UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Re: USCIB Comment Letter on the OECD Revised Discussion Draft on BEPS Action 6: Preventing Treaty Abuse

Dear Ms. de Ruiter,

USCIB[1] is pleased to have this opportunity to provide comments on the OECD's revised discussion draft (RDD) on BEPS Action 6. USCIB has attempted to keep these comments as short as possible.

General Comments

USCIB stands by its comments of April 4, 2014 and January 6, 2015, on the OECD's discussion draft on BEPS Action 6 and the follow-up work on that discussion draft. The Action 6 2014 Deliverable did not address many of the concerns we raised. In particular, the 2014 Deliverable, the follow-up discussion draft, and the RDD (hereinafter "the guidance") do not give due regard to the impact on the vast majority of potential beneficiaries of income tax treaties that do not engage in abusive practices and that, due to the broad reach and vagueness of the proposals, would in many cases lose access to tax treaties and, in any event, will be deprived of the certainty and predictability that is a fundamental goal of tax treaties. We want to be very clear that, in our view, the recommendations in the guidance would fundamentally change the role of tax treaties by effectively depriving *bona fide* enterprises and business transactions of the protection accorded by tax treaties from excessive and double taxation, at serious

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

cost to the global economy.[2] We believe a more balanced approach is necessary: one that recognizes the fundamental purpose of treaties while recognizing and addressing legitimate issues of abuse of tax treaties. In our prior letters, we suggested specific changes to help achieve this balance. This letter does not repeat all those recommendations, although we stand by them, and the most important points are reiterated in this letter.

USCIB believes that the difficulty of achieving the proper balance is amplified by the speed at which the OECD is attempting to accomplish these changes. In the context of addressing treaty shopping we find this especially difficult to understand. The US – Netherlands Tax Treaty, which represented a significant shift in government attitudes towards treaty shopping, was signed on December 18, 1992. The need to address treaty shopping concerns has thus been widely understood for more than two decades. During that period the US has been insisting on LOB provisions in all of its treaties. Nevertheless, other countries have not taken steps to address this issue and now the OECD is attempting to develop and implement detailed anti-treaty shopping rules without the time needed to give proper attention to the complex issues and possible repercussions of any changes.[3] We believe that the failure to take the time to do the necessary work will result in faulty rules which governments and businesses will spend years, if not decades, undoing. This is especially the case in the context of treaty shopping because of the possibility that a faulty rule will be enshrined in the Multilateral Instrument (MLI) under Action 15 and ripple through the treaty networks of many countries rather than having a trial in the bilateral context to see if the rule works appropriately. If a faulty rule has been implemented through the MLI it may be difficult to fix that rule.

The OECD has been basing its Entitlement to Benefits proposal on the most recent version of the US LOB. That version has been subject to considerable criticism and controversy, incorporates elements of US domestic law policy, and continues to be under internal US review as the US develops a new Model Income Tax Convention. Therefore, i the detailed provisions of the current US LOB should not be the standard for an internationally accepted model.

Specific Comments

Simplified LOB

USCIB was one of the commentators that suggested the use of a simplified LOB. USCIB is pleased to see the OECD take up this suggestion, but is disappointed with the suggestion in the RDD that the simplified LOB apply in conjunction with the principal purpose test (PPT). The simplified LOB was suggested as a replacement for the complex, US-based rule which is not appropriate for use as a general model. Keeping the complex LOB provision and adding the simplified LOB only for use in conjunction with the PPT is not consistent with our suggestion. We continue to recommend that the complex LOB be deleted from the OECD Model, and the simplified LOB be included in its place.

[2] The OECD should be attempting to measure the impact of these changes on global trade and investment.

[3] In particular, the timing on this action item may be wrong. It would be appropriate to look at treaty abuse after other action items are completed. For example, if Action 4 significantly reduces the scope for base eroding interest payments, then the rules proposed in Action 6 may be excessive and their primary impact might be to impose undue restrictions on legitimate cross-border investment.

Further, it is not at all clear that there is **any** benefit to the inclusion of the simplified LOB since paragraph 5 of the RDD provides that "the non-application of the simplified LOB in a given case should not be interpreted in any way as suggesting that the PPT would not be applicable to that case." We had previously understood that if an LOB applied in combination with a PPT, it would be intended to reach different forms of so-called "treaty abuse" such that a taxpayer that satisfied an entity level test could not be challenged on the basis that the entity did not qualify for treaty benefits, but rather only that the particular transaction was a conduit arrangement. If this is not the case, and a country can challenge the entity's status as a qualified resident even though it satisfies the simplified LOB provision, then there is no point to the simplified LOB and it should be deleted entirely. Rather, entity eligibility based on an LOB standard should be treated independently of alternative means of addressing treaty abuse by entities otherwise entitled to treaty benefits – either through a PPT or more targeted anti-abuse rules.

