this study I will examine the origin and the general framework of the beneficial ownership concept, as well as the purposes and structure of the Limitation on Benefits Provisions (LOB) and the Principal Purpose Test, as instruments to prevent the improper use of tax treaties trough particular strategies such as the "treaty shopping", in order to finally make a comparison between the instruments with the aim to challenge the legitimacy and efficiency of these rules.

Furthermore, by making this analysis I will try to determine in light of the efficiency principle, if in order to prevent the treaty abuse, it is necessary to include in the tax conventions express

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[1] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States*. Kluwer Law International

provisions adopting Limitation on Benefits provisions along with the Principal Purpose Test which is the OECD approach proposed in BEPS Action 6.

Research question

After analyzing the above mentioned, I will propose a comparison between the LOB clause and the PPT rule, in order to address the following research question:

Are the LOB provisions efficient measures to prevent tax treaty hopping by taxpayers?

Sub research questions:

As mentioned, the objective of the study is mainly to examine the measures to prevent the treaty abuse. To reach this objective and in order to be able to answer the research question defined above, the sub research questions will be constructed as follows.

(i) Once the provisions suggested by BEPS Action 6 are described, the analysis will be focus in answer the sub- question, what is the role of the PPT rule in countering tax abusive practices?

The answer to this question will depend on the analysis of the provisions that will be mainly focus on the complexity of the LOB provisions contained in the Action 6 report, and the analysis of the PPT rule, with the purpose to understand the implications of the implementation of the provisions on cross border transactions, both for taxpayers and tax administrations.

Subsequently, I will address the following sub-research question:

(ii) Will the implementation of the PPT rule cause uncertainty among the taxpayers?

As will be explained further in this study, the OECD recognizes that a standalone LOB provision is probably not enough to counter all treaty abuse schemes, and therefore recommends the inclusion of a PPT rule as a tool to counter other situations that may not be deal by the LOB provision. The PPT rule is certainly an instrument for tax administration to counter treaty abuse circumstances, but can cause uncertainty to taxpayers that even though meet the requirements of an already complex LOB provision could still be denied treaty benefits, due to the broader scope of application of the PPT rule.

2. TAX TREATIES

As mentioned, to address the study of treaty abuse it is necessary to first explore the tax treaty regime, in order to provide a broad knowledge of the main aspects of the system, such as the tax treaty concept, the objectives of the regime, the treaty principles and the general framework of the treaty rules. After this, it will be possible to evaluate the tax treaty abuse, in particular the use of tax treaties as a strategy to circumvent or minimize source taxation in foreign jurisdictions. Finally, I will evaluate the various set of rules adopted in the tax treaties to tackle this strategies.

First I will start with the concept of tax treaties, including a brief historical background of the system. Subsequently, I will study the general objectives of bilateral tax treaties, the main treaty rules, and the principles that rule the structure of the tax treaty regime.

The purpose of this chapter is to provide the tools to approach in a proper manner the concept of tax avoidance and treaty abuse and how they can influence the tax treaty regime. This examination can also give us the instruments to understand the thin line between legitimate tax planning through structures that arise as a result of the application of the tax treaty provisions (gaps inherent in a bilateral treaty system and its limited scope) and treaty abuse.

2.1. Concept

Double tax treaties are international agreements between sovereign nations, which are subject to the general international law rules contained in the Vienna Convention on the Law of Treaties. As a general rule, bilateral tax treaties confer rights and impose obligations on the Contracting States, in order to promote better market conditions and therefore benefit the taxpayers of the States involved.

In a first stage, once the treaty is signed by the Contracting States, arises the obligation to initiate the procedures under the domestic law of each country. As a general rule, in democratic countries, the treaty must be discussed and approved by the parliament of each Contracting State to be valid. Otherwise it would be invalid according to Article 46(2) of the VCTL. Following the debate before the parliament the discussion on the treaty must be concluded by an exchange of instruments also known as ratification, which is usually performed by the president or head of the corresponding government. After this the treaty becomes binding for international law purposes and the benefits of the treaty can be granted to the residents of the

Contracting States[2].

As will be explained in more depth further in this document, one of the main concerns of the tax treaty system is to ensure that treaty benefits only be granted to the residents of the contracting states, never to third parties, and that there must be a strong economic connection of the residents with the countries involved in a tax treaty. This issue has a special relevance for the system, due to the fact that residents of third countries in order to obtain treaty benefits, structure their transactions in such a way to circumvent the residence requirement to obtain treaty benefits, by interposing the so called conduit companies in one of the contracting states, which as a general rule are companies without any economic substance, incorporated with the main or sole purpose to gain benefits from a tax treaty.

The purpose of this chapter is to analyze the OECD Model Convention approach to prevent a third country resident to invoke a tax treaty benefit, contained in articles 10, 11 and 12 of the Model Convention. In a broad sense, these provisions allow the reduction of withholding taxes levied by the source state on passive incomes such as dividends, interests and royalties that flows from the source state to a resident of the other contracting state. In order to achieve that goal, the OECD Model Convention requires the recipient of the income to be the beneficial owner of the income.

It is important to fully understand that under the tax treaty system, the Contracting States will not in any way render their tax sovereignty. The tax treaty system acknowledges that each Contracting State will apply its own domestic tax law. It is worth noting that tax treaties will not serve as instruments to solve conflicts of tax laws between the States or allocate tax jurisdiction. Tax treaties are a mechanism to avoid double taxation through the limitation of tax claims for certain items of income, in situations where both Contracting States may claim the right to tax. The residence and source principles are the leading concepts of the tax treaty regime and are the base of the instruments and rules to determine the manner in which taxing rights are distributed between the Contracting States in order to avoid double taxation.

As we will study in more depth later on in this study, by signing a tax treaty, the Contracting States agree not to levy taxes in some specific occasions, or tax with limitations on the tax rate for example, establishing rules to determine when a State reserves the right to tax either fully or partly a taxable income.

How does a tax treaty work under domestic law? As mentioned above, the tax treaty imposes limits to the domestic taxation, through the application of a tax treaty a Contracting State will

[2] Vogel K. (2015). *Klaus Vogel on Double Taxation Conventions, Fourth Edition*. Wolter Kluver Law & Business, p. 24-28

renounce its tax right in favour of the other Contracting State by basically granting an exemption either by the exemption system or the credit system (Art. 23A or 23B OECD Model Convention), method that must be agreed upon mutual consent by the Contracting States.

According to the above, one have to conclude that tax treaties do not create taxing rights or claims for any of the Contracting States other than those tax rights that already exist under domestic tax law.

2.2. Function of Tax Treaties

In the preamble to tax treaties one of the objectives addressed is to avoid or eliminate double taxation as well as to prevent tax evasion. The double taxation concept has always been seen as one of the major obstacles in international trade. For the purposes of this study I will refer to the concept used by Professor Van Weeghel *"the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same item of income for identical periods"*[3].

The principles of residence and source are fundamental to the construction of the treaty system, and their application determine the manner in which the taxing rights are allocated between the Contracting States to avoid or minimize double taxation.

- **Residence principle:** As a general rule the vast majority of countries in order to determine the tax liability of its residents, apply the worldwide income, based on "those who are residents in their territory"[4].

  Residence is determined by the strong connections with the state, which are used to justify the unlimited tax liability of the subject. The reasoning behind the imposition of unlimited tax liability to the residents of a jurisdiction, is that they benefit from the organization and infrastructure of that country to develop their respective economic activities.

- **Source principle:** Under the source principle a country is entitled to levy taxation on the income that is generated within its territory, regardless of the residence of the taxpayer.

To prevent double taxation, countries in their domestic laws can adopt unilateral measures, such

[3] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States.* Kluwer Law International, p. 9.

[4] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States.* Kluwer Law International, p. 12.

as foreign tax credits recognizing the taxes paid abroad. Nevertheless, the tax treaty system has introduced tax attribution rules for income generated in one jurisdiction by residents of another treaty state, and had designed a set of rules to distribute the taxing rights between the contracting states. So, it is through the instrument of attribution of taxing rights that the tax treaties propose to solve the issues of double taxation and the conflict between the residence principle and the source principle.

The tax treaty system allows contracting states to choose either a credit system or exemption system to avoid double taxation. Also it is important to point out that the tax treaty regime recognizes the different income categories that are adopted under domestic tax law. As a general rule, the residence state have taxing rights over income generated from movable and intangible property, and portfolio investment income. On the other hand, the source state has jurisdiction to tax business income as long as that income is attributable to the activities of a permanent establishment in that state. Therefore, source principle taxation under the tax treaty system is triggered if a strong economic connection exists between the entity and the source contracting state, in such case the residence country could have residual taxing rights and must provide tax relief to prevent double taxation.

One can argue that one of the objectives to design structures creating tax residence in one jurisdiction to access tax treaty benefits, is to reduce or prevent the withholding taxes levied in the source country on payments of passive income such as interest, royalties and dividends to residents of the other contracting state. The withholding rates on source income are the result of negotiations between contracting states, meaning that withholding rates vary from one treaty to another, also depending on the categories of the income. The tax treaty system have three main objectives:

2.2.1. Avoidance of double taxation

The main objective of tax treaties is the avoidance of double taxation. To do this, the contracting states agreed in the design of common definitions within the text of the treaty to assign fully or partly the right to tax to one of the countries involved, leaving to the other state residual rights. This objective is achieved by granting tax relief either by the credit system or the exemption system.

According to Professor Van Weeghel, the OECD tax treaty convention assumes that *"an item of income will be taxed in at least one of the contracting states*[5]*"*. According to this point of

[5] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States.* Kluwer Law International, p. 33.

view, the whole idea behind the system is that the contracting states will agree on a method (exemption system or credit system), that allows the taxation of an item of income fully one time, always having in mind that by entering into a tax treaty the contracting states do not renounce to the right to tax, simply the treaty system assign the right to tax to one of the parts involved, which means that the domestic law will apply to the item of income, but the contracting states will choose the method to avoid the double taxation.

2.2.2.Prevention of tax avoidance and evasion

This study will focus on the effectiveness of the instruments adopted to counter tax treaty abuse, such as LOB provisions and the Principal Purpose Test, which are mechanisms in line with the prevention of tax avoidance and evasion as an objective of the treaty system.

