Analysing the likely trends in treaty anti-avoidance provisions in selected Asian jurisdictions post OECD BEPS Action 6

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Topic overview

- Analysis of how the OECD BEPS recommendations on Treaty Abuse (Action 6) would impact the tax treaty policy positions of selected Asian jurisdictions – specifically on the core issue of US style LOB vs. PPT adoption.

- The selected Asian jurisdictions are Australia, China, Hong Kong, Japan, Korea, Malaysia, Singapore, and Taiwan.
Paper outline

1. A summary of the BEPS action plan 6 recommendations relating to the US-style Limitation on Benefit ("LOB") and the Principal Purpose Test ("PPT").
2. Looks into the underlying tax policy rationale and drivers for the US (for the LOB) and the UK (for the PPT) having decided upon their respective policy approach in their tax treaties.
3. Analysis of the anti treaty-shopping treaty provisions found in existing tax treaties of each of the selected Asian jurisdictions to assess different approaches and common themes across treaties entered into by these jurisdictions.
4. Discussion of the likely route each of the selected jurisdictions -- the adoption of the LOB or the PPT -- will choose as its main tax treaty policy position in the post-BEPS world.
BEPS Action 6
Preventing treaty abuse

• OECD’s proposed changes to model tax convention and commentary
  – Affirmative statement that treaties should avoid creating opportunities for non-taxation or reduced taxation
  – General anti-abuse rule aimed at arrangements one of the principal purposes of which is to obtain treaty benefits (“PPT”)
  – Specific treaty anti-abuse rules to address particular treaty provisions, including US-style limitation on benefits provision (“LOB”)
Principal purpose test (PPT) BEPS proposal

- BEPS Proposed wordings:
  - “Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income 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”

- Subjective and discretionary
Principal purpose test (PPT) Existing Asian treaties

Similar approach found in existing treaties -- Dividends, Interests, Royalty, Capital Gains and Other Income articles

• Singapore/UK DTT: Art. 10(7), Art. 11(9) and Art. 12(8)
  » Art. 10(7): The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

• Hong Kong/Japan DTT: Separate Art. 26 (Limitation of Relief)

• Japan/UK DTT: Art. 10(9), Art. 11(10), Art. 12(6), Art. 21(5)

• Korea/UK DTT: Art. 10(6), Art. 11(10), Art. 12(7), Art. 22(4)
Principal purpose test (PPT) 
Existing Asian treaties

General stand-alone treaty articles

• Taiwan/Luxembourg DTT: Art. 27
  » Notwithstanding the provisions of any other Article in this Agreement, a resident of a territory shall not receive the benefit of any reduction in or exemption from tax provided for in the Agreement by the other territory if as a result of the consultations between the competent authorities of both territories it is established that the conduct of operations by such resident had for the main purpose or one of the main purposes to obtain the benefits of this Agreement.

• Malaysia/India DTT: Art. 28(2)
  » A resident of a Contracting State shall not be entitled to the benefits of this Agreement if its affairs were arranged in such a manner as if it was the main purpose or one of the main purposes to take the benefits of this Agreement.
UK style PPT
Key observations

• Balancing of providing certainty / deterrent effect
• Certainty through “Filters” (positive/negative)
• Key considerations in applying the test:
  – Purpose, Advantage, Main definitions
• Safeguards
  – Burden of proof on the tax authority
  – Double reasonableness test
    » Sets a high threshold by asking whether it would be reasonable to hold the view that the arrangement was a reasonable course of action
  – Independent advisory panel clearance
US style LOB
Key observations

• Based on Article 22 of the US Model Tax Convention
• Objective of the LOB clause (2006 US Model Treaty Technical Explanation on Art. 22)

  » Art. 22 contains anti-treaty shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.
US style LOB
Objective tests

- Aimed at establishing connection of the treaty claimant to its claimed residence state
- Required to meet one of the prescribed tests to access treaty benefits

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<thead>
<tr>
<th>Qualified Person (QP)</th>
<th>Non Qualified Person (NQP)</th>
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<tbody>
<tr>
<td>Publicly traded company test</td>
<td>Active trade or business test</td>
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<td>Ownership test</td>
<td>Derivative benefits test</td>
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<td>Headquarters test</td>
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US style LOB
Evolution

• 1977 US Model Tax Convention
  – “Investment or Holding Companies” article
  – Applied only to dividends, interests and royalties
  – Targeting corporations enjoying “special measures” in the other country

• 1981 US Model tax Convention
  – “Limitation on Benefits” article
  – All treaty benefits
  – Ownership requirement and special measures test
  – Negative “Principal purpose” test

• 1996 US Model Tax Convention
  – Recognition that intent-based approach was not working and tax administration ill-equipped to identify treaty-shopping intent
  – Adoption of a series of objective tests
US style LOB
Existing Asian treaties

• US treaties (with Australia, Japan and Thailand)
• Japan/Switzerland DTT
• Japan/NL DTT
• Japan/France DTT
• Japan/Australia, Japan/New Zealand, Japan/Sweden and Japan/UK DTTs (modified LOB and PPT)
• China’s recent treaties with Ecuador and Russia!
• China/Mexico DTT (modified LOB and PPT)
Trend and likely approach -- LOB or PPT?

**Australia**

- LOB not a common feature in Australian tax treaties
- >50% of existing treaties do not contain either the US-style LOB nor the PPT
- More PPT versus LOB in existing treaties
- Perception that LOB does not provide for flexibility
- Likely to adopt the PPT
Trend and likely approach
LOB or PPT?

China

- Many recently renegotiated treaties adopt PPT (e.g., treaties with Belgium, France, Netherlands and Switzerland), with “no treaty override on domestic anti-avoidance rule” provision
  > Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement. [China/Belgium treaty, Art. 23]

- Treaties with Ecuador and Russia adopt LOB!
- Treaty with Mexico contains simplified LOB
- Case by case approach (both LOB/PPT inclusion)
Trend and likely approach
LOB or PPT?

Japan

- No specific policy has been announced
  - Recently renegotiated treaties with the Netherlands and Switzerland adopt LOB
  - Treaty with Australia contains LOB and the PPT
- Recent treaty with Hong Kong contains the PPT
- Case by case approach depending on the other country’s preference, with a preference for LOB (or LOB and PPT together)
Trend and likely approach LOB or PPT?

Korea

- Majority of existing treaties have no stand-alone anti-treaty shopping article
- Increasing trend of tax authorities applying domestic law-based substance-over-form principle to challenge tax treaty benefits
- No treaty with LOB – renegotiation of existing US treaty (1979)
- More recent treaties contain PPT (which include catch-all PPT and specific PPT)
- Likely to adopt PPT
Trend and likely approach
LOB or PPT?

Singapore
- PPT in recently signed treaties
- Likely to adopt PPT
- Domestic law provides that tax treaties prevail
  - Domestic GAAR?
  - A few Singapore treaties (e.g., Israel/Singapore) specifically provide for GAAR application to deny treaty benefits with respect to any artificial transactions

Hong Kong
- Treaties that contain anti-treaty shopping provisions all adopt the PPT
- Likely to adopt PPT
Trend and likely approach LOB or PPT?

Taiwan

- Most of existing treaties have no separate anti-treaty shopping provisions
- Recent treaties contain PPT e.g., treaties with Austria, Belgium, Hungary, India, Israel, Slovakia, Switzerland and UK
- Likely to adopt PPT