TAXREP 18/14

(ICAEW REP 50/14)

ICAEW TAX REPRESENTATION

BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

Comments submitted on 9 April 2014 by ICAEW Tax Faculty in response to OECD public discussion draft *BEPS Action 6: preventing the granting of treaty benefits in inappropriate circumstances* published on 14 March 2014

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the public discussion draft BEPS Action 6: preventing the granting of treaty benefits in inappropriate circumstances http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf published by OECD on 14 March 2014.

2. We will be represented at the OECD Public Consultation Meeting at OECD Headquarters in Paris on 14 and 15 April 2014. .

3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a world leading professional membership organisation that promotes, develops and supports over 142,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

5. As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

RESPONSE TO DISCUSSION DRAFT

7. The discussion draft contains three main recommendations:

1. A treaty title and preamble should contain a clear statement that it is (being entered into) to prevent tax avoidance and to avoid creating opportunities for treaty shopping;
2. A treaty should include a specific anti-abuse rule based on the Limitation of Benefits (LOB) provisions included in treaties concluded by the United States (US) and other countries; and
3. A treaty should also include a more general anti-abuse provision.

8. These recommendations are amplified in the discussion draft in section A and there is also section B to clarify that treaties are not intended to create double non-taxation and section C which sets out tax policy considerations that countries should consider before entering into a tax treaty with another country.

9. The major part of the discussion draft, section A, is taken up with detailed consideration of the provisions that should be included in tax treaties and the interrelationships between domestic and treaty provisions.

10. Our general view is that recommendations 1 and 2 above should be put forward as alternatives and that there should not be a formal OECD position that both LOB and a general anti-abuse rule are necessary.

11. We also believe it is unhelpful, and will create uncertainty, if the term "tax avoidance" is used rather than treaty abuse. Some countries have a very broad view as to what is, or is not, tax avoidance and we believe its indiscriminate use in OECD documents will create uncertainty for business which will, in our view, be undesirable.

12. In our view, and in the experience of our members, US style LOB provisions have proved exceedingly complex and difficult to administer.

13. We also do not believe that a formulaic LOB provision is necessary because it is difficult to conceive of a tax abuse situation that would fall within the LOB and not also fall within the general anti-abuse rule.

14. Indeed the discussion draft itself supports this proposition because it suggests that the general rule may be needed in case tax abuse situations fall outside the LOB provisions.

15. Paragraph 18 of the discussion draft, introducing the general anti-abuse rule states:

> "the following [general anti-abuse] rule ….would provide a more general way to address treaty abuse cases, including treaty shopping situations that would not be covered by the specific [LOB] anti abuse rule .. (such as certain conduit financing arrangements."

16. It is also interesting to note that the discussion draft does not suggest the opposite scenario that an LOB provision is required to deal with cases that would not be caught by a general anti-abuse rule.

Detailed comments on LOB provisions

17. Because it is formulaic with no reference to purpose or intent, there is a real risk that a LOB provision will catch situations which are not abusive and which are actually within the spirit of the treaty. For instance our members have direct experience with the existing LOBs that the wording can cause real issues for portfolio companies into which Pension Funds and Private Equity houses co-invest (as they cannot easily meet any of the tests of qualified persons).

18. The LOB rules are so densely drafted and complicated that very few companies or individuals can understand them. Given the proposal to also have a wider and simpler general rule, it is very hard to see how such difficult to understand provisions can be viewed as meeting the standard tenets of taxation (simplicity, (lack of) complexity and proportionality). See the section below which sets out the OECD Ottawa Taxation Framework condition principles.

19. Our members and member firms know from US experience that a whole industry can develop around giving advice on the meaning of LOB provisions even for the many residents who should clearly qualify for treaty relief.

20. Before any country considers bringing in any such provisions into its own treaties it should consider whether, within their tax system, it is appropriate to have such complex rules without also introducing a clearance or ruling mechanism. This will be particularly so in countries (such as the UK) where it is necessary to apply for treaty relief.

The Ottawa Taxation Framework Conditions – Principles

21. The OECD Committee of Fiscal Affairs produced a report "Electronic Commerce: Taxation Framework Conditions" in which it set out taxation principles that should apply to electronic commerce. These principles were welcomed by the Ministers attending the Ottawa Conference on Electronic Commerce in 1998 and these continue to form the basis for appropriate tax policy.

22. These Principles were reproduced in the OECD discussion draft published on 24 March on BEPS Action 1: Address the tax challenges of the digital economy and we believe the

principles are equally sound in the context of domestic tax systems more generally and international and tax treaty rules. We have reproduced the principles in Annex 2 to this paper.

Derivative benefit provisions

23. This is discussed in paragraphs 13 to 17 of the discussion draft.

24. We believe that a derivative benefit provision is necessary in conjunction with an LOB provision as satisfaction of such a provision will be a clear indication that treaty shopping is not in point.

25. We also believe that under EU/EEA law (Open Sky judgment C-467/98) a Derivatives Benefits provision is required in all treaties entered into by EU/EEA countries.

26. EU law, the Papillon case (C-418/07) also requires an intermediate company test to encompass all EU/EEA subsidiaries.