The OECD Model Convention does not explicitly refer to tax avoidance as an objective of the treaty system, but with the BEPS discussion, particularly Action 6 it is recommended to amend the title and preamble of the Model Convention to include such objective. This is not the case of the US Model Convention, which expressly states the prevention of fiscal evasion as a main purpose.

Tax avoidance and evasion objective has been present in the discussions and several amendments of the OECD Model Convention, but is probably addressed in a better manner in the commentaries to the Model Convention.

Both the academia and the governments that are part of the OECD and those that are not in this group are engaged in the development of the measures to tackle tax avoidance, tax evasion and the improper use of treaties, which are terms that have unique definitions and also different consequences in the practice of international taxation law. Tax evasion refers to the taxpayer behavior who knowingly intents to avoid the payment of taxes to a tax administration, it is clearly a case of a crime against the public administration; tax avoidance is not a crime in itself since it comes to the design of structures to circumvent or minimize taxation charges, but still can be within the scope of legitimate tax planning, design as a response to commercial or business reasons.

In the case of the improper use tax treaties, I will follow the statement of professor Vogel regarding the qualification of such concept, as a form of tax avoidance.

2.2.3.Non-discrimination

Another objective of tax treaties, at least in the OECD Model Conventions is to prevent discrimination of nationals of the contracting states. The provisions contained in the OECD Model Convention are related to non-discriminatory taxation in respect of permanent establishments, deductibility of royalty and interest payments, and prevention of non-discriminatory treatment to non-resident-controlled enterprises.

The non-discrimination provisions prevent the imposition of a larger or smaller tax burden on income attributable to a non-resident. But it is also important to note that these measures must ensure that treaty-based withholding tax measures are applied equally by the parties involved.

3. TAX TREATY CONVENTIONS

When countries decide to enter into a tax treaty, one of the main points in the negotiation process is to determine to what extent, the source state will agree on limiting or renouncing its taxing rights. If the source state agrees on restricting its taxing rights, the residence state will fully tax the profits of its resident, whereas if the source state does not agrees to the restriction of the taxing rights, the residence state shall either grant an exemption or a credit for taxes payed in the source state, in order to avoid double taxation.

There are two main models often used by the countries as a starting point to negotiate their double tax conventions, the OECD Model Convention and the UN Model Convention.

The two Model Conventions differ from one another in the way they apply the source base taxation, taking into consideration the aim of the each organization and the status of its members. The OECD is an international organization, and its members are industrialized countries, which have the same economic standards. On the other hand, the UN Model is explicitly directed to provide guidance to developing countries.

3.1. OECD Model Convention

The OECD Model contains seven chapters. Chapters I and II outline the scope of the Convention, establishing the requirements for the application of the tax treaty and introducing the definitions to the terms of the treaty. Chapters III and IV contain the distributive rules of the tax treaty for each item of income. Chapter V provides the tax relief methods (exemption and credit systems). Chapter VI contains a series of administrative provisions such as the Mutual Agreement Procedure (MAP), also contains the non-discrimination clause. Chapter VII establishes the entry into force and the termination clause of the treaty. Finally, the treaty also consists of the protocols annexed to a treaty which are part of the treaty and have binding force.

The OECD Model is primarily intended to grant taxing rights to the resident state, and very few items of income are assigned to the source state. For instance, the residence state has the right to tax dividends and interest. If the source state also tax these items of income, the withholding tax shall not exceed certain rates.

As a general rule, in the OECD Model the source state may tax the business profits derived from activities within the source state (through a Permanent Establishment). The residence state then is not allowed to tax those profits under the tax treaty, but the resident state would tax the profits in accordance with its domestic legislation.

3.2. UN Model Convention

As stated before, the needs of developing countries are taking into account by the UN Model Convention. The United Nations in the 1960s set up a group of experts to design a Model Convention with guidelines for the developing countries, creating a proposal in which primarily the taxing rights belong to the state of source. Nonetheless, it is important to say that the UN Model followed the OECD Model with few differences in its structure.

Under the UN Model the taxing rights are granted to the source state. The rationale behind this is that the source state in the UN Model is usually a developing country, so they can tax a larger portion of the income derived in their jurisdiction.

4. TREATY ABUSE PROVISIONS

As a starting point and in general terms, treaty abuse consists of transactions or arrangements structured by persons who are not resident of a contracting state, in order to obtain the benefits of a tax treaty whose benefits are only intended to be granted to residents of the contracting states, also known as treaty shopping.

The identification of an abusive transaction is really difficult for several reasons, first, it is not always easy to sort out those transactions that in fact are abusive and against the law, and on the other hand, such a broad concept as the tax abuse, run to the risk to include bona fide transactions or arrangements, creating uncertainty among taxpayers.

The position of the OECD Committee on Fiscal Affairs is that treaty abuse upsets the efforts and sacrifices incurred by the contracting parties in their double taxation convention, to the extent that the existence of abusive transactions could result in a disincentive for countries to enter into double tax treaty conventions.

4.1. The definition of abuse

According to Stef Van Weeghel[6] the term "treaty shopping" encompasses those situations in which a person who is not entitled to the benefits of a certain tax treaty, incorporates a legal person or makes use of an individual in order to obtain those benefits that are not available directly.

The tax benefits that a taxpayer seeks to obtain by the interposition of a legal entity between the payor and the final and true recipient of the income, are basically the reduction of source-based taxation, altogether with a low residence base taxation in the country where the legal entity is incorporated.

The OECD Committee on Fiscal Affairs, explained the reasons why treaty shopping is undesirable, as follows:

(i) Breached of the principle of reciprocity: Treaty benefits are intended to benefit the persons residents of the contracting states, so those benefits abusively extended to third parties are obtained in a way nor intended by the contracting states.

(ii) Double non-taxation situations: The idea of a tax treaty is that the benefit is granted in one of the contracting states on the basis that such income is going to be taxed in the other contracting state. Therefore the design of abusive structures can lead to situations in which a third party can access a treaty benefit in the source state, also avoiding taxation in the residence state.

(iii) Disincentive to enter into tax treaties: The availability of treaty benefits through the interposition of conduit companies can lead to a disincentive to enter into tax treaties by the State of residence of the final recipient of the income, because the residents of such State can indirectly receive treaty benefits without the need to provide reciprocal benefits.

As will be explained later, the purpose of this study is to analyze the set of rules implemented

[6] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States.* Kluwer Law International, p. 95-158.

and proposed to counter treaty abuse, and specifically treaty shopping, a mechanism through which a person establishes a legal entity in certain country with the purpose of obtaining the benefits of a tax treaty concluded between that country and another country, neither of which is the country of residence of the taxpayer.

4.2. Anti-abuse rules

Countries are engaged in an effort to design anti-abuse rules to prevent the avoidance of taxation mainly, and specifically the design of rules to prevent the circumvention of the residence principle in order to obtain treaty benefits that are not supposed to be granted to taxpayers that are not residents of the contracting states.

In the next chapter I will analyze the rules designed by the tax treaty regime in order to prevent treaty shopping. The mechanisms that will be presented are the Beneficial Ownership concept; the Limitation on Benefits Provisions –LOB-, and the Principal Purpose Test –PPT-.

5. ANALYSIS OF THE ANTI-TREATY SHOPPING MECHANISMS

5.1. The Beneficial Ownership Concept

As explained in section 2.2., the vast majority of countries base their taxation systems on the residence and source principles, which could lead to double taxation issues when it comes to international transactions. Countries may avoid this problem either unilaterally adopting legislation that relieves certain items of income from tax or bilaterally by entering into tax conventions.

One of the main objectives of the Tax Treaty system is to prevent double taxation of the tax residents of the contracting states, by mutually agreeing to restrict their taxing rights under domestic tax laws. As a consequence of the application of tax relief in accordance with the tax treaty provisions, usually the contracting states agreed on partially, or fully, exempt passive income from withholding tax levied by the source country.

The idea behind the tax treaty system is that the benefits should only be granted to the residents of the contracting states, never to third parties, and that there must be a strong economic connection of the residents with the countries involved in a tax treaty. However, residents of third countries interpose the so called conduit companies in one of the contracting states in order to obtain tax benefits.

The purpose of this chapter is to analyze the OECD Model Convention approach to prevent a third country resident to access treaty benefits, contained in articles 10, 11 and 12 of the Model Convention. In a broad sense, these provisions allow the reduction of withholding taxes levied by the source state on passive incomes such as dividends, interests and royalties that flows from the source state to a resident of the other contracting state. In order to achieve that goal, the OECD Model Convention requires the recipient of the income to be the beneficial owner of the income.

The term "beneficial ownership" is not defined within the Model Convention, which represents a difficulty to interpret and apply the concept. The beneficial ownership is a test that uses an economic substance approach to determine whether the recipient of a revenue is the true owner of the income and not a resident of a third country.

5.1.1. History of the concept of Beneficial Ownership and origin within double tax conventions

5.1.1.1. Legal origin of the beneficial ownership concept

First, I will briefly refer to the origin of beneficial owner as a legal concept, then I will address its origins as an economic approach to prevent treaty shopping through the use of conduit companies (OECD approach).

The concept of beneficial ownership originated in equity law, a legal branch of English law. In English law, the beneficial ownership concept is used in the trust practice, where the definition of ownership can be divided in legal ownership in the head of the trustee, and economic or beneficial ownership in the head of the beneficiary.

As said, English law uses the concept of beneficial ownership primarily to establish a difference in the ownership rights of trustees and ownership rights of beneficiaries in a trust. This has a particular importance due to the fact that although the trustees as legal owners can administer the trust in itself, they only can perform their duties and hold the ownership for the benefit of the beneficiaries. Therefore, only the beneficiaries as beneficial owners will be entitled to appropriate the benefits of the trust. For the purposes of this thesis the point that we have to take into consideration is that from an economic and double tax conventions treaties point of view, there is clear distinction from legal ownership and beneficial ownership drawn by the right to benefit from a certain property.

The OECD approach made use of the beneficial owner concept to design an economic test to grant treaty benefits to a resident of a Contracting State. Please bear in mind that the definition of beneficial ownership in the case of English law, and other countries that adopt the same definition, is contained within a specific provision in domestic law, whereas, in the case of the tax treaty system, the concept was introduced in articles 10, 11 and 12 without any definition.

5.1.1.2. Origin within tax Conventions

Now, I will refer to the origins of the term "beneficial ownership" within the context of the tax treaty system.