<u>New treaty provisions on "special tax regimes"</u>

USCIB understands the concern that once a treaty is in place, countries find it difficult to deal with changes in the other countries' law which change the balance of the treaty bargain and may result in the inappropriate granting of treaty benefits. Termination of a treaty is a drastic step and one that countries may be loath to take because of the impact on other taxpayers that are not benefitting from the special regime. Partial termination, although permitted in certain circumstances under the Vienna Convention on the Law of Treaties, is also a difficult step. So providing guidance on circumstances under which it would be considered appropriate to partially withdraw treaty benefits may be a sensible step. We believe, however, that adopting this provision as part of the 2015 Deliverable on Action 6 is premature.

This is a novel proposal that needs appropriate review. It seems clear that the proposal is intended to subject so-called "patent boxes" to additional scrutiny and possible special treatment. On initial reading it is not clear what else may be covered. USCIB would like to point out the following questions we have identified, although given the short timeframe for comment we are certain we have not identified all of the potential issues, and we have no solutions to propose.

The term "special tax regime" is very broadly defined and could call into question a wide variety of commonly adopted tax provisions. For example, would the following types of provisions be considered special tax regimes: research and development credits; amortization deductions, particularly if accelerated; original issue discount deductions – are these notional interest deductions? Is there any requirement that the special regime provide a material benefit? If so, what is material? Will there be any attempt to define the "substantial activity requirement"? Will this be integrated with the decisions made on Action 5 on Harmful Tax Practices?

The suggestion that provisions could be explicitly identified as "special tax regimes", or not, is a welcome suggestion. However, it is difficult to say how this could be implemented in the context of the MLI. Will a list of good and bad regimes be included? Who will determine what is on the good or bad list? If, for example, a country believes that its patent box legislation is not a special tax regime because it satisfies the substantial activity requirement, would another country be able to reject that conclusion

and assert that the patent box is, in fact, a special measure in the context of the MLI? If so, how would they do that?

New general treaty rule intended to make a tax treaty responsive to certain future changes in a country's domestic tax laws

As stated above, USCIB understands concerns with changes in law that change the balance of benefits under an already negotiated tax treaty, and an appropriate rule may be necessary to deal with these issues. USCIB believes that inclusion of this rule in the 2015 Deliverable is also premature. Our concern is made clear if the OECD proposal is compared to the recently proposed changes to the US Model. The OECD proposal looks to the adoption of an exemption for substantially all foreign source income (including interest and royalties), while the US proposal looks to the combined aggregate effective rate of tax. These are very different options raising very different issues. The OECD approach is much narrower; presumably reducing the tax rate significantly, but not to zero, would be acceptable under the OECD approach. Would an exemption that was carved back to account for the availability of deductions be considered to exempt substantially all foreign source income?

Commentary on the discretionary relief provision of the LOB rule

The ability of taxpayers to have access to an efficient and practical discretionary grant process becomes increasingly important if the objective tests in the proposed LOB article are overly restrictive, with the result that a double tax agreement intended to provide treaty benefits for tax residents of the treaty partners only provides benefits for a limited class of tax residents absent a practical and expeditious process for the discretionary grant of treaty benefits. In the United States, the discretionary grant has been described as the "safety net" in recognition that the objective tests in the LOB article may unintentionally deprive bona fide residents of the treaty country access to the treaty and the protections it affords against double taxation and excessive taxation. Thus, we were disappointed that the discussion of the discretionary relief provision conveys a disturbingly restrictive approach, similar to many aspects of the proposed LOB article more broadly. Importantly, rather than providing greater clarity as to when the standard embodied in the proposed treaty text is met – establishing that the establishment, acquisition or maintenance of the resident, and the conduct of its operations, did not have a principal purpose of obtaining the benefits of the treaty – the proposed commentary focuses on placing burdens on the taxpayer of establishing its residency had a "clear non-tax business reason." Would a resident company that previously met the publicly traded test and is acquired by a private equity fund be able to meet this clear business reason even if it could establish that there was not a principal purpose of obtaining treaty benefits? Would a company that established residency in the treaty country because the country provided tax incentives for locating manufacturing operations in an economically depressed area meet this standard? Adding additional restrictions to what was originally and appropriately described as a safety net makes the provision more in the nature of an additional limitation on treaty eligibility for treaty residents that are not treaty shopping, a result particularly inappropriate in a rule that already gives the tax authority broad discretion.

Our previously expressed concerns over the restrictive nature of the discussion draft continue to apply, including:

- The statement that the fact that a tested subsidiary company would obtain a treaty rate reduction no greater than could have been obtained by the parent company under its resident country's treaty with the source country is not sufficient to establish the lack of a treaty shopping motive. The revised discussion draft continues to give insufficient attention to the serious problems of lengthy procedures that can leave a taxpayer deserving of access to the treaty with an extended period of uncertainty and deprivation of treaty benefits during the pendency of the procedure. Determinations by a tax authority that a transaction violates the principal purpose test should be subject to the treaty's mutual agreement procedure.