Comments on a more general anti-abuse rule

27. This is discussed in paragraphs 18 to 33 of the discussion draft.

28. We fully support the intention that this general anti-abuse rule should be supplemented by detailed Commentary and that there will also be a number of examples to illustrate its potential impact. We have included some of our own examples below which we hope will be helpful when drafting the document for the OECD CFA to approve at is meeting in June.

29. We note that example A in paragraph 33 more or less repeats the facts of the Royal Dutch Shell case on 'beneficial ownership' in the Netherlands Supreme Court while example B repeats the facts of the Royal Bank of Scotland case on the same issue in the French Supreme Court. The judgments in these two cases demonstrate that existing treaty provisions are up to the task of preventing improper use of treaties and combatting treaty shopping.

30. In terms of the proposed Article X subsection 6 in the discussion draft many genuine commercial transactions will fall within the first leg of the test since there are few major business decisions which are made without factoring in tax costs, in the same way with other relevant costs. The risk that most business structures will be caught by the first leg is increased by the distinction drawn on page 12 between: a) the decision around the 'form' of the transaction finally takes; versus, b) the initial decision to proceed with the transaction in the first place. While tax is often not a key factor in deciding to structure a businesses operation (such as manufacturing, distribution etc) in a certain way, it would be normal for tax to then factor into the decision on the exact form of the operation, (along with all other relevant costs). Companies which accept the responsibility to pay a fair and reasonable amount of tax will still look at how different locations, for example, can bring with them different tax costs in the same way that they would look at how different locations might reduce labour costs. This would be a normal business consideration as a way to further enhance an existing business decision where this can be done without tax abuse.

31. For these reasons, it is likely that a lot of focus will be placed on the second leg of the general anti-abuse test. Since this is a subjective and developing test it will be important for the OECD paper to give significant guidance in this area and include as many examples as possible. Further, since history has shown that views can develop in this respect, it should be recommended that the Contracting Parties, when entering into a new treaty, specifically state the extent to which they still agree with the commentary. Such statements could also address the treatment of new business models etc that have developed since the commentary and are now common place.

ICAEW examples

32. We have set out in Annex 3 some examples which we believe are relatively commonplace in today's (international) business world and which if included in the Commentary would, we believe, help to understate the potential impact of the general anti-abuse rule.

Resolving dual residence cases of persons other than individuals

33. This issue is discussed in paragraph 50 to 53.

34. We believe that the proposed approach will undermine legal certainty and the rule of law by placing the matter within the hands of the competent authorities without real guidelines or rules for them to apply.

35. The mere assertion that there have been cases involving avoidance is insufficient to displacing a legal rule with administrative power. The proposal assumes that the tie-breaker rule ought to be aimed primarily at preventing abuse and not at resolving double taxation. No actual abuse is identified or explained. The problem should be identified and if genuine, a solution may be found.

36. A sound principle based approach would involve reverting to the discussion in the 2003 paper on company residence and the communication revolution to consider whether the current single factor test continues to be appropriate in the 21st century.

37. We also believe that dual resident companies are now relatively rare. When they were used in the past it was usually to allow for double utilisation of losses or deductions. Most countries that were concerned with this abuse have now introduced domestic laws to prevent the benefit so that, in practice, such companies are now extremely rare. The UK legislation, section 18 Corporation Tax Act 2009, is an example of such domestic law which ensures that a company cannot in fact be dual resident.

38. In the few situations where dual residents are now seen, it is usually due to commercial reasons (eg a company being incorporated in one place for corporate law or listing benefits but managed in another as this is when the management live for historic, commercial or family reasons).

Abuse of domestic law by use of treaties

39. We believe greater prominence needs to be given to the principles of public international law, see footnote 12 on page 21 of the discussion draft, which ensure that where an issue is covered in a treaty it cannot be overridden by domestic law.

40. If treaty partners want to ensure that domestic law prevails then this should be specifically provided for as a "carve out" in the wording of the relevant treaty.

Double non-taxation – section B of discussion draft

41. The expression "tax treaties are not intended to be used to generate double non-taxation" carries with it the implication of artifice. No attempt is made in the document to distinguish between double non-taxation that may occur as a result of the simple coexistence of national tax systems and the normal operation of tax treaties on the one hand, and transactions involving artifice that are regarded as abusive which result in unintended double non-taxation.

42. Further, it would be helpful for the wording to clarify that the focus is on tax abuse 'under the treaty' to avoid unnecessary uncertainty and discussions in the future. Consider, for example, a multinational group that chooses to set up a processing centre or manufacturing site in a certain location to take advantage of local labour laws, cheaper human capital and lower social security costs etc. While one of these purposes might be viewed as 'tax' related, social security costs are not usually the remit of double tax treaties and so a group should not need to worry about uncertainty of treaty relief on other income flows etc in this situation.

43. The proposed preamble is, by itself unhelpful. It is no substitute for a clear description of the class of persons who qualify for treaty benefits. In the absence, for example, of the US style of limitation on benefits article such statements are only confusing, since, in terms, the treaty would apply to any person meeting the residence requirements of article 4, and subject to any specific limitations set out in the distributive provisions of the treaty. It should only be recommended where such substantive general limitations on benefits are agreed by the contracting states.