The OECD first Model Convention was presented on 1963, but the term "beneficial ownership" was introduced until the OECD Model Convention of 1977[7]. As mentioned before, the term was included in the articles 10, 11 and 12 that deal with dividends, interests and royalties respectively, these provisions address the reduction of withholding taxes by the source state, and the term beneficial owner was introduced as a test to determine if a subject is entitled to treaty protection.

According to the commentaries on articles 10, 11, and 12 of the OECD Model Convention 1977, the purpose of the introduction of the concept was to clarify the meaning of the words ―paid….to a resident of a contracting state‖ in Articles 10(1), 11(1) and 12(1):

"Article 10

1. *Dividend **paid** by a company which is a resident of a Contracting State **to** a resident of the other Contracting State may be taxed in that other State.*
2. *However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the **beneficial owner** of the dividend the tax so charged shall not exceed…*[8]

Article 11

1. *Interest arising in a Contracting State and **paid to** a resident of the other Contracting State may be taxed in that other State.*
2. *However, such interests may also be taxed in the Contracting State of which it*

[7] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States.* Kluwer Law International, p. 54-91.
[8] OECD, *Model Tax Convention on Income and on Capital 2014,* article 10.

*arises and according to the laws of that State, but if the recipient is the **beneficial owner** of the interest the tax so charged shall not exceed…*[9]

Article 12

1. *Royalties arising in a Contracting State and **paid to** a resident of the other Contracting State shall be taxable only in that other State if such resident is the **beneficial owner** of the royalties.*[10]*"*

The commentary on articles 10, 11 and 12 makes it clear that the source State is not obliged to render its taxing rights just by the fact that the receiver of the income is a resident of the other Contracting State. The statement is that the recipient of the income must be the ***beneficial owner*** of the income.

5.1.2.Interpretation of the term Beneficial Ownership[11]

Applying the beneficial ownership test to interposed companies from an economic perspective seeks to prevent treaty benefits being passed on to residents of non-contracting states. According to this approach, treaty benefits on passive income can only be granted to residents of the contracting states that are ultimately the recipients of the economic benefits, irrespective of who is the immediate recipient of the income.

Articles 10, 11 and 12 of the OECD Model Convention apply the term beneficial owner as a provision to prevent the design of tax planning to allow residents of a third state incorporate a conduit company in a contracting state to obtain a withholding tax reduction. I will now refer to the use of conduit companies to invoke treaty protection.

5.1.3.Conduit companies strategies

From this point, I will explain the approach adopted by the OECD regarding the use of conduit entities to circumvent the tax treaty system, by making reference to relevant case law in various jurisdictions that will allow us to comprehend the interpretation of the term beneficial owner.

A conduit company is a company incorporated in the resident state, that stands between a company located in the source state that pays passive income (dividends, interests or royalties) to a company incorporated in the other contracting state, and a company located in another non-contracting which seeks to obtain the benefits of the tax treaty between the source state and the

[9] OECD, *Model Tax Convention on Income and on Capital 2014*, article 11.
[10] OECD, *Model Tax Convention on Income and on Capital 2014*, article 12.
[11] Van Weeghel S. (2010).IFA General Report.

resident state.

I will present an example to illustrate the use of a conduit company. Company A that is resident in State R derives passive income (dividends, interest or royalties) in a company resident in State S (source state). In this case there is no tax treaty between State R and State S, so State S levies withholding taxes on the flow of income to the resident state. However, there is a tax treaty between State S and State X, which reduces the withholding taxes on the passive income paid by residents of State S to residents in State X, where the foreign source passive income is tax exempt.

5.1.3.1. Direct conduit companies

In order to eliminate the withholding tax to passive income flowing from State S to State R, the company in State R incorporates a wholly owned subsidiary in State X and transfers ownership of all the assets and rights held on the State S (the company incorporated in State X has no economic substance). We can assume that as a legal owner of the passive income derived from State S, the State X company can claim relief from the withholding in State S, and then based on a contracting obligation, passes on the income to State R. For the purposes of the example, we can assume that the company incorporated in State X is a conduit company incorporated with the sole purpose of obtaining the benefits from the tax treaty between State R and State S, structure that has been called by the OECD as the ***direct Conduit*** tax planning scheme.

5.1.3.2. Stepping stone conduits

Another tax planning scheme is the so called ***stepping stone conduits,*** which has the same basic features of the direct conduit structure with the difference that in the example proposed, the State X will include in the passive income received by the conduit company in its gross taxable income. For the purposes of the example, State X will allow its resident fully deduction for the income that will pass on the State R resident. Then the outcome is that Conduit Company will not be charged with any tax in State X.

From the outlined example, one can conclude that the purposes of a conduit company are the avoidance or reduction of source taxation under the treaty between the source State and the resident State where the conduit company is incorporated; and passing on the income that was granted with the withholding tax reduction or elimination to the resident of a non-contracting State (beneficial owner).

As mentioned earlier, now I will present the relevant case that will allow to understand how to interpret the term beneficial ownership, and its difficulties:

5.1.4. Aiken Industries Inc. case[12]

5.1.4.1. Facts and circumstances

A company resident of the Bahamas, Ecuadorian Corp Ltd, which will be referred as "Ecuadorian", fully owned by a US resident company called Aiken Industries. Aiken owned all the shares in Mechanical Productos Inc (hereinafter Mechanical)Ecuadorian Ltd also owned all the shares of Compañía de Cervezas Nacionales (hereinafter CNN), a resident of Ecuador, which, in turn, beneficially owned all the shares in Industrias Hondureñas, which will be referred as "Industrias", a company resident of Honduras.

Ecuadorian made a loan to Mechanical in return for a promissory note. There was no double taxation treaty between the US and the Bahamas, Mechanical withhold taxes on the interest payments to Ecuadorian. Ecuadorian involved Industrias in the transaction and transferred the promissory note of Mechanical in return of several promissory notes.

The purpose of the transaction was to take advantage of tax benefits under US- Honduras double tax convention of June 26 of 1956, consisting in a withholding tax exemption on interest payments. The Internal Revenue Service (IRS) argued before the US Tax court that the existence of Industrias should be disregarded for tax purposes because Ecuadorian was deemed to be the true owner and the recipient of the interest. Aiken Industries replied that Industries fulfilled with the requirements to be held resident and was entitled to treaty protection under the US- Honduras Treaty.

The court then had to decide whether Industrias was entitled to treaty protection, in order to determine if Mechanical was exempt to withhold taxes on the interest payments to Industrias.

5.1.4.2. The court decision and the influence in the interpretation of the term "beneficial owner"

The US Tax Court when decided the *Aiken Industries* case did not refer to the term beneficial ownership as known today, because neither the US-Honduras double tax treaty or Article 11 of the OECD Model Convention of 1969 contained the term beneficial owner.

[12] *Aiken Industries v. Commissioner of Internal Revenue,* 56 T.C. 925 (1971)

Nonetheless, the court interpreted the wording of the US- Honduras Tax Treaty according to the language and context of the treaty, and concluded: *"As utilized in the context of article IX, we interpret the terms received by to mean interest received by a corporation of either of the contracting States as its own and not with the obligation to transmit it to another. The words 'received by' refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds"*[13].

To decide the case, the Court interpreted the object and purpose of the treaty to limit its benefits to the contracting states. One can assume that the interpretation of the US Tax Court became one of the starting points to the approach adopted later by the OECD in Articles 10, 11, 12 and the commentaries, where the beneficial owner was introduced to clarify the conduit companies' tax planning strategies. To summarize, the Court concluded: Industrias was a conduit company for the transfer of interest payments from Mechanical to Ecuadorian; Industrias had any *beneficial interest* in the payments it received[14].

5.1.5.Switzerland, the Re V SA case[15]

In the *V SA* case, the Swiss Federal Tax Appeal Commission also referred to the ordinary meaning of the term beneficial ownership taking and economic approach.

5.1.5.1. Facts and circumstances

Two British companies incorporated V SA in Luxembourg. V SA acquired from a US resident all the capital in I SA, a Swiss company, with a loan from the British shareholders. I SA made dividend payments in 1996 and 1997 to V SA. According to Article 10 of the Switzerland-Luxembourg double tax treaty of 1993, dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the *effective beneficiary* of the dividends the tax so charged shall not exceed….

When V SA applied for the refund of the withholding tax levied in the source state, the Swiss tax authorities denied the benefits from the Luxembourg- Swiss tax treaty based on the fact that all the dividends received from the Swiss subsidiary were used to pay interests and other charges, and that the company itself admitted to the Swiss tax authorities that Luxco was not

[13] *Aiken Industries v. Commissioner of Internal Revenue,* 56 T.C. 925 (1971)
[14] Van Weeghel S. (1998). *The Improper Use of Tax Treaties, With Particular Reference to the Netherlands and the United States*. Kluwer Law International, p. 60
[15] *Re V SA 4 ITLR 191 (The Federal Commission of Appeal in Tax Matters, Switzerland).*

the beneficial owner of the dividends received.

As Adolfo Marin States, in this case, *"the Commission concluded that a company which transfers to a third person, in the form of deductible interest and charges, the dividends it receives without having the power to fully dispose of them is not the "beneficiary" of the income. This definition of beneficiary, the Commission noted citing the 1986 OECD Conduit Report, is close to the concept of beneficial owner, which is the "person who economically has the benefit of an item of income. Such a concept "is not applicable to conduit companies like intermediaries between the debtor and the person who will ultimately receive the item of income". Thus, Luxco could not be granted the refund requested since it was not a beneficiary or beneficial owner for the purposes of the Luxembourg- Switzerland DTC"*[16].

The Swiss Commission also noted that V SA did not provide all the information requested by the tax authorities. The annual reports of the company showed that the entire income it received was paid as interest and other charges to the British shareholders, and that the only significant asset was its holding on I SA. Taken into consideration all the facts and circumstances, the Commission concluded that V SA was only a conduit company and therefore was not entitled to treaty benefits.

As we also saw in the *Aiken Industries* case, the Swiss Federal Commission applied an economic approach to interpret the term beneficial ownership as fundamental requirement to access treaty benefits.

5.1.6.The Indofood case[17]

5.1.6.1. Facts and circumstances

Indofood was an Indonesian corporation that wanted to raise funds by issuing loan notes on the international market in 2002. If Indofood had decided to issue notes, it would have to withhold 20 per cent tax on interest payments to note holders whose country of residence did not have a double tax agreement with Indonesia.

