Christos A. Theophilou
Taxand Cyprus | Partner | International Tax – Transfer Pricing

INSIGHT: Treaty Shopping – Is the New Principal Purpose Test a Game Changer?

(PART 2)

PRINCIPAL PURPOSE TEST

In order to end tax loopholes used by multinational enterprises ("MNEs") for improper use of tax treaties, the Organization for Economic Co-operation and Development ("OECD") has recommended, under base erosion and profit shifting ("BEPS") Action 6: Prevent Treaty Abuse, an anti-abuse provision, namely the Principal Purpose Test ("PPT"). Such a provision will come into effect in selected tax treaties through the Multilateral Instrument ("MLI").

Effectively, more than 100 jurisdictions (including Cyprus, Russia and Ukraine) have concluded negotiations on the MLI that will swiftly implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by MNEs.

Following the signing ceremony held in Paris on June 7, 2017, 84 countries have signed the MLI and another six jurisdictions have expressed their intent to sign the MLI. It is expected that a few thousand tax treaties will be amended in order to implement the BEPS treaty proposals, such as the PPT.

Accordingly, the MLI will only apply to double taxation treaties ("DTTs") in cases where both contracting states are party to the MLI; therefore the MLI will not impact any DTTs where only one of the contracting states is a party to it. Cyprus, under Articles 1 and 2 of the MLI, extended its application to the 55 individual treaties signed by Cyprus, plus the three treaties covered under the old treaty with the Republic of Yugoslavia (Bosnia and Herzegovina, Montenegro and Serbia) plus the three treaties covered under the old treaty with the USSR (Azerbaijan, Kyrgyzstan and Uzbekistan). As a result, no tax treaties of Cyprus have been excluded.

The next steps of the MLI process in Cyprus are:

- ratification of the MLI, which is already completed;
- publication in the Official Gazette, expected soon;
- exchange of notes with the respective countries; and
- publication in the Official Gazette for the amendment of individual treaties.

Thus, the MLI will be effective as from January 1 of the following year (which is the earliest that they can come into effect). Nonetheless, as noted above, the provisions of the MLI will come into effect when the other contracting state has also ratified the MLI. Thus, the individual 55 tax treaties are expected to be amended gradually in the coming years.

PPT: Division of Three Parts

Turning to the PPT, which reads as follows: "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."

Notably, in 2014, the OECD has included in its Commentary a similar wording that provides similar powers to contracting states.

The PPT can be analyzed in three parts.

The first part of the PPT ("Notwithstanding the other provisions of this Convention,") makes it clear that it applies, irrespective of any other anti-abuse provision of any double tax treaty, and therefore it will serve as a safety net to the tax authorities to counter any tax treaty benefits that could not have done so through a specific anti-abuse provision such as the beneficial owner clause.

Put simply, "notwithstanding" means that the PPT does not go through other specific anti-abuse provisions included in the treaty and therefore leaves them intact, thus they still apply. As a result, the PPT appears to be an additional weapon included in the tax authorities' arsenal against aggressive tax planning techniques used by MNEs.

Thereafter, the PPT is divided in two parts.
The first part ("a benefit under ... in that benefit") the tax authorities need to "reasonably conclude" that "one of the principal purposes" was to obtain a treaty "benefit." Such a threshold, however, seems likely to be very low as it is expected from the tax authorities only to "reasonably conclude" and not to factually prove.
It can be argued that the words "reasonably conclude" can have a very broad meaning. It would be very easy for the tax inspector to reasonably conclude not the principle purpose but one of the principle purposes.
In other words, "reasonable to conclude" means that if you have set up a structure to take a treaty benefit, then the tax inspector of that country can disallow the treaty benefit if it is indeed reasonable to conclude (it takes a reasonable person to conclude) by a tax inspector who by looking at the burden of proof does not need conclusive evidence but, from their perspective, one of the principle purposes is taking a treaty benefit.
However, the tax inspector would deny the treaty benefit if it was only "one of" the principle purposes and not the main purpose. Effectively, the OECD is using a very low threshold as the tax inspector could still deny the treaty benefit even if there are commercial reasons for using a treaty.
In other words, if you have a strong commercial reason for having the structure and also a similar tax reason, then it seems likely that this is one of the principal purposes of having the tax structure. Put simply, taxpayers, when entering into transactions, are encouraged to take into consideration only non-tax reasons.
Finally, regarding the last part ("unless it is established ... Convention") if the tax inspector has reasonably concluded that one of the principal reasons of the taxpayer was to take a treaty benefit, then the taxpayer, to avoid denying the treaty benefit, must "establish" that this was "in accordance with the object and purpose" of the treaty.
Thus, unlike the burden of proof that lies on the shoulders of the tax inspector who needs reasonable and conclusive evidence, the taxpayer must provide concrete evidence to prove their position. What is more, unlike the taxpayer, the tax authorities need to prove that the benefit was in accordance with the object and purpose of the treaty.
Effectively, the object and purpose of the treaty comprise the title, preamble and text of the treaty. In other words, the burden of proof eventually lies on the shoulders of the taxpayer and therefore the taxpayer has to come up with proof/provide evidence that this specific cross-border structure, granting the treaty benefit, is in accordance with the relevant provisions of the double tax treaty.
In light of the above provisions, companies have two options. First, it may be reasonable to take a treaty benefit but such benefit need not be one of the principal purposes of establishing the structure. Consequently, commercial and business reasons need to prevail over tax reasons of having a particular cross-border structure. Second, in a different case, such a structure needs to be in accordance with the object and purpose of the treaty.

PLANNING POINTS

In light of the above, the uncertainty of the Beneficial Ownership Clause will undoubtedly be further compounded by the PPT, particularly regarding financing, holding and licensing structures.
Although it is unclear whether the Beneficial Ownership Clause requires economic substance, the PPT, apart from economic substance, requires business purpose and commercial reasons as well. Notably, the PPT was introduced as an additional treaty anti-avoidance tool to fill in the gaps of other specific treaty anti-avoidance tools such as the Beneficial Ownership Clause, in order to prevent treaty shopping.
Put simply, the PPT works as a safety net when other provisions are circumvented. As a result, to minimize the additional uncertainty, such structures need to be analyzed and reviewed bearing in mind, on the one hand, that there are no contractual obligations in place to pass on the income to another person and, on the other hand, that there are no tax reasons when entering into a transaction and if so, this would be in accordance with the object and purpose of the treaty.
It would be considered rather difficult to prove the existence of any business and commercial reasons of a simple holding structure whose parent company purpose is limited to holding one subsidiary.
Instead, it would seem more likely that a top holding company, whose purpose is to hold and manage numerous subsidiaries, will have more economic substance as compared to a single holding company structure. What is more, a single holding company structure purpose seems to be to route the dividends received from its subsidiary to its shareholder.
By contrast, the top holding company structure example that holds numerous subsidiaries, in case the dividends are not routed directly to the shareholders but are reinvested within the group, provides further commercial and business purposes to the structure itself.

- The holding company SPV is no longer a preferred solution;
- Taking into account any business risks/ considerations (if any), a company, in addition to its holding activities, could provide financing to group companies, license intangibles, provide services and carry out trading activities; and
- This would substantiate a claim that there are various business reasons for the existence and operation of the company.

The current international tax environment is certainly becoming more and more demanding for MNEs in terms of economic substance, but also for providing business and commercial reasons as well. Hence, structures such as holding, financing and licensing SPVs need to be revisited to ensure that they comply with the new requirements.

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