Policy considerations when entering into a tax treaty – section C of discussion draft

44. This is an important section. It should emphasise that States should have a clear understanding of the relevant rules of a State with whom they proposed to conclude a treaty. It should make clear that States that conclude treaties must grant the treaty benefits they have agreed, and should be taken to recognise the implications of their international obligations. In this respect States should be cautioned that the Model treaty functions as a precedent that must be tailored to specific circumstances.

45. The Model however also presupposes a comprehensive approach to the subject and proposed paragraph 15.2 should clarify that a comprehensive approach is recommended rather than picking out odd topics.

46. Proposed paragraph 15.1 should make clear that these paragraphs drafted in the context of the BEPS project, focus on the concerns of that project and are not intended to be comprehensive (It may be noted that of the six proposed paragraphs, 4 are devoted to avoidance).

47. Proposed paragraph 15.3 should be rephrased to be clear that it is not an encouragement to unilateralism. States should be encouraged to conclude treaties rather than simply relying on unilateral measures. The fact that domestic law measures such as relief for foreign tax coincide with treaty provisions is not a reason for treaties not to exist. Treaties provide a measure of stability and certainty in framing the international tax order and States wishing to adopt different approaches should be encouraged to do so on a consensual, rather than a unilateral, basis.

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APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)

APPENDIX 2

Ottawa Taxation Framework Conditions – Principles

The OECD Committee of Fiscal Affairs produced a report "Electronic Commerce: Taxation Framework Conditions" in which it set out taxation principles that should apply to electronic commerce. These principles were welcomed by the Ministers attending the Ottawa Conference on Electronic Commerce in 1998 and these continue to form the basis for appropriate tax policy.

These principles are:

Neutrality: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency: Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and Simplicity: The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

APPENDIX 2

ICAEW examples of commonplace international business structures

Shared service company
A shared service company (covering operational activities such as human resources, IT, accounting, legal etc) is set up to reduce costs by taking advantage of economies of scale (enabling a reduction in staff numbers and other costs) and to allow for standardised processes and a common technology platform. The company's location has been chosen with reference to labour costs, labour expertise and infrastructure but social security costs and also the treaty network of the relevant country have also been factored in.

Central procurement company
A central procurement company is set up to reduce input costs as a result of great purchasing power and better controls/processes over spending. The company's location has been chosen by reference to labour costs and access to appropriate personnel but the local tax rate has also been taken into account.

Data processing hub or call centre
A data processing hub or call centre is set up to reduce staff and IT costs and to improve quality. Again the location is chosen by reference to labour laws, costs and expertise but the the local tax rate are social security costs are also considered.

Regional distribution centre
A regional distribution centre is set up to allow for better stock management and reduced delivery times. The company's location has been chosen with reference to the quality and quantity of transport links and labour laws but also taking into account local GST/VAT rules and/or custom duties. In an extension of this example, consideration may also have been given to whether a tax holiday might be possible for such activities in certain countries, particularly in Asia. It would be good to cover both variants of the example to enable readers to understand whether the OECD members see a difference between tax being considered where it is a tax covered by the double tax treaty and tax being considered where it is not.

Manufacturing subsidiary
Similarly, a new manufacturing subsidiary has been set up and the location chosen with reference to labour issues, access to materials and expertise etc but also taking into account the local tax rate and custom duties.

Group IP company
A group IP company is set up to help protect IP value and strengthen IP enforcement. The location has been chosen by reference to local IP protection laws. However, there are various different scenarios here. It could be a pure IP management company or it could also carry out marketing of trademarks or R+D etc. In such cases, the location would also have been based on access to staff with the right expertise and experience. In each scenario, it is likely that the treaty network would also be relevant as might local incentives such as patent boxes etc. It would be good for the guidance to have an example like this which builds in the substance/activities of the IP Co to establish what current thinking is on what is acceptable. This is particularly important given the example on page 9 of the discussion draft since whether IPco in that example should be considered outside the intent of the treaties may depend on the actual facts regarding what it does locally.

Regional sales company
A regional sales company is set up to create a local foot print. However, it is also located to take advantage of a low local tax rate and/or low GST/VAT.

Holding company

A Holding company is located in a good treaty network company. Again, there are variations to this example which it would be good to explore in the commentary from, at one extreme, a pure holding company which is just set up and into which only 1 subsidiary is transferred to, at the other extreme, one which has been set up for many years as a regional holding company with many subsidiaries.

Parent company

A parent company, P Co, has 3 subs (Subs 1,2 and 3). Sub 3 needs cash or services. All of subs 1, 2 and P Co are companies with good substance and which have the available cash and resources to help. But each company is in a different location and each country has a treaty with Sub 3 country but with different rates for interest and royalty WHT. Therefore, P Co recommends that the services/ cash are provided in the most tax efficient manner as all other things are equal. An example like this, compared to a pure conduit or empty subsidiary providing cash/services, would help again to show where the limits are on what's seen as being within the spirit of the treaties.