Under the Indonesia-Mauritius double tax treaty of 1996, Article 10(2) of the treaty limited Indonesian withholding tax on interest payments by 10 per cent. In order to reduce the tax cost, Indofood incorporated a Mauritian subsidiary.

The loan notes were issued for five years and were governed by the civil law of the United

[16] Marin Jimenez, A. (2010). Beneficial Ownership: Current Trends, *World Tax Journal*, 41
[17] *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch [2006] EWCA Civ 158.*

Kingdom. Their conditions required Indofood to pay interest to the Mauritian resident, which in turn had the obligation to transfer the interest to JP Morgan, a bank in the United Kingdom, whose purpose in the transaction was to act as the trustee and principal paying agent for the note holders.

In 2004, the Indonesian government gave notice to terminate the Indonesia-Mauritius double tax treaty. Since the consequence of the termination of the treaty is that Indofood as from January 1st of 2005 would have had to withhold tax at 20 per cent, it decided to redeem the notes.

To prevent the sudden redemption of the notes, JP Morgan proposed to Indofood to incorporate a Dutch subsidiary, hereinafter Dutch BV, and should assign Dutch BV the ownership of its debt to the Mauritian resident. The structure was designed so Dutch BV would be entitled to an Indonesian withholding tax reduction under Article 10(2) of the Indonesia-Netherlands double tax treaty of 29 January 2002.

The condition to proceed with the structure was that Dutch BV could be regarded as the beneficial owner of the interest from the source states (Indonesia). Indofood requested the advice of the General Tax Director in Indonesia on the issue of whether Dutch BV would be recognized as the beneficial owner under the Indonesia-Netherlands double tax treaty, the answer was negative based on the substance over form principle of Indonesian law and the application of anti-abuse rules.

The dispute went to the Court of Appeal in the United Kingdom. In order to determine whether establishing Dutch BV was a reasonable measure, and therefore could be considered the beneficial owner of the interest payments from Indofood under the Indonesia- Netherlands double tax treaty. The court held that Dutch BV could not be regarded as the beneficial owner of the interest.

The main points of the decision were:

- Beneficial owner test refers to the actual owner of passive income such as Dividend, Interest, or Royalty that has the full privilege to directly benefit from the income.

- *"The term "beneficial owner" is to be given an international fiscal meaning not derived from the domestic laws of the contracting states. This is really an important feature of the decision, which ruled out attributing t the term the meaning it has under*

English law"[18].

- The Court determined as a result of the structure that the Dutch BV could never derive any direct benefit from the interest payable to the Indonesian Company.

The court began with an examination of the legal structure and found that Dutch BV would be contractually obliged to pass on its income to JP Morgan. It did not, however, consider this finding to be conclusive. In this case was clear that the Court focused on investigating the economic, commercial and practical planning behind the structure.

The court noted a particular situation, after the first interest payment to the Mauritian subsidiary, Indofood had been paying interest directly to JP Morgan, these fact lead the court not to consider the Dutch BV to have the full privilege to directly benefit from the income and therefore be qualified as the beneficial owner. Therefore, the court considered the Dutch BV as a trustee or administrator of the income, because neither the Mauritian company nor the Dutch BV could not derive any direct benefit from the interest payment from Indofood. The court assumed that these conclusions were in accordance with the object and purpose of the Indonesian double tax agreements with Mauritius and the Netherlands.

The approach of the Courts in the Indofood case shows that the main issue in conduit company cases is whether the arrangement is consistent with the object and purpose of a double tax agreement. The court considered the arrangement as a whole to analyze the economic implication of the transactions involved in the structure to finally conclude that the Dutch BV and the Mauritian company were not the beneficial owner of the interest payments.

5.1.7.Conclusion

It seems to me that the term "beneficial ownership" in the context of the treaty system is an appropriate instrument to test whether the recipient of the passive income is a company in a third country.

As we saw in the cases presented, the object and purpose of double tax treaties requires courts to analyze facts in a strictly economic perspective. To do so, we can conclude that the courts, (i) test the substantive business activity of the recipient of the passive income, to determine if it is entitled to a reduction in withholding tax, in other words, courts do not consider letterbox companies to be the beneficial owner, (ii) courts determine if a the recipient of the income has

[18] Marin Jimenez, A. (2010). Beneficial Ownership: Current Trends, *World Tax Journal, 44*

control over passive income derived from the source company, or if it was only incorporated to passing on the income to a non-contracting resident.

The "beneficial ownership" concept in essence refers to the right to appropriate the benefits of an income. In tax treaty system, the concept operates as an economic test applied to counter treaty shopping strategies through conduit companies. One of the main challenges of the treaty system is to ensure that treaty benefits are limited to residents of the contracting states. In the context of double tax conventions, the beneficial ownership test ensures that a resident who is invoking a withholding tax reduction owns the income and that the purpose is not to pass on the income to a resident of a non-contracting state.

5.2. Limitation on Benefits (LOB)

In this chapter I will provide an overview of the approach to prevent treaty abuse taken by the US in their bilateral tax treaties and the approach proposed by the OECD in BEPS Action 6. Specifically, on the Limitation on Benefit Rules (LOB).

As explained, anti-avoidance rules are a tool used to counter the abusive conduct of taxpayers in order to eliminate or reduce tax charges on international transactions. Often, taxpayers structure their businesses or transactions in such a way result with as little tax as possible. However, when the only or the primary reason for choosing the structure is tax motivated it should be considered to be an abusive behavior, and those circumstances must be prevented by the countries engaged in tax treaties through the use of anti-avoidance rules.

5.2.1.Concept and LOB provisions in the US

The LOB provisions recognizes that countries engage in tax treaties with the aim to provide treaty benefits to the residents of the contracting states. However, the LOB provisions through the introduction of additional requirements, intent to determine who qualifies as a resident of one of the contracting states in order to be entitle to treaty benefits.

The US position is that specific and detailed provisions must be included in a tax treaty in order to prevent the abusive access to treaty benefits to non-contracting states.

The US in their 1981 model Convention, later amended in 1996 and 2006, contained LOB provisions. As a general rule, and as explained in previous chapters, non-contracting states access the benefits of a tax treaty between two contracting states by incorporating a legal entity (conduit company) in of the contracting states, with no other purpose than obtaining the treaty benefits, that is, with no substantial reason for establishing the tax structure, which is known as "treaty shopping".

The LOB provision contained in Article 22 of the US Treaty Model determines whether an entity has a sufficient nexus to the contracting state to be treated as a resident for treaty purposes. It is worth noting that the intention of the LOB provision is not modifying the definition of resident in tax treaties, but "*it may be thought of as an attempt further to refine the residence concept, disqualifying those legal entities which, although in principle subject to the residence country's tax jurisdiction, are positioned so that their income is not in fact sufficiently subject to taxation in that country to warrant the extension to them of treaty reductions of sourced-based taxation.*[19]"

From the US perspective, the treaty-shopping situations were characterized by three circumstances. (i) The beneficial owners of the legal entity were not residents of the country in which that entity was incorporated; (ii) there is no real economic connection with the contracting state; and (iii) the companies or other legal entities involved were subject to little or no tax in the treaty jurisdiction[20].

The concern of the US at the time was that through those structures, residents of non-contracting states had free access to the US tax treaty network, and that those countries without a tax treaty with the US will have no incentive to enter into one, agreeing on the reciprocal concessions to the US and its investors which the treaty making process implies, due to the fact that they have effective access to treaty benefits via tax planning.

To counter this situation, the US Treasury Department suggests the inclusion of a "limitation on benefits" clause designed to prevent treaty shopping. The changes to the LOB clause over the years (1996 and 2006) are off course directed to make it more difficult for non-contracting states residents to benefit inappropriately from a US tax treaty.

The initial requirements of the US LOB provisions were very complex and difficult to meet. For instance, the 1980 US Model included a LOB provision in article 16, denying treaty benefits to an entity resident in one of the contracting states if more than 75% of the beneficial interest in the entity were not owned by individuals resident of the same state and no substantial part of

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[19] American Law Institute (1992), *International Aspects of US Income Taxation- Proposals on Income Tax Treaties- Part II*, ALI Philadelphia, p. 150

[20] American Law Institute (1992), *International Aspects of US Income Taxation- Proposals on Income Tax Treaties- Part II*, ALI Philadelphia, *p. 151*

its income was paid out from the entity as interest, royalties or other deductible payments to residents of a third country. Those two tests are known as the ownership and the base erosion tests. They require that a substantial part of the proceeds of the resident company remain in the country.

Studies and the application of these rules over those first years, led to believe that such strict requirements were actually an obstacle to legitimate structures that were in fact real businesses, but due to the ownership test, they were required to comply with a high ownership threshold. In response to that concern, the 75% threshold was reduced to 50%, in treaties signed by the US in the 1990s.

The LOB articles included in recent tax treaties are based on the 2006 US Model Tax Convention, which included other requirements such as the public trading test, the derivative benefits rules, and provisions regarding triangular arrangements.

Another feature of Article 22 of the 2006 US Model Convention is that it contains a list of "qualified persons" that are persons entitled to the benefits of the tax treaty. Nevertheless, those persons who do not fall within the scope of the qualified person definition, could be entitled to the treaty protection if certain requirements are met.

The purpose of all these requirements, is to limit treaty benefits to those entities that are residents of the contracting states, and that are really taxable subjects in the countries involved in a tax treaty.

The LOB provisions in general then consists in various tests designed to determine whether a person qualifies as a resident for treaty purposes. There are four basic tests included in a LOB provision, and that I will proceed to explain. (i) Ownership test; (ii) Base erosion test; (iii) Publicly traded test; and, (iv) Business nexus test.

5.2.1.1. The ownership test

The ownership test generally requires that 50% or more of the beneficial interests (vote and value of the corporation's shares), is owned directly or indirectly by persons resident in the same country as the company.

The aim of this test is to ensure that the taxation could be imposed by the resident state, that is, the residence tax rules will apply and therefore the income will be taxed at least once.

5.2.1.2. Base erosion test

The base erosion test usually determines that less than 50% of the company's gross income is paid, directly or indirectly, to persons who are not residents of the same country as the company. By achieving this the LOB provision will prevent that the company is used as a conduit (*"if more than a specified percentage of the entity's gross income is used to make deductible payments to persons not resident in the treaty country"*[21]*)*. This test is the second tier of the ownership test, that is, even if the ownership test is met, the taxpayer in order to have access to treaty benefits will have to meet the base erosion test.