Requirement that each intermediate owner be a resident of either Contracting State

Our prior comments have detailed the reasons why a proscription on access to treaty benefits for a subsidiary company that otherwise meets the relevant LOB criteria based on the fact that the intermediate owner is not a resident of the state of residence of the tested company or, in the case of derivative benefits, an equivalent beneficiary, would extensively limit access to treaty benefits as non-resident/non-equivalent beneficiary intermediate owners are common for legitimate corporate reasons. We submitted in our prior comments that no coherent policy reason has been given for this limitation. The revised discussion draft notes that the tested company could make base eroding payments to the intermediate owner. However, the ability of a tested company to make base eroding payments to an affiliate has nothing to do with where the affiliate is in the group structure. Base eroding payments can be made to a sister company or a subsidiary for example and, in most cases, such payments are already subject to anti-base eroding rules and may be further limited by other proposals. The only relevance of an entity being an intermediate entity in the ownership chain is that dividends can be paid to the intermediate entity, and dividends do not erode the tax base of the tested entity. The proposed requirement would serve no policy goal and would place a severe restriction on the access to treaty benefits.

Proposed new restrictions on application of the “active business” provision

The active business test is based on the sound principle that if a treaty resident is engaged in the active conduct of a trade or business in the country of residence, it has a legitimate nexus to the resident country that establishes that it is not treaty shopping as long as the income for which treaty benefits are claimed is connected to that trade or business and, where the income is received from an affiliate in the source country, the business in the residence country meets a substantiality standard. The test is patterned after the comparable test found in most US income tax treaties. In those treaties, there is typically an attribution rule which allows business activities in the residence country conducted by an affiliate to be treated as conducted by the tested company. This is a recognition that business enterprises may organize their functions in the residence country through multiple entities, including a local holding company and, once it is established that there is a legitimate business presence in the residence country, it is artificial to handcuff the taxpayer to require all business connected income be

received directly by the entity conducting the business. The revised discussion draft notes that the US delegate has proposed that attribution only apply to a tested company if the tested company, itself, is conducting business. Under this proposal a dividend from an affiliate in the source country in the same trade or business would qualify if paid directly to a residence country operating subsidiary of the tested entity but not if the dividend is paid to the tested company in cases where it is a holding company that meets the test through attribution from the operating company. This would place an artificial restriction on taxpayers and is in conflict with decades of US tax treaty policy. It should be stressed that a holding company can obtain treaty benefits under the active business test *only* for income that is connected to the business; the provision is not an open door for holding companies to broadly obtain treaty benefits. To force the investment in the source country affiliate to be held by the operating entity, rather than the holding company simply impedes the right of the taxpayer to structure its operations in the residence country in a manner most compatible with corporate policy, typically dictated by operational efficiency. Accordingly, the proposal of the US delegate should be rejected as inconsistent with the intent of the test for no justifiable policy reason.

<u>The design and drafting of the rule applicable to permanent establishments located in third States</u>

USCIB does not support the proposal to delete subparagraph f) from the proposed provision relating to income derived by a permanent establishment situated in a third State. Deleting that subparagraph could potentially deny the availability of treaty benefits to royalties earned from the exploitation of an intangible asset generated through the value-creating activities of the PE itself. This would be contrary to the stated goals of the BEPS Project. The suggestion that recipients of such royalties should rely exclusively on subparagraph e), which relates to income derived in connection with or incidental to the active conduct of a business carried on through the PE, is not an adequate response, as that fails to take into account the possibility that some States might not view such royalties as derived in the active conduct of a business unless the PE continued to be engaged in the development of similar intangibles or the royalties were derived from unrelated persons.

USCIB supports the suggestions referenced at paragraph 106 of the RDD (i.e., that the rule denying benefits should not apply to PEs located in a country with which the State of source has a treaty if the effective rate of tax on the PE is not lower than 60 per cent of the rate of tax in that country; that the application of the rule should be subject to some form of discretionary relief similar to that found in paragraph 5 of the LOB rule; and that the rule should not focus on the existence of a low tax rate as such but should focus on situations where shares, loans or intangible rights or property are artificially transferred to a permanent establishment).

<u>Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules</u>

USCIB supports the statement made at paragraph 108 of the RDD that the conclusions already reflected in the Commentary on Article 1 concerning the interaction between treaties and domestic anti-abuse rules will remain applicable, in particular with respect to treaties that do not incorporate the PPT rule. The RDD indicates that the existing Commentary on Article 1 will nevertheless need to be reviewed (e.g., to prevent overlap with the new proposed Commentary and to take into account any recommendations

for domestic law anti-abuse rules arising from other Action Items, such as Actions 2, 3, 4, and 8-10). USCIB stresses the importance of preserving the conclusions already reflected in the Commentary on Article 1 in undertaking any such amendments, including the conclusions that could limit the application of new domestic law anti-abuse rules in certain cases.

Sincerely,

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