Akshay Shah
(CA, LLB, B.Com)

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International Tax
Knowledge Update #4

BEPS
(Base Erosion and Profit Shifting)

ACTION PLAN 6

OVERVIEW:

Over the last decades, bilateral tax treaties, concluded by nearly every jurisdiction in the world, have served to prevent harmful double taxation and remove obstacles to cross-border trade in goods and services, and movements of capital, technology and persons. This extensive network of tax treaties (3000 to 4000 treaties in force worldwide) has, however, also given rise to treaty abuse and so-called "treaty-shopping" arrangements. BEPS Action 6 is one of the four BEPS minimum standards applicable to all members of the Inclusive Framework on BEPS and any jurisdictions of relevance.

Let us understand this Action plan in brief:

Action Plan – 6 [Prevention of tax treaty abuse]

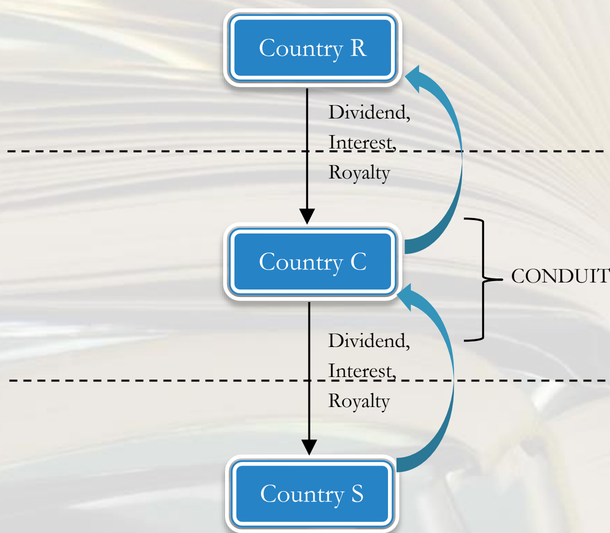
Action 6 of the BEPS Project identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.

What is treaty shopping?

"Treaty shopping" generally refers to a situation where a person, who is resident in one country (say the "home" country) and who earns income from another country (say the "source" country), is able to benefit from a tax treaty between the source country and yet another country (say the "third" country). This situation often arises where a person is resident in the home country but the home country does not have a tax treaty with the source country. Treaty shopping typically involves the attempt by a person to indirectly access the benefits of a tax treaty between two jurisdictions without being a resident of one of those jurisdictions. Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving jurisdictions of tax revenues.

For example, "Treaty shopping" occurs where a person resident of a Country R('R') who expects to derive dividends, interest or royalties sourced in another Country S('S') sets up an entity in a third Country C('C') that will receive the dividends, interest and royalties in a more tax beneficial way than if such income were paid directly from Country S to the person resident of Country R. The tax advantage results from the fact that the tax treaty between Country S and Country C provides for a more advantageous withholding tax rate in Country S on dividends, interest and royalties paid to a

Country C resident than the rate that would apply in Country S if the income were paid directly to the Country R resident because there is either no tax treaty applicable between Country R and Country S or, if there is one, it provides for less generous withholding tax rates than those available to the Country C resident under the treaty between S and C. The entity in Country C operates as an intermediary between the source Country (S) of the dividends, interest and royalties and its controlling shareholder in Country R because it pays on the income received (in the same or another form) to such controlling shareholder. In view of its channeling function, the entity established in Country C is typically, and also for the purposes of this study, referred to as "a conduit company" or a "conduit".



Hence, this kind of "Treaty shopping" describes the situation in which a resident of a third Country (i.c. R) "shops" into an otherwise unavailable treaty between two other Contracting States (S and C) to be able to enjoy the benefits of that treaty. For this purpose, such resident interposes a conduit company in a Country which has a favorable tax treaty with the source State of the income. The purpose of this kind of "Treaty shopping" is the avoidance or reduction of withholding taxes in the source Country.

To counter treaty shopping, the minimum standard on treaty shopping requires jurisdictions to include two components in their tax agreements: **an express statement** on non-taxation (generally in the preamble) and one of **three methods** of addressing treaty shopping.

The Express Statement:

As set out in paragraphs 22 and 23 of the Final Report on Action 6, jurisdictions have agreed to include in their tax agreements an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. The following preamble now appears in the 2017 OECD Model Tax Convention:

*"Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (**including through treaty-shopping arrangements** aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)"*

Three Methods of addressing Treaty Shopping

Method 1

A specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of

treaty benefits to entities that meet certain conditions. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence.

Method 2

In order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or "PPT" rule) is included in the OECD Model Tax Convention. Under this rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty

Method 3

PPT rule together with either a simplified or a detailed version of the LOB rule i.e. a combination of both

In addition to the above, there are **targeted rules** to address other forms of treaty abuse:

a. Dividend transfer transaction that artificially lower withholding tax on dividends;
b. Transaction that circumvent the rule that prevents source taxation of sale of shares deriving value primarily from immovable property;
c. Dual residency of entities;
d. Transfer of property and assets to a permanent establishment

MEASURES TAKEN BY INDIA

Action Plan 6:

- *Introduction of General Anti-Avoidance Rule ('GAAR'):*GAAR could be invoked if the main purpose of an arrangement is to obtain tax benefit and its tax consequences could include denial of treaty benefit and re-characterisation of the transaction. The GAAR would allow the revenue authorities to analyse and go deeper into the transactions and / or arrangements and would permit them to draw inference whether a particular entity is a conduit entity without any real economic substance / activity and the main purpose of setting up the entity is to obtain preferential tax benefit;
- *Preamble clause in tax treaties:* Most of the India's tax treaties contains "prevention of fiscal evasion" as one of the objectives for which the treaty has been entered into;
- *LOB clause:* Many Indian tax treaties covers a LOB clause. Most of these LOB clauses contain the subjective test of the "main purpose" rule for treaty entitlement;
- *Amendments in domestic law:* The domestic tax laws has been amended from time to time to ensure that object and spirit of tax treaties is not undermined. For eg. Requirement to furnish a tax residency certificate, requirement to obtain a Permanent Account Number, self-declarations containing prescribed information as well as a compulsory application to be made to the tax officer to determine the appropriate withholding tax in certain cases

CONTACT US

Akshay Shah

Email: ca.akshah@gmail.com

Contact No.: 9958975768

Website: www.jainshah.com

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