5.2.1.3. Publicly traded test

If a comprehensive LOB provision was only formed by the ownership and base erosion test, entities with a legitimate commercial or business nexus in the residence state would not fulfill the requirements and will not get treaty access. This is especially relevant for public corporations to whom it is really difficult to establish the identity and residence of their individual shareholders. Due to these circumstances, the LOB provision also includes a Publicly Traded Company Test.

The main reason for the existence of the "publicly traded" test is that the public record of operations and financial statements of a publicly traded company could provide protection against the use of the company as a conduit, and therefore gives some substance to the fact that the outgoing payments to third countries will be legitimate.

As explained above, without the publicly traded company test, it will be almost impossible for public companies to qualify for treaty benefits because they could not identify their owners, nor their residence.

Under this rule, a company that is a resident of a contracting state qualifies for treaty protection, regardless to whether or not any other tests are satisfied, if there is substantial and regular trading of its principal class of stock on an approved stock exchange located in one of the two

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[21] American Law Institute (1992*), International Aspects of US Income Taxation- Proposals on Income Tax Treaties- Part I*I, ALI Philadelphia, p. 156

treaty states, for instance in the case of the US NASDAQ, or more exchanges in the other contracting state, and other exchanges as may be agreed by the competent authorities.

The LOB provision included in the 2006 US Model Convention applies only if the principal class of a company's shares are traded on a recognized stock exchange located in the company's residence state. However, in some tax treaties the Publicly Traded Company Test may be satisfied by trading on a stock exchange located in a company's residence state in other jurisdictions that are considered to be part of the economic area of the treaty country.

5.2.1.4. The "Business Nexus" Test

The Business Nexus Test requires that the company is engaged in an active trade or business in its country of residence, then those activities in that country must be substantial in relation to its source state activities, if the payer is a related party, and the income is derived in connection with or incidental to that trade or business.

Through this test, the company will have treaty benefits *"with respect to items of income if that income is derived in connection with, or is incidental to, the active conduct by the legal entity of a trade or business in the residence country. The intent of such a provision is to allow an entity carrying on business in a country to secure treaty benefits for functionally related investments made in the source country without regard to whether its owners reside elsewhere or whether it is publicly-traded. In these "active business" cases, it is presumed that the legal entity is subject to substantial tax in its country of residence, and the functional relationship between the business it conducts there and the treaty protected income which it receives is taken as evidence that the entity is not merely serving as a - conduit for income which might "normally" have been routed elsewhere"*[22].

The Limitation on Benefits provisions under the US approach are an effective measure to counter only specific abusive conduct by taxpayers who design structures with the only purpose to obtain treaty benefits.

The problem with the US position is that the LOB provision tends to be very complicated and specific, and do not address all the forms of treaty abuse, giving rise to tax planning opportunities because of their inflexible nature.

[22] American Law Institute (1992*), International Aspects of US Income Taxation- Proposals on Income Tax Treaties- Part II*, ALI Philadelphia, p. 159-160

Now I will refer to the approach taken by the OECD to counter treaty abuse.

5.2.2.The Limitation on Benefit provision according to BEPS ACTION 6

In 2013, the OECD started to work on the issue of profit shifting and base erosion. The main purpose of the project is to establish effective ways to ensure that profits are taxed in the jurisdiction where the economic activities are performed and where the value is created. According to the OECD, the project is a result of the growing necessity to tackle aggressive tax planning aimed to circumvent the compliance of tax regulations in order to obtain benefits through the improper use of tax treaties or taking advantage of mismatches between domestic tax law systems.

The BEPS Action Plan contains 15 actions with proposals in different areas, such as, anti-avoidance, transfer pricing, and improper use of tax treaties, to provide Member States with solutions to counter the profit shifting to the so called tax heavens.

One of the main purposes of the BEPS project is to prevent treaty abuse, in particular treaty shopping, which is addressed by Action 6. The BEPS Action 6 is dedicated to "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances", as the OECD considers tax treaty abuse as one of the most important sources of BEPS concerns[23].

In September 2014, the OECD published the comments by Member States to the draft report with the recommendations on this matter. After the discussions, the final draft of BEPS Action 6 was published October 2015, the report contains three areas to work on, in order to counter treaty abuse:

a. The design of treaty provisions and domestic rules to prevent granting of treaty benefits in inappropriate circumstances;

b. A clarification that the treaties are not intended to be used to generate double non-taxation;

c. Identifying the tax policy considerations that countries should consider before engaging in tax treaties.

[23] OECD, *BEPS Action 6 Final Report*, p. 13

The implementation of the proposals included in BEPS Action 6 will take place in form of changes in the OECD Model Convention.

First, I will start analyzing the objective of preventing treaty abuse as an objective of BEPS Action 6. To prevent the use of treaties in inappropriate circumstances BEPS Action 6 presents two types of cases:

(i) Cases where a person circumvents provisions of the treaty itself, and;

(ii) Cases where a person circumvents the provisions of domestic tax using treaty benefits.[24]

As De Broe states[25], the cases where a person circumvents provisions of the treaty itself, mainly consist of treaty abuse through *treaty shopping*, that is, situations in which a person (non-contracting state) who is not entitled to the benefits of certain tax treaty, circumvents the residency requirement through the incorporation of a conduit company in one of the contracting states, to obtain treaty protection; or, *rule shopping*, that consists in transactions made by a person already with access to treaty benefits, who designs its transactions in such a way to obtain more favorable benefits within the tax treaty. In both of the situations described, two elements are present, (i) a person is subject to a domestic law that derives in tax liability; and (ii) a person improperly invokes treaty benefits to avoid that tax liability. It is worth noting that in this kind of treaty abuse situations, the conduct of the taxpayer is motivated by obtaining the benefits of a tax treaty.

As a general rule, to have access to treaty benefits the main requirement is to be resident of one of the contracting states. The residency condition requires the taxpayer to be liable to tax in the corresponding contracting state. Therefore, treaty shopping in its most basic form consists in the circumvention of the resident requirement, by the use of conduit companies by non-contracting parties to obtain treaty protection. The approach of the OECD to prevent treaty abuse is the inclusion of specific provisions in the tax treaties. According to the BEPS Report, three action are recommended in order to attack treaty abuse:

[24] OECD, *BEPS Action 6 Final Report*, p. 17.
[25] De Broe L. and Luts J (2015), BEPS Action 6: Tax Treaty Abuse, *Intertax*,124-125

a) Amendment of the title and preamble of the OECD Model Convention in order to clearly state the purpose of the tax treaties is not intended to generate opportunities for treaty abuse.

b) Incorporation of a Limitation on Benefits provisions (LOB).

c) Incorporation of the Principal Purpose Test (PPT) as a General Anti-Abuse Rule (GAAR), to address those situations of treaty shopping that the LOB would not cover.

5.2.2.1. The LOB provision

As explained in section 5.2.1., the US has developed as its main approach to counter treaty shopping, the Limitation on Benefits provision. Please note that the LOB provisions has spread to be also found in other tax treaties, following the US version. It is worth noting that the OECD included in the commentary of Article 1 of the Model Convention the LOB clause, which is similar to the US clause. It is the intention of this chapter to analyze the version of the LOB article provided in the BEPS Action 6 report.

The OECD recommendation consists of the inclusion of a specific anti-abuse rule as the Limitation on Benefits to prevent granting treaty benefits in abusive situations, by establishing various requirements and thresholds to be entitle to treaty benefits. Under the current OECD Model Convention, the taxpayers in order to have access to the treaty benefits have to fulfil the conditions set forth in articles 1, 3 and 4 of a Model Convention. The idea of the LOB provision is that meeting the requirements of articles 1, 3 and 4 is no longer enough. The proposal is that in order to have treaty protection a taxpayer must be regarded as a "qualified person" by meeting the requirements of the LOB provision, basically because the OECD considers that the requirements on the current articles are easy to circumvent.

Paragraph 1 of the proposed LOB provision establishes that in order to have access to treaty benefits, a resident of a contracting state must be a "qualified person". Paragraph 2 of the proposed LOB article included in the BEPS Report, sets out the definition of "qualified persons" who automatically have access to treaty benefits. The articles stipulates:

2. "[Definition of situations where a resident would be a qualified person, which would cover

a) an individual;

b) contracting states or its political subdivisions and entities that it wholly owns;

c) certain publicly-listed entities and their affiliates (stock exchange test)

d) certain charities and pension funds

e) other entities that meet certain ownership requirements (ownership and base erosion test)

f) *certain collective investment vehicles][26]"*

In particular, in the case of the requirements of subparagraphs c) and e) contains two tests (i) the stock exchange test, and (ii) the ownership and bass erosion test, which a person must fulfil in order to be a qualified person, which I will explain in a specific section bellow.

However, if a resident does not meet the above requirements, he can still have access to treaty benefits, if he fulfils the requirements of paragraphs 3, 4 or 5 of the LOB provision.

Paragraph 3, contains the activity test, with respect to a specific item of income. According to this test, the resident has to be engaged in the active conduct of a business in the residence state.

Paragraph 4, is the so called "derivative benefits clause", that allows to certain entities owned by residents of other states to obtain treaty benefits which they would have obtained also if they had invested directly.

And, Paragraph 5, contains a discretionary relief clause, giving the possibility to grant treaty benefits to non-qualified residents on request of a taxpayer. According to this rule, the tax authority may grant benefits to taxpayers under discretion, to those who fail the tests, but should be granted treaty benefits as the taxpayer did not have as one of their principal purposes the obtaining of treaty benefits.

In general, a corporation or a company, would be considered to be a qualified person and therefore eligible for treaty benefits if it meets the following objective tests: (i) publicly traded test; (ii) the ownership test and the base erosion test; (iii) active business test; (iv) derivative business test, together with the base erosion test; and, (v) corporations that nevertheless do not fall within the scope of the "qualified person" concept, but which are considered to be bona fide by tax authorities under the discretionary relief clause (paragraph 5)[27].

[26] OECD, *BEPS Action 6 Final Report*, p. 21

[27] Jiang Q. (2015), Treaty Shopping and Limitation on Benefits Articles in the Context of the OECD base Erosion and profit Shifting Project, *Bulletin for International taxation,* 139-148

Because of these tests, the LOB provision is highly complex, and can be difficult to apply for some countries tax authorities, but offers legal certainty in granting treaty protection. As the OECD admits in the Report: *"The administrative capacity of some countries might prevent them from applying certain detailed treaty rules and might require them to opt for more general anti-abuse provisions"*[28]

The LOB provision is so complex, due to the fact that under this approach the OECD do not rely on the intention or purpose of the taxpayers, thus including a set of objective rules. These objective requirements are very technical and complicated to administer, such as the ownership test, but as said, gives certainty to taxpayers to determine whether or not they have access to the treaty benefits.

In the following sections I will address the tests included in BEPS Action 6 provision in more detail:

5.2.2.2. The publicly traded company test

The publicly traded company test is contained in paragraph 2(c) of the LOB article in the BEPS Action 6 report. The rationale of this test is that the shares of a publicly traded company are as a general rule subject to strict legislation, and companies listed on a stock exchange usually have a strong connection with the state of incorporation, which gives to the OECD sufficient reason to conclude that these companies are unlikely to be conduit companies incorporated only for treaty shopping reasons.

According to this test, a company or other entity can be considered as a qualified person if:

(i) The principal class of its shares (and any disproportionate class of shares) is regularly and primarily traded on one or more recognized stock exchanges located in the contracting state in which the company is resident;

(ii) The principal class of its shares is regularly traded on any recognized stock exchange and at the same time, the company's or entity's primary place of management and control is in its resident contracting state; or

[28] OECD, *BEPS Action 6 Final Report*, p. 14

(iii) At least 50% of the company's or entity's shares are owned, directly or indirectly by five or fewer publicly traded companies that satisfy either requirements (i) and (ii)[29].

As mentioned, the reason of this test is that publicly traded companies are unlikely to be conduit companies incorporated only for treaty shopping reasons, because these kind of companies are subject to severe rules, but also serves to tax authorities as an effective tool to monitor these companies.

5.2.2.3. The ownership test and the base erosion test

The ownership test and the base erosion test are contained in the paragraph 2(e) of the proposed LOB article, and it comprises two cumulative tests that need to be complied with. The two tests ensure that a majority of the equity (the ownership test) and non-equity (the base erosion test) are owned by residents of the contracting states.

5.2.2.3.1. The ownership test

The ownership test requires that at least 50% of the voting power and value of the company's shares must be owned, directly or indirectly, by 'qualified persons'.

5.2.2.3.2. The base erosion test

The base erosion test is satisfied when less than 50% of the company's gross income for the taxable period, is paid to persons who are not qualified residents of either contracting state in the form of deductible payments.

This test requires a sufficient percentage of local ownership and the absence of significant base erosion, in other words, the taxpayer must have a real nexus in the contracting state.

It is very important to note that, in order to be effective, the ownership test must always be accompanied by the base erosion test. Otherwise, tax planning opportunities are exploited, in the sense that the ownership test requires a sufficient percentage of local ownership ensuring as a first tier that the beneficiaries of a transaction are residents of the contracting states, but it is necessary to take into consideration as a second tier the base erosion, since the treaty shopping

[29] Jiang Q. (2015), Treaty Shopping and Limitation on Benefits Articles in the Context of the OECD base Erosion and profit Shifting Project, *Bulletin for International taxation,* 144

can also arise when significant deductible payments are paid to related parties residents in a non-contracting state.

5.2.2.4. The active business test

The active business test applies to "active conduct of a trade or business", that is, the company have to perform some substantive economic operations in the residence state, and not simply performing managing activities of its subsidiaries. Therefore, the LOB provision requires that the business activity performed in the residence state is substantial in relation to the business in the source state. The rationale of this provision is that the OECD presumes that treaty shopping is unlikely to happen in relation to active businesses. The OECD under this test assumes that a legal entity is subject to substantial tax in its country of residence, and that there is a strong relation between the business conduct in the state of residence and the income derived from the state of source, which leads the OECD to believe that the company is not serving as a conduit company to treaty shopping. Then, the active business test is based on the fact that when a transaction has economic substance, and is not artificially planned for tax avoidance purposes, it should not be considered as treaty shopping.

The active business test applies to each item of income separately. Qunfang presents an example to illustrate this test: *"a company (A Co), which is a resident of one contracting state is entitled to treaty benefits: (1) if A Co is engaged in an active business and trade in its residence slate and the income derived from the other contracting state is derived in connection with, or incidental to, A Co's trade or business; and (2) where the income derived by A Co is from a trade or business activity conducted by A Co in the other contracting state or arising in the other contracting state from an associated enterprise, the condition in (1) should be narrowed to be that A Co's trade or business is substantial in relation to the trade or business carried on by A Co or the associated enterprise in the other contracting state. Whether a trade or business activity is substantial is determined based on all the facts and circumstances. The article also provides that activities conducted by persons connected to a person should be deemed to be conducted by such a person"* [30].

[30] Jiang Q. (2015), Treaty Shopping and Limitation on Benefits Articles in the Context of the OECD base Erosion and profit Shifting Project, *Bulletin for International taxation,* 146

5.2.2.5. The derivative benefits test

The derivative benefits test entitles the "equivalent beneficiaries" that are eligible for equivalent or more favorable benefits under a parallel tax treaty between the source state and the third state to treaty benefits.

According to the commentary on Paragraph 4 of the LOB provision, "*this derivative benefits test entitles certain companies that are residents of a Contracting State to treaty benefits if the owner of the company would have been entitled to at least the same benefit had the income in question flowed directly to that owner. To qualify under this paragraph, the company must meet an ownership test and a base erosion test"*[31].

An equivalent beneficiary is a resident of a third state who *"(i) would be entitled to treaty benefits according to the LOB article in the tax treaty between that third state and the state in respect of which the benefits of the relevant tax treaty are being claimed, and, if there is no LOB article in such a tax treaty, the resident must satisfy the LOB article in the tax treaty in respect of which the benefits of the relevant tax treaty are being claimed, and (ii) with regard to dividends, interest and royalties, is, under the tax treaty between the third state and the state in respect of which the benefits of the tax treaty are being claimed, subject to a rate of tax that is at least as low as the rate for such income under the relevant tax treaty"*[32].

The OECD believes that treaty shopping does not exists if the taxpayer decided to pay the income directly to the final recipient, and those recipients would be entitled to the same treaty benefits.

The derivative benefits test requires a certain level of ownership by equivalent beneficiaries. Under this test a company resident in one contracting state is entitled to treaty benefits if: (i) at least 95% of the aggregate voting power and value of its shares is, directly or indirectly, owned by seven or fewer equivalent beneficiaries (ownership test); and (ii) less than 50% of the company's gross income, as determined in the company's state of residence is paid to persons who are not qualified residents of either contracting stale in the form of deducible payments (base erosion test).

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[31] OECD, *BEPS Action 6 Final Report*, p. 42
[32] Jiang Q. (2015), Treaty Shopping and Limitation on Benefits Articles in the Context of the OECD base Erosion and profit Shifting Project, *Bulletin for International taxation, p. 147*

5.2.2.6. The discretionary relief clause

The LOB provision also includes a residual rule that qualifies entities or transactions that fail to comply with tests explained in the sections above. These persons may nevertheless be entitled to treaty benefits at the discretion of tax authorities. This can be characterized as the subjective test within the LOB clause.

The OECD do not provide an explanation for this test. Nonetheless, the US explained the rationale for this clause in the technical explanation to article 22 of the 1996 US Model Convention:

> *"this discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice or long standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits*"[33].

According to the commentary on the discretionary relief included on the report, the authorities may grant benefits to a taxpayer who does not meet the LOB requirements, if it is justified that such taxpayer did not have as "one of its principal purposes" obtaining benefits under the tax convention. Paragraph 65 of the commentary on the detailed version states:

> *"65. The reference to "one of the principal purposes" in paragraph 5 means that obtaining benefits under a tax treaty need not be the sole or dominant purpose for the establishment, acquisition or maintenance of the person and the conduct of its operation. It is sufficient that at least one of the principal purposes was to obtain treaty benefits. Where the competent authority determines, having regard to all relevant fact and circumstances, that obtaining benefits under the Convention was not a principal consideration and would not have justified the establishment, acquisition or maintenance, of the person and the conduct of its operations, it shall treat that person as being entitled to these benefits, or benefits with respect to a specific item of income or capital. Where, however, the establishment, acquisition or maintenance of the person and the conduct of its operations is carried on for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining*

[33] *US Model Tax Convention on Income: Technical Explanation*. (1996), Models IBFD, p. 116-117

benefits under other treaties will prevent the obtaining of benefits under one treaty from being considered a principal purpose for these operations"[34].

When it comes to the application of the discretionary relief, the tax authorities have a rather broad scope to determine when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining tax benefits was not one of the principal purposes of any arrangement or transaction, in order to grant treaty benefits. In my opinion, the discretionary relief gives the opportunity to identify after a serious analysis those legitimate structures that nevertheless fail to meet the LOB requirements, do not have the purpose to circumvent the treaty provisions in an inappropriate manner.

On the other hand, the fact that this paragraph grants wide discretion to the competent authorities to determine if a taxpayer can be granted tax relief under a tax convention, can render meaningless the LOB provision, in the sense that the paragraph fail to provide objective criteria for the tax authorities to determine when the provision shall apply.

The criteria for a discretionary decision are laid out in the commentaries on the discretionary relief clause, establishing that the resident who is not entitled to treaty benefits may request the tax authorities of the country to grant the benefits to exercise its discretion, the competent authority is supposed to take into account all relevant facts and circumstances.

In my opinion, the proposal is not sufficient to provide specific legal basis to the discretionary relief, it seem to me that the commentaries provide through examples a guidance to tax authorities in reference to the facts and circumstances to be taken into account by the authorities in exercising its discretion, based mainly on tax business reasons. The OECD recognizes that is impossible to provide a detailed list of all the facts and circumstances that the tax authorities have to take into account to determine if the taxpayer is eligible for the discretionary relief, and encourages countries to adopt guidelines on the types of cases that should be considered to qualify for discretionary relief.

5.3. The Principal Purpose Test (PPT)

The OECD recognizes that a standalone LOB provision may not be enough to counter all the forms of treaty shopping. Therefore, the OECD proposed the inclusion of the Principal Purpose Test (PPT) as an instrument to address other forms of treaty shopping not covered by the LOB

[34] OECD, *BEPS Action 6 Final Report*, p. 44-45

clause. The PPT clause takes the form of a general anti-abuse rule, to prevent tax treaty abuse by testing the principal purposes of the transactions.

Paragraph 7 of the BEPS reports, states:

> *"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.[35]"*

First, it is important to understand the meaning of the term "benefit under this Convention" included in the PPT rule. Paragraph 7 of the commentary on the PPT states that the rule includes all limitations on taxation imposed on the State of source under Articles 6-22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations.

According to Lang, the scope of application of the PPT rule is limited to the respective treaty. The rule refers to the "benefit under this Convention". Therefore tax benefits granted on the basis of domestic tax law could not be denied by invoking that rule. *"It is equally inconceivable that that rule could resonate with other treaties and provide a legal basis for denying benefits under other treaties concluded by one of the contracting states or even by completely different states. A rule in a bilateral treaty corresponding to Article X(6) cannot even cover other international law treaties concluded between the same contracting states - even if they have the same or similar personal or substantive scope of application*"[36].

On the other hand, after determining that the PPT rule is restricted to the scope of the corresponding tax treaty, it is important to remark that the PPT rule does not extend to the entire treaty, that is, if the PPT rule is applied, the benefit will not be granted in respect of an item of income.

Second, from the wording of the article, one can realize that the PPT rule contains two tests, (i) Subjective test, and (ii) Objective test:

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[35] OECD, *BEPS Action 6 Final Report*, p. 55

[36] Lang M. (2014), BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties, *Tax Notes international*, 656

5.3.1.1. Subjective test:

According to the article, a benefit under the convention shall not be granted if after analyzing all the facts and circumstances, obtaining a benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

The current OECD commentary on article 1 to the Model Convention in its paragraph 9.5, already contains guidelines regarding the main purposes of a given transaction or arrangements, stating that *"A guideline principle is that the benefits of a double convention should not be available where a main purpose for entering into certain transaction or arrangement was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant Provisions*[37] *"*.

Kok states that the PPT rule included in BEPS Action 6 recognizes the concept of *"fraus conventionis"* of the Dutch doctrine, that stipulates: *"Acting in fraudem conventions in tax law, is when a taxpayer uses a scheme/transaction with the sole, of or at least, essential purpose to obtain the desired tax consequences on the basis of the relevant tax treaty, whilst that scheme/transaction defeats the object and purpose of the treaty"*[38].

As Kok also states, there is a difference between the current commentary on article 1 and the proposed PPT rule, consisting in the PPT rule requires that "one of the principal purposes" of the transactions is obtaining the tax benefit, while under the *"fraus conventionis"* doctrine it is required that the "sole or essential purpose" was obtaining the tax benefit, being the result that the PPT rule is broader in the application of the subjective test.

According to the paragraph 12 of the commentary on the PPT rule*, "the reference to "one of the principal purposes" in paragraph 7 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit"*[39].

The proposal of the OECD has been criticized by scholars, for instance, De Broe and Luts consider that the rule must be applied if the treaty benefits are the only or main purpose of the transactions or arrangements. It is worth noting that also as Kemmeren states, the PPT rule

[37] OECD, *Commentaries on the Articles of the Model Tax Convention, commentary on article 1*
[38] Kok, R. (2016). The Principal Purpose Test in Tax Treaties under BEPS 6. *Intertax Volume 44(5)*. 407
[39]OECD, *BEPS Action 6 Final Report*, p. 58

could be against the concept of abuse of the ECJ, which states that obtaining the tax benefits has to be the essential objective of the transaction[40].

Now, when it comes to the application of the subjective test, we have to determine when 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"*.

It seems to me that to fulfil this part of the subjective test, taxpayers will face a difficult challenge, in the sense that even if the transaction or arrangement is motivated by different purposes other than tax benefits from a tax treaty, the arrangement will still fall under the scope of the PPT rule.

In my opinion, although the main purpose of the Tax Conventions is to prevent double taxation, and tax avoidance, it is also true that another important objective of tax treaties is facilitate cross border transactions, so I find the OECD proposal contradictory to this purpose, especially having in mind that in my view, under normal circumstances, cross border transactions will always have as one of the purposes the access to treaty benefits, otherwise governments as representatives of its residents would not have an incentive to engage in the tax treaty in the first place.

As a result of the proposal, one can assume that burden of proof is shifted to the taxpayers, due to the fact that even if the tax authorities are still required to proof that there is a presence of the tax benefit motivation (subjective element), they will not be obliged to find conclusive proof that the purpose of obtaining treaty benefits was one of the principal purposes. Therefore, to the taxpayers will not be sufficient to demonstrate that their arrangements or transactions were inspired also by motives different that tax benefits, they will have to proof that the tax benefit obtained in these circumstances is in accordance with the object and purpose of the relevant provisions of a certain Convention that is the objective test.

5.3.1.2. Objective test:

Even if it is reasonable to conclude that one of the main purposes of the arrangements was obtaining a benefit, but 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, the taxpayer as an exception can have access to the treaty benefits.

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[40] Kemmeren E. (2014), Where is EU Law in the OECD BEPS Discussion?, *EC Tax Review 4*, 192

The OECD do not provide a reference to the "object and purpose" of the treaty. Therefore, the "object and purpose" of a treaty provision has to be interpreted in accordance with the "object and purpose" of the treaty in general. The starting point of a tax treaty to find such a reference is the preamble of the treaty. In this regard, the OECD proposed the amendment of both the title and the preamble of the tax treaties:

Title: *Convention between (State A) and (Slate B) for the elimination of double taxation with respect to taxes on income and on capital and the Prevention of tax evasion and avoidance.*

Preamble*: "(State A) and (State B), Desiring to further develop their economic relationship and to enhance their co-operation in tax matters, {i}ntending 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 arrangement: aimed at obtaining reliefs Provided in this Convention for the indirect benefit of residents of third States) {h}ave agreed as follows:".*

In reference to this requirement, Lang states that "*it is evident that the object and purpose of legal provisions must always be taken into account in their interpretation. Any interpretation that contents itself with the mere wording of a rule would indeed not correspond to the state of the art of legal method. Even those holding the view that the wording of a rule is not just the beginning of the interpretation but also defines its limits will have to realize that the wording alone is most rarely so unambiguous so as to allow for the interpretation of a rule while ignoring its object and purpose. Therefore, the interpretation of all rules, both favorable and unfavorable, must always consider their object and purpose, not only when it is assumed that one of the main motives of the taxpayer was to obtain any benefit. For international law treaties, article 31 of the VCLT confirms the universal significance of focusing on the object and purpose of a rule in its interpretation"*[41].

Therefore, in this regard, one have to assume that in all cases of application of the rules of a certain tax treaty, those provisions must be applied in accordance with the object and purpose of the tax treaty.

[41] Lang M. (2014), BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties, *Tax Notes international, 661*

5.3.2. Consequences of the PTT rule

The consequence of the PPT rule is that "a benefit under this Convention shall not he granted". As stated before in the explanation of the PPT rule, the benefits refers only those under the corresponding tax treaty.

The denial of the benefits derived from the abused treaty provisions is the consequence of the PPT application. However, for instance once the source state establishes that the transaction falls within the scope of the PPT rule, the next step is to determine the tax treatment of the arrangements or transactions designed in the first place to access the treaty benefits. The proposed PPT rule in BEPS Action 6 does not provide guidance in this respect. However, in my opinion, based on the general criteria of the PPT rule, if the residence state considers that the PPT was not applied properly by the source state, the dispute, must be resolved through a Mutual Agreement Procedure (MAP).

5.3.3. LOB provision Vs. PPT rule, how the two rules interact within the tax treaty.

The BEPS Action 6 report, states that the PTT rule applies notwithstanding other provisions of this Convention. Paragraph 3 on the Commentary, gives guidance on the relation between the two approaches to counter treaty abuse included in the BEPS proposal:

> *Paragraph 7 supplements and does not restrict in any way the scope or application of the provisions on paragraphs 1 to 6 (the limitation-on-benefits rule): a benefit that is denied in accordance with these paragraphs is not a "benefit under the Convention" that paragraph 7 would also deny. Moreover, the guidance provided in the Commentary on paragraph 7 should not be used to interpret paragraphs 1 to 6 and vice-versa.*

And paragraph 4 reads as follows:

> *"Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 6 does not mean that these benefits cannot be denied under paragraph 7. Paragraphs 1 to 6 are rules that focus primarily on the legal nature, ownership in, and general activities of, residents of a Contracting State. As illustrated by the example in the next paragraph,*

these rules do not imply that a transaction or arrangement entered into by such a resident cannot constitute an improper use of a treaty provision"[42].

According to the Commentary, if one of the objective requirements of the LOB provision to be considered as a qualified person for treaty purposes is not met, the treaty benefits should be denied irrespective if the corresponding transactions could fall under the scope of the PPT rule.

According to paragraph 4, even if the objective conditions of the LOB rule are met and a taxpayer is a qualified person, the treaty benefits can still be denied if the PPT rule applies, which is clearly a disadvantage for the taxpayers, in the sense that this rule does not provide any legal certainty. De Broe and Luts states:

> *"Per the lex specialis derogate legi generali maxim, where two rules govern the same factual situation, the more specific rule trumps application of the more general rule. This maxim equally applies to anti-abuse rules, whereby the PPT should be considered as the general rule compared to the more specific LOB clause, the beneficial ownership requirement and other special anti-abuse rules ('SAARs`).*
>
> *Consequently, it is submitted that once a purported abusive arrangement passes these SAARs, the PPT should only apply to the extent the allegedly abusive behavior is completely out of the scope of the type(s) of treaty abuse the SAARs intend to counter"*[43].

Nonetheless, in the specific case of the LOB provision and the PPT rule, from a tax treaty perspective the two concepts are independent, with their own legal premises.

It is necessary to address the differences between the PPT rule as proposed by the OECD and the discretionary relief included in the LOB provision, and how can the two provisions interact with each other within a tax treaty. First, as explained in point 5.2.2.6 of this document, the discretionary relief is a residual rule that gives the discretionary right to tax authorities to grant benefits to entities, transactions or structures that fail to meet the LOB requirements, but can be determined by the tax authorities that such person or structure did not have as one of its principal purposes obtaining benefits under the DTC. On the other hand, as also explained, based on the PPT rule, tax authorities can deny treaty benefits to a transaction or structure that

[42] OECD, *BEPS Action 6 Final Report*, p. 55-56
[43] De Broe L. and Luts J. *(2015),* BEPS Action 6: Tax Treaty Abuse, *Intertax,* 133

comply with the LOB provision, if the tax authorities conclude that obtaining treaty benefits one of the main purposes of the taxpayer.

After the analysis of the two clauses, it would seem that there is a clear difference for the application of whether the discretionary relief or the PPT rule. In my opinion, the main similarity between the two clauses is that both grant a discretionary power to the tax authorities in deciding to grant or deny treaty benefits. Notwithstanding, the discretionary relief implies that the person claiming treaty benefits fail to meet the requirements of the LOB provision, but despite that, tax authorities considered based on a discretionary basis, that the person did not have as one of the principal purposes the obtaining of treaty benefits. Whereas, under the PPT rule scenario, tax authorities have the discretionary power to deny treaty benefits to a structure that despite the fact that meet the requirements of the LOB provision, is considered by the tax authorities to have as of the main purposes obtaining treaty benefits.

6. CONCLUSIONS

The purpose of this study was to present an analysis of the instruments used by the treaty system to counter treaty abuse, based on the approach of the OECD in BEPS Action 6 to prevent the improper use of a tax treaties. Moreover, by doing so, I intended to answer the question, Are the LOB provisions efficient measures to prevent tax treaty hopping by taxpayers?

To answer the question, I established that the current OECD MC provides in its commentaries a framework to prevent treaty abuse, stating that contracting states can make use of domestic anti-abuse rules to counter such circumstances. Nonetheless, according to the OECD, the approach contained in the commentaries is not enough to deal with the inappropriate use of tax treaties, therefore the need to address this issue through specific provisions implemented in tax treaties which are proposed in BEPS Action 6, as the project identified treaty abuse as one of the most important sources of BEPS concerns.

The OECD has developed in BEPS 6 a set of treaty provisions aiming to ensure that states include in their tax treaties appropriate measures to prevent treaty abuse and treaty shopping in particular. The proposal of the OECD can be summarized in:

(i) The amendment of the title and preamble of the tax treaties including a statement that contracting states have the common intention not to create opportunities for double non-taxation through treaty abuse, particularly treaty shopping;

(ii) The inclusion of a Limitation on Benefits clause –LOB- altogether with a Principle Purpose Test –PPT-

(iii) The inclusion of either a standalone LOB clause or a PPT clause.

As was explained in this study, the proposed LOB provision represents an important attempt to counter at least those most apparent abusive structures, by establishing a set of formal and highly complex requirements. Nonetheless, it is impossible for a rule based provision to deal with all the possible abusive situations, especially more elaborate tax structures designed to comply with the LOB requirements. Consequently, a standalone LOB provision is not the more efficient measure to counter all treaty abuse cases. The OECD recognized this circumstance, and proposed the inclusion of a PPT rule base on discretionary approach that can be an important instrument to counter other abusive structures.

In identifying tax treaty abusive structures, the tax administrations and courts must engage in a case by case analysis to evaluate properly all of the relevant facts and circumstances giving rise to the presumably abusive structure, in order to prevent an undesirable outcome, such as an unjustified denial of treaty benefits.

The existence of treaty abuse, lead to the availability of tax benefits and the access to treaty networks by non-contracting parties, which distorts the level playing field of countries, in the sense that it can result in a revenue loss for those countries affected by abusive conducts by taxpayers and ultimately reduces the incentive to negotiate a tax treaty.

The LOB clause has a rule based nature aimed to create legal certainty among taxpayers, but it is highly complex to implement by either taxpayers and by the tax administrations, given the high administrative requirements to administer such an instrument.

On the other hand, the PPT rule has a high subjective component that gives tax authorities the opportunity to address tax abusive schemes that the LOB clause could not deal with, but can create legal uncertainty among taxpayers, along with an objective test that is met as long as the granting of the treaty benefit would be in line with the object and purpose of the treaty provision.

The OECD suggests the implementation of anti-abuse provisions such as the one mentioned above, but also allows states to apply domestic anti-abuse rules to counter this phenomenon. To that end, the OECD proposed the inclusion of saving clause, which allows contracting states to apply their domestic anti-abuse rules, to its resident taxpayers since the effect of such a clause is that, the treaty leaves taxation by the State of residence unaffected.

This study proposed to evaluate the features of both the LOB provisions and the PPT in order to outline their main characteristics to perform a comparison between the two clauses in order to identify their advantages and disadvantages, in light of criteria such as, convenience for both taxpayers and tax administrations, complexity, and state policy matters.

6.1. Conclusions regarding the LOB provisions

The treaty abuse scenario is very broad and the implementation of measures to counter it can lead to situations in which legitimate transactions or arrangements that are not structured with the purpose to access treaty benefits are included in the abusive practice bucket. However, the OECD also allows tax authorities the discretion to grant treaty benefits to legitimate structures that fail the LOB test, through the discretionary relief clause, which has some features of the PPT rule within the LOB provision.

This issue has a particular importance due to the fact that today taxpayers can circumvent the resident requirement, by just complying with formal requirements in order to obtain the residence status. Therefore, the PPT rule could truly achieve its purpose by limiting abusive tax planning possibilities.

The OECD recognizes that the LOB clause is highly complex and that there is the possibility that some countries will not have the administrative capacity to implement and administer the measure. The suggestion to include a LOB provision in tax treaties is certainly a well-directed effort to ensure the existence of an economic nexus with the state that claims jurisdiction to tax.

The LOB provision suggests a list of tests that, when satisfied, would give entitlement to treaty benefits. The first test of the LOB provision is the publicly traded test, which requires a company to be regularly traded on one of the recognized stock exchanges as defined in article 10(5) (a) of the OECD Model. According to the OECD, this test is sufficient to ensure that companies will not be used as conduits, because of the need of compliance with strict securities laws, which serves as an effective tool to restrain any abusive tax planning. The publicly traded company offers to tax administrations a convenience advantage, in the sense that can be considered easy to administer.

The second test, consist of two tiers, the ownership and the base erosion test. The ownership limb requires that at least 50% of the company is owned by residents of the contracting states, which ensures local ownership. The base erosion test requires that less than 50% of the company's gross income is paid, directly or indirectly, by means of deductible payments to third stale residents, ensuring that the company will not be used as a conduit to pass on the income received.

Given the formal nature of these tests, the fact that the base erosion test requires that less than 50% of the person's gross income by means of deductible payments is paid to third states residents, can still be considered as a great amount depending on the level of income of the person, and can give rise to tax planning opportunities to the extent that the income can be accumulated and distributed in such a way to take into consideration not to exceed the 50% limit.

As mentioned, the aim of these test is to guarantee that most of the equity and the gross income of the company are owned by residents of the contracting states. Nonetheless, in my opinion, the ownership and base erosion tests provide a set of strict and complex rules, only directed to verify formal characteristics of the transactions. In the end, these tests will provide certainty to taxpayers, in the sense that they will know for certain when they will have access to treaty benefits, but could also give rise to tax planning opportunities through structures designed to meet the requirements, but that from an economic point of view could be intended to circumvent treaty provisions.

On the other hand, there is the business active test that examines the economic connection to the residence state, through the evaluation of the active trade or business in the resident state; the connection between the item of income to the business in the resident state; and examines if the business activity is substantial in comparison with the activity that gives rise to the income in the source state.

As a result, the proposed LOB clause is a fine approach to counter through formal requirements those more apparent tax planning structures, but in my opinion, it could be still subject to sophisticated tax structures. However, when it comes to bona fide or legitimate structures that fail to meet the LOB requirements, the LOB provision provides a solution by the proposed discretionary clause, which allows tax authorities to evaluate the facts and circumstances of the transactions in order to determine if they can be subject to treaty benefits.

6.2. Conclusions regarding the PPT rule

While is clear that the implementation of the LOB clause is a step forward to tackle treaty abuse, is not a perfect provision and therefore not entirely efficient measure that still can be circumvent by more elaborated tax planning schemes. Therefore, the objective of this study was also to address the sub research questions, (i) what is the role of the PPT rule in countering tax abusive practices?, and (ii) will the implementation of the PPT rule cause uncertainty among the taxpayers?

As mentioned, the PPT rule is an advantage for the tax administrations based on a discretional approach to determine when a structure can be considered as abusive.

Due to the complexity and highly administrative burden of the LOB provision, the states in their treaty negotiations can decide for the implementation of the PPT rule which is certainly more flexible, and easy to control.

Nonetheless, the PPT rule grants too much discretionary power to the tax authorities, creating uncertainty among taxpayers due to the lack of objective criteria in the design of the rule. Also, the PPT place the burden of proof in the taxpayers, facilitating the administrative process to the tax administrations, affecting the playing field for the taxpayers.

From a tax administration perspective, the subjective test of the PPT rule can be relatively easy to asses, due to the discretion granted to the tax authorities. Nonetheless, it is important for the objective test to be structured in such a way that can provide some relief and certainty to the taxpayers. Under the current proposal regarding the objective test within the PPT rule (object and purpose) does not offer the appropriate background for its interpretation.

In my opinion, the main obstacle of the PPT rule is that it seems to be tailored only for the interests of the tax administrations, however the introduction of such a general anti-abuse rule can be seen as an effective tool to deny treaty benefits to structures that appear suspicious to the tax authorities.

The proposed PPT rule is subjective, ambiguous and creates uncertainty, which could produce difficulties for legitimate business or bona fide transactions, hampering a taxpayer's necessity to rely on the treaty provisions.

In my opinion, the truth of the matter is that the PPT will be an indispensable tool against the abuse of tax treaties, due to the fact that is not possible to fully objectify all the fact and circumstances that can give rise to tax avoidance or abuse of tax treaties in a more general manner. In order to reduce the level of uncertainty, the rule should contained more procedural measures. It is worth noting that states in the negotiating process can adopt the wording and measures in the clause that fit better to their interest and policies.

Finally, whether the proposal contained in BEPS Action 6 will result in an effective tool to deny treaty benefits in inappropriate circumstances will depend on the ability of states to amend their bilateral tax treaties, and their willingness to include such provisions in further negotiations